UNDERSTANDING MORTGAGE MARKET BEHAVIOR: CREATING GOOD MORTGAGE OPTIONS FOR ALL AMERICANS

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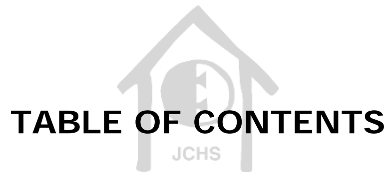

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EXECUTIVE SUMMARY

Over the last two decades, the rise of risk based pricing, the growing importance of the secondary mortgage market, and the emergence of mortgage brokers in the marketing and origination of residential home mortgages has keyed a virtual revolution in U.S. financial markets. The dramatic increase in mortgage lending – especially in non-prime lending -- has brought with it a diverse array of new mortgage products. This growth has expanded access to credit to consumers who have not traditionally been well served by the mortgage market and has enabled millions of homeowners to tap accumulated home equity to help meet their consumption and investment needs.

Despite the benefits of the new mortgage market, there are nevertheless reasons for concern. For example, the recent rise in mortgage delinquencies and foreclosures suggests that some households are taking on debt that they have little or no capacity to repay. Alternatively, there is growing evidence that many families are taking out mortgages that they do not understand or that are not suitable for their needs. The fact that foreclosures are higher within non-traditional products may not be a surprise, as these products are priced for greater risk and therefore greater default rates. Even so, the concentration of foreclosures in many of the nation's lowest-income and economically vulnerable neighborhoods threatens to reverse recent gains in efforts to expand homeownership opportunities for all.

This paper examines consumer and lender behavior in the increasingly complex mortgage marketplace and the implication of this behavior for the fair and efficient allocation of mortgage credit. This review suggests that many consumers have a limited ability to evaluate complex mortgage products and they often make choices which they regret after the fact. Consumer and lender behavior also contributes to the observed differences in outcomes by race and ethnicity. Understanding these behaviors may therefore provide insight into how best to eradicate any remaining disparities.

Some mortgage marketing and sales efforts are designed to encourage consumers to select specific products. Such practices have the potential to exploit consumer decision-making

weaknesses. While marketing communications often provide consumers with relevant information to make informed choices, some marketing and sales practices appear to cross the line. Instead of supporting informed choices, aggressive and misleading marketing can play on consumer fears and lack of knowledge. In fact, some individuals and firms on the market's supply side use their considerable knowledge of consumer behavior to aggressively "push market" inappropriate mortgage products.

With limited ability to make down payments, and pay closing costs and upfront fees, many consumers finance these costs into the loan -- increasing both the monthly payment and total costs over the life of the loan. Many of today's loan products seek to provide mortgages that help prospective homebuyers overcome affordability barriers, or enable existing homeowners to utilize equity in their homes for a variety of purposes. Yet aggressive lending can saddle these same low-income and low-wealth individuals with mortgage debt that they are unable to pay, and in doing so simply worsen their economic circumstances.

Principal Findings

Traditional theory assumes that consumers have known preferences and a fixed amount of income, face transparent prices, and can rank the "utility" of the options to make selections that are in their best interest over time. While traditional economic theory predicts some aspects of the choices consumers make in routine settings, it offers limited guidance on how consumers behave in complex and stressful situations. Meanwhile, the field of behavioral economics is shedding light on the ways that consumers actually behave in the marketplace, including:

(1) Consumer Preferences Are Malleable, Not Fixed

Consumers often enter the market without knowing exactly what kind of mortgage they want or need, and therefore are susceptible to outside influence.

- Instead of being fixed, consumer preferences depend on how choices are framed, and the context and order in which information is presented. This can lead consumers to change their minds, or have "preference reversals."

- Because of product complexity, consumers are often unsure of which product may best meet their needs, or whether they even need a particular product.
- Consumers are "loss averse," and tend to overweight perceived short-term losses, leading them often to make choices based on their current circumstances instead of their long term best interests.

(2) Consumers Often Lack Awareness of Mortgage Prices

Given the complexity of loan pricing and the variation of loan features, consumers have difficulty understanding alternative mortgage products.

- Lack of mortgage pricing transparency and the fact that mortgage purchases are an infrequent event adds to the consumer's shopping difficulties.
- The pricing information that consumers do receive, as a result of disclosure requirements, often comes too late in the process.
- Where consumers make a decision they come to understand was a mistake, high transaction costs makes it difficult for consumers to correct the mistake.

(3) Consumers Struggle with Choices that Involve Risks and Payments over Time

Given that the mortgage transaction has multiple time and cost dimensions, consumers often are unable to determine what actual risks they face over time. This multi-period decision making problem is particularly difficult for consumers to solve and "short cut" methods often lead to costly mistakes.

- Mortgage pricing complexity makes it challenging to translate various components of mortgage pricing into a single metric for the purpose of comparison shopping.
- Consumers more often choose a product with immediate gain and future risk, rather than accept certain loss or higher payments at the loan's onset.
- Consumers have differing and often inconsistent time preferences depending on the framing of choices regarding payment over time.

(4) Consumers Often Struggle With Mortgage Shopping

While standard economic theory assumes that consumers shop for the best available price and terms, even the most sophisticated borrowers often find it difficult to effectively shop for mortgages.

Recommendations

Historically, public officials and voters in the United States have been reluctant to allow government entities and regulators to intervene in the market process. Any attempt to override consumer choice has received a high level of scrutiny. Yet, rather than accept consumer choice as given, this paper argues that those concerned about fairness in the mortgage market – government officials, industry leaders and consumer advocates – should work cooperatively to eliminate practices that take undue advantage of consumer's limitations in selecting the mortgage products that best suit their needs. Framing the choices presented to consumers in terms they can best understand and enabling consumers make choices that reflect their longer term interests, can help create an environment that guides consumers to "good loans." [1]

Defining a "Good Loan"

Recognizing that the needs of consumers vary as widely as mortgage products, there is not one loan product that meets the needs of all consumers. At the same time, it is the responsibility for all parties engaged in the mortgage market to ensure that consumers have access to "good loan" products. What constitutes a good loan product is subject to debate, but most would agree that a good loan product is transparent and fairly priced, that on net provides benefits to the consumer, and that does not expose a borrower to unexpected foreclosure and default risks. Specifically, "transparent" means consumers understand both the advantages and risks associated with a loan product, "fairly priced" means the loan is priced in a manner that is consistent with the underlying loan risks and costs of providing the loan, and "net benefit" means the loan is

[1] For further discussion of this point in general see: Bertrand, Marianne, Sendhil Mullainthan, and Eldar Shafir. 2006. "Behavioral Economics and Marketing in Aid of Decision Making Among the Poor." *Journal of Public Policy and Marketing* 25 1: 8-23.

consistent with both the short and long-run interests of the consumers and that consumers have a reasonable prospect of being able to repay.

Generating Effective Interventions

Everyone engaged in the mortgage industry has a part to play in improving the efficiency and fairness of the marketplace. Because consumers have malleable preferences, lack price awareness, struggle with shopping and have difficulty making choices with time dimensions, new initiatives are necessary to overcome today's aggressive marketing practices. These include:

(1) Provide for a Second Opinion through a Trusted Advisor Network.

Building on the existing community-based infrastructure as well as national scale organizations and foundations committed to social justice, a third-party advice system could provide a network of "trusted advisors" with incentives aligned with the borrowers' interests.

- Expand community-based and national nonprofit efforts to provide mortgage counseling services that guide consumers to "good loan" products.
- Establish a for-profit 'buyer's brokers' network that works explicitly for the buyer for a flat fee.
- Develop tools to support these networks including a second opinion hotline, on-line pricing guide, and national database of representative rate sheets.

(2) Steer Consumers Toward Socially Beneficial Choices.

Often, making small changes in the context in which a decision is made can make a big difference in how consumers choose. Community-based groups and national nonprofits can change the "default" option and steer consumer to "good loans."

- Aggressively market "good loan" products.
- Move beyond providing information and have pre-screened lenders homebuyer fairs to provide loan pre-approval letters.
- Provide binding offers through the on-line hotline.

(3) Enhance Information Transparency and Encourage Industry Self-Regulation.

In addition to expanding consumer assistance mechanisms, provide for timely and accurate information to the consumer and trusted advisor networks, while eliminating "bad actors" in the marketplace.

- Provide Truth In Lending Act disclosures 3 to 7 days prior to closing.
- Have the Good Faith Estimate be binding earlier in the application process.
- Encourage industry self regulation and the adoption of the Interagency Guidance on Nontraditional Mortgage Product Risks (Guidance) as an industry best practice, while providing for sanctions for those that ignore the standards.

(4) Establish Minimum Standards and Apply Rules Equally to the Marketplace.

Create effective and adequately funded enforcement strategies to ensure that all mortgage brokers, loan officers, and mortgage originators play by the same rules.

- Expand the Guidance to cover all lending institutions, not just federally regulated deposit taking institutions, and provide for enforcement mechanisms.
- Encourage the Federal government to assist states that carry the significant responsibility for regulating key elements of the mortgage market, by providing funding and support.
- Adopt a federal mortgage broker licensing law to establish minimum standards.

Moving Forward

This paper identifies specific actions that regulators, industry participants, and the non profit sector can take to rid the mortgage marketplace of abusive practices and to expand the ability of all consumers to gain access to "good mortgage" products. Non profit entities need to adapt consumer assistance programs to reflect the complexities of the modern mortgage market. Regulators need to create clear guidance and fair rules of the game that are applied equally across the marketplace.

Mortgage industry leaders also have an important role to play, but not all industry participants will choose to "take the high road." Some industry participants will take advantage of the limited ability of consumers to make informed choices. As a result, mortgage industry leaders must not only define a series of best practices, they must also put in place mechanisms that insure compliance by all industry participants. In short, the "high roaders" must work together to drive the "low roader" practices out of the marketplace.

Improving the effectiveness of existing regulations is one approach, while creating new regulatory approaches that are uniformly applied to all industry participants is another. Adapting consumer education and counseling programs is also important, as is strengthening the capacity of the industry to police itself. Each of these efforts must build on a thorough understanding of how consumers and industry participants actually behave, not an idealized depiction of their behavior. This paper seeks to enhance this understanding and use this knowledge to forge sensible solutions that help consumers obtain "good loan products" and keep consumers from falling victim to deceptive practices.

CHARACTERISTICS OF TODAY'S MORTGAGE MARKET GIVE RISE TO CONCERNS ABOUT UNFAIR MORTGAGE PRICING

The last two decades have witnessed a revolution in mortgage finance. As recently as 1990, lenders offered relatively few mortgage products. The products that were offered had relatively uniform interest rates and served borrowers meeting stringent credit standards, loan-to-value and debt-to-income ratios. Not so today, as risk-based pricing has changed underwriting standards and origination volumes have soared,[2] diverse mortgage products have flourished in both the traditional prime and growing non-prime markets,[3] and a broker-dominated mortgage delivery system has emerged.[4] The rise in non-prime lending and the proliferation of alternative mortgage products have expanded access to credit to millions of homebuyers who otherwise would not have qualified for mortgages. Additionally, homeowners can now tap their home equity to meet a range of financial needs.

Meanwhile, the structural changes of the marketplace have raised concerns that not all consumers receive fair and equal treatment and that abusive mortgage practices have accompanied the very same product innovations that have benefited many consumers. While some consumers may knowingly accept a higher degree of risk and uncertainty, many consumers may not be aware of the risk and simply rely on a continued increase in home values or future improvement in their financial status. Still others are finding themselves exposed to mortgage fraud, as complaints and problems are on the rise across the country.[5]

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[2] Inside Mortgage Finance. 2005. *Top Subprime Mortgage Market Players & Key Subprime Data 2005.* Bethesda, MD: Inside Mortgage Finance Publications. Reports that sub-prime mortgage originations grew from $40 billion in 1994 or 5 percent of all originations in 1994 to $600 billion or 21.3% in 2005.

[3] Examples include interest-only loans that defer principal payments for a set number of years, payment option loans that defer a portion of interest payments and roll the difference into principal, and low documentation loans that let borrowers with erratic or hard-to document resources provide limited details about their income and assets. While in 2003 these non-traditional mortgage products were just a novelty, by the second half of 2005 First American LoanPerformance estimates that interest-only loans have grown to account for 20 percent of all mortgage originations, while the payment option mortgages and low documentation loans each have more than a 10 percent share of the mortgage market. See Joint Center for Housing Studies. 2006. The State of the Nation's Housing: 2006. Cambridge: Harvard University. 17. Available at http://www.jchs.harvard.edu/publications/markets/index.html

[4] Apgar, William C., and Allegra Calder. 2005. The Dual Mortgage Market: The Persistence of Discrimination in Mortgage Markets. In Xavier de Souza Briggs, ed. *The Geography of Opportunity: Race and Housing Choice in Metropolitan America*. Washington, DC: Brookings Institution Press.

[5] Department of Justice, Federal Bureau of Investigation. *Financial Crimes Report to the Public.* May 2005. In fact, the FBI has received a four fold increase in reports of mortgage fraud, from over 4,000 in FY 2001 to over 17,000 in FY 2004, while federally-regulated institutions alone reported over one billion dollars in losses due to

Non-prime loans by definition are riskier and more default prone.[6] The recent surge in foreclosures results in large part from the growth of non-prime lending and the extension of loans to borrowers with a more limited capacity to repay. Foreclosures can and do have a devastating impact on individual families who lose their home and are left with a damaged credit record.[7] Beyond the increased risk to the borrower, society also pays a price in terms of the negative spillover effects that delinquent and foreclosed properties may have on nearby properties.[8] In distressed neighborhoods, foreclosed properties can remain vacant for a prolonged period of time, depressing property values and contributing to neighborhood instability and stigma.

Recognizing the many potentially adverse consequences that flow from the improper placement of higher-priced mortgages with borrowers incapable of repaying these loans, this section reviews the issues raised by recent studies of mortgage market pricing. This section then discusses how the incentive structure of the industry may contribute to market outcomes that are inefficient, unfair, or both.

Existing Research Presents Conflicting Views of Mortgage Pricing Fairness

Some analysts suggest that a substantial subset of non-prime borrowers pay more than they should based on credit, prepayment and other risk and cost factors alone, and note persistent discrepancies between the share of non-prime loans going to African Americans and Hispanics and the share going to similarly situated whites.[9] Others dismiss such claims, arguing that raw disparity ratios

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mortgage fraud in FY 2005. Available from http://www.fbi.gov/publications/financial/fcs_report052005/fcs_report052005.htm#d1

[6] Crew Cutts, Amy and Robert A. Van Order. 2003. *On the Economics of Subprime Lending*. Office of the Chief Economist, Freddie Mac. Employing the best available data on loan performance, Cutts and Van Order estimated that as of June 2002 the serious delinquency rate for conventional prime loans was 0.55 percent (serious delinquency is defined as loans that are already in foreclosure and/or with payments that are 90 days or more late). In contrast, subprime loans had a serious delinquency rate of 10.44 percent, nearly 20 times higher.

[7] Duda, Mark and William Apgar. 2004. *Preserving Homeownership: Community Development Implications of the New Mortgage Market*. Report prepared for the Neighborhood Housing Services of Chicago.

[8] See for example: Neighborhood Housing Services of Chicago. 2004. *Preserving Homeownership: The Community Development Implications of the New Mortgage Market.* Chicago: The Neighborhood Housing Services of Chicago.

[9] Fishbein, Allen, and Patrick Woodall. 2006. Exotic or Toxic? An Examination of the Non-Traditional Mortgage Market for Consumers and Lenders. *Consumer Federation of America*. Available from http://www.consumerfed.org/pdfs/Exotic_Toxic_Mortgage_Report0506.pdf Other studies that find disparities in the share of non-prime lending going to minorities include: HUD User. 2000. *Curbing Predatory Home Mortgage*

are meaningless since they do not control for differences in legitimate risk factors, such as credit histories and loan-to-value ratios, among different racial and ethnic groups.[10]

Given the growing complexity of today's mortgage products, assembling the mortgage pricing data needed to complete a study that fully controls for differing risk factors is difficult. Of particular concern is the fact that the most detailed data on mortgage pricing are typically controlled by lenders and generally are not made available to outside analysts. However, beginning in 2004, changes to Regulation C mandated that lenders disclose in their Home Mortgage Disclosure Act (HMDA) reports whether a loan has an Annual Percentage Rate (APR) above a specific threshold.[11] Since HMDA does not contain information on credit history and other loan risk factors, HMDA data alone do not provide conclusive evidence about the differences in pricing by race and ethnicity. Even so, the Federal Reserve Board (FRB) is now using HMDA data to identify lenders that merit further review for potential violation of fair lending laws.

In a recent study, the FRB researchers used 2004 HMDA to examine racial patterns of mortgage pricing.[12] Interestingly, the FRB researchers examined the impact on black-white and Hispanic-white gaps in access to higher-priced loans. The study used a series of variables that identified the organization making the loan, the extent to which each organization was subject to regulation under the Community Reinvestment Act (CRA), and whether and how they initially sold the loan

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Lending, U.S. Department of Housing and Urban Development and U.S. Department of the Treasury. June 2000. Available from http://www.huduser.org/publications/hsgfin/curbing.html.
Bradford Calvin. 2002. *Risk or Race? Racial Disparities and the Subprime Refinance Market.* Center for Community Change. May. Available from http://butera-andrews.com/legislative-updates/directory/Background-Reports/Center%20for%20Community%20Change%20Report.pdf And Calem, Paul, Kevin Gillen, and Susan Wachter. 2004. The Neighborhood Distribution of Subprime Mortgage Lending. *Journal of Real Estate Finance and Economics* 29 4 December.

[10] Wallace, Elliehausen and Michael Staten. 2005. *Are Legislative Solutions to Abusive Mortgage Lending Practices Throwing Out the Baby with The Bath?* Guidance from Empirical Research. Draft presented at the 41st Annual Conference on Bank Structure and Competition. 4-6 May, at Federal Reserve Bank of Chicago. Available from http://www.fmcenter.org/site/pp.asp?c=8fLGJTOyHpE&b=810363 See also Staten, Michael. 2005. *The New HMDA Pricing Data: What Can They Tell Us About Pricing Fairness?* Credit Research Center, McDonough School of Business, Georgetown University.

[11] The Federal Reserve Board's Regulation C implements the Home Mortgage Disclosure Act (HMDA). Available from http://www.ffiec.gov/HMDA/RegC.htm

[12] Avery, Robert B., Glenn B. Canner, Robert E. Cook. 2005. New Information Reported under HMDA and Its Application in Fair Lending Enforcement. *Federal Reserve Bulletin*, September. 344-394.

to a GSE or other secondary-market outlet. The FRB researchers concluded that these supply side variables mattered and were highly correlated with the magnitude of the observed racial gap.

The FRB researchers were careful to note that their results point to one of several possibilities. First, these supply side effects could simply reflect that some lenders specialize in higher-priced lending and these specialists correctly identified those borrowers who are legitimate candidates for higher-priced loans. Alternately, this segmented marketplace could be caused by borrower self-selection whereby borrowers correctly choose the product-lender combination that best matches their needs and credit histories. Lastly the FRB raised the possibility that "minority borrowers are incurring prices on their loans that are higher than warranted by their credit characteristics" which could trigger fair lending concerns.[13] In other words, one potential conclusion is that the observed patterns could be the result of illegal targeting of protected classes.

Noting that the HMDA data lacked critical information on borrower risk, the FRB did not offer any firm conclusion as to which hypothesis was correct, choosing instead to simply note that that HMDA data alone are "insufficient to account fully for racial or ethnic differences in the incidence of higher-priced lending."[14] In an effort to further explore the issue of racial differences in access to lower-priced prime loans, FRB researchers collaborated with researchers at the Credit Research Center (CRC) of Georgetown University. The CRC prepared a special analysis using a proprietary data set from eight large subprime lenders that included a wide range of borrower characteristics and risk factors, but did not identify the specific lender. Using this database and controlling for these risk factors, the analysis explained most of the observed racial gap.[15] Yet even accounting for a detailed set of borrower characteristics and risk factors, the analysis of the CRC data reveal that "for some products the racial or ethnic differences were fully accounted, whereas for other products, unexplained differences remained." In particular, the FRB observed that even with the additional controls, a 1.0 percentage point difference remained between the white and black share of higher-priced, home purchase lending.

[13] Ibid., 381.
[14] Ibid., 379.
[15] Ibid., 386. With the CRC dataset, the study looked at pricing outcomes for conventional first-lien home-purchase and refinance loans from the eight lenders as adjusted by borrower-related factors. While the CRA database accounted for about 22 percent of the types of loans in question, absent identification of the lenders it is impossible to assess the extent to which these data are representative of the total universe of all higher-priced loans.

While statistically significant, whether these differences are important is a matter of opinion. For example, the CRC data included the activities of 8 lenders. Unlike the analysis that the FRB researchers completed with the HMDA data, it was not possible to test for racial gaps in the lending activity of particular lenders. As a result, aggregation across lenders could dampen the magnitude of a more significant racial gap recorded for a particular lender. While there appears to be limited evidence of an overall racial gap in the aggregated data, it should be noted that higher-priced lending accounted for over 80 percent of all loans in the sample. This raises the possibility that since this group of lenders specializes in higher-priced non-prime products, these specialists may uniformly offer this product to all customers, even those who would qualify for a prime product. Absent a broader control group of prime lenders, the CRC database is not well suited to evaluate this alternative explanation and the reported findings simply affirm that whatever mispricing exists in the sample is not correlated with race.

FRB researchers raised other potential methodological concerns. For example, the FRB researchers were careful to note that the CRC results could simply reflect the absence of comprehensive information on specific loan products from specific lenders not available in either the HMDA or CRC data.[16] It is also possible that the continued presence of disparities, even after controlling for a range of borrower specific risk factors, may reflect a less than well-functioning market place in which many minorities obtain loans at prices higher than is warranted by their credit characteristics or risk profile. This could result, for example, from a relative absence of lenders offering prime products in individual neighborhoods or entire metro areas with higher minority proportions. Such a situation would increase the difficulty for a well-qualified minority to obtain a lower-priced mortgage. Alternatively, a market area could contain a range of prime and non-prime lenders, but some minority borrowers may be steered to lenders that typically offer higher-priced loans than their credit characteristics warrant.

According to FRB researchers, whether or not this reflects a discriminatory outcome would require information on the "specific credit circumstances of each borrower, the specific loan products they seek, and the business practices of the institutions they approach for credit."[17] The

[16] Ibid., 387.
[17] Ibid., 380.

FRB article points to the need for institution-specific analysis to understand which lenders and products warrant heightened scrutiny regarding their loan-pricing activities. To this point, the FRB now uses this type of statistical analysis of HMDA data as a screening tool to identify institutions and products that warrant closer review concerning potential fair lending violations. Further, this type of examination is now applied to the various delivery channels of individual organizations to ensure that different channels do not produce disparate loan pricing across race, ethnicity or other prohibited characteristics.

Furthering this line of investigation, the Center for Responsible Lending (CRL) conducted a study that utilized publicly available HMDA data augmented by information from a large, proprietary non-prime database to develop a database of 177,487 loans that contained borrower, loan, property and pricing characteristics, including credit scores.[18] Unlike the CRC data used in the 2005 FRB study that represented the activity of only eight selected lenders, the CRL study presented data on a broad cross section of the non-prime market. It also addressed prevailing interest rates and state specific information, focusing solely on disparities within the non-prime marketplace. While controlling for risk, the results showed that African-American and Latino borrowers are more likely to receive higher-priced non-prime home loans than white borrowers, even after accounting for differences in risk.[19] These results mirror a previous CRL study that demonstrated that for non-prime purchase loans, borrowers with prepayment penalties paid higher interest rates than similarly situated borrowers without these penalties, even though the presence of a prepayment penalty should enable the lender to offer financing at a lower rate.[20]

[18] Gruenstein Bocian, Debbie, Keith S. Ernst, and Wei Li. 2006. *Unfair Lending: The Effect of Race and Ethnicity on the Price of Subprime Mortgages*. Center for Responsible Lending. 2 August. Available from http://www.responsiblelending.org/reports/HMDA2006.cfm. Using both HMDA and loan performance data, the combined database looked at 177,487 non-prime loans.

[19] Black, Harold A., and Alan Schlottmann. 2006. *An Analysis of Unfair Lending: The Effect of Race and Ethnicity on the Price of Subprime Mortgages.* Prepared for the American Financial Services Association. This report critiqued the CRL study and questioned whether the matched records between the two databases are representative of overall lending patterns.

[20] Ernst, Keith. 2005. *Borrowers Gain No Interest Rate Benefits from Prepayment Penalties on Subprime Mortgages*. Durham, NC: Center for Responsible Lending. This study used multivariate regression models to estimate separate results for each year 2000-2002 for fixed-rate loan products using Loan Performance Asset-Backed Securities (ABS) Database of securitized subprime loans, which includes FICO scores and Loan to Value and Debt to Income ratios.

The CRL finding that similarly situated buyers pay different prices for similar products challenges the presumption that the mortgage market is economically efficient. An "efficient" mortgage market allocates capital according to the risk and cost profile of the loan and the ability of the borrower to repay. Standard theory implies that consumers participate in this process by shopping for the best mortgage terms available in the marketplace. Individual mortgage lenders must then offer the best price possible for each type of mortgage or risk losing business to others.

In fact, these assumptions are not always met in today's mortgage market, particularly in the non-prime sector. Instead, many consumers lack both the information and the capacity to evaluate the merits of alternative mortgage products and, as a result, are easily influenced by "push marketing" tactics. Through aggressive product promotions and advertising, mortgage lenders can influence consumer choice and encourage consumers to select a mortgage that may not be in the consumer's best interest. Therefore, shopping by consumers may not provide the market check that is present in less complex markets where consumers are better informed and/or more capable of making judgments on their own. Consequently, mortgage market outcomes do not adhere to the "one price rule" -- that in an efficient market the same good is priced identically throughout the market place.[21]

Industry Compensation Structure May Further Distort Market Outcomes

Today's complex and highly competitive financial services environment has driven the development of new products and new approaches to market and sell these products.[22] The most significant change has been the emergence of a broker-led (i.e., third party) system of mortgage originations and pay incentives that are tied to both the product type and the size of the

[21] For further discussion see Apgar, William C. 2004. *Credit, Capital and Communities: The Implications of the Changing Mortgage Banking Industry for Community Based Organizations.* Cambridge: Harvard University, Joint Center for Housing Studies. See also Apgar, William C., and Mark Duda. 2004. *Preserving Homeownership: The Community Development Implications of the New Mortgage Market*. Chicago: Neighborhood Housing Services of Chicago.
[22] Apgar, William C., and Chris Herbert. 2004. *Review and Synthesis of the Literature on Subprime Mortgage Lending and Alternative Financial Service Providers.* Cambridge: ABT and Associates for HUD.

loan.[23] The broker channel now accounts for 45 percent of all mortgages and fully 71 percent of all non-prime loans.[24]

Mortgage brokers are independent third party agents that receive fees, such as origination or processing fees, for taking loan applications and processing needed paper work. When they are ready to lock in loan terms, the broker typically chooses a lending institution to fund the mortgage and, the customer typically accepts the broker's suggestion.[25] Despite what many borrowers believe, the broker is not an "agent" working on the consumer's behalf. Although mortgage brokers are compensated for these services in part by borrowers, brokers may also receive yield spread premiums from the wholesale lender, and hence have an incentive to place particular products that may or may not reflect the borrower's best interest.[26] Loan officers are not immune to these issues as banks and thrifts may also provide loan officers additional compensation for placing specific products or generating additional loan volume.

Fee structures where the lending agent (mortgage broker or loan officer) is rewarded differentially depending on the nature of the loan can create problems, particularly when the interests of the borrower are not aligned with those of the mortgage broker or loan officer. Rather than simply search for the best loan product for the customer, the presence of yield spread premiums or a differential compensation system may encourage mortgage brokers or retail loan officers to "push market" particular products to the extent that the market will bear, and regulatory and lender oversight will allow.[27]

[23] Today, there are some 53,000 firms (with some 419,000 employees) engaged in mortgage brokerage activities, up markedly from the 7,000 firms operating in 1987. Wholesale Access Mortgage Research and Consulting, "Mortgage Brokers 2004," July 28, 2005, Columbia Maryland.
[24] Mortgage Bankers Association. 2006. *Residential Mortgage Origination Channels.* MBA Research Data Notes. Washington, DC: Mortgage Bankers Association.
[25] Jackson, Howell, Jeremy Berry and Laurie Burlingame. 2002. *Kickbacks or Compensation: The Case of Yield Spread Premiums*. Draft January 2002.
[26] Ibid. The authors report that a number of factors influence the setting of yield spread premiums, but the most significant is the rate of interest on the borrower's loan. In the mortgage banking industry, a "par loan" is a loan that a lending institution funds at 100 cents on the dollar. An "above par" loan is one that bears a somewhat higher interest rate and for which lending institutions are willing to pay more. Typically, the excess over par is paid to mortgage brokers in the form of a yield spread premium. The average amount of yield spread premiums is typically in the range of $1000 to $2000 per loan, and, when present, is usually the largest component of mortgage broker compensation.
[27] Bajaj, Vikas and Christine Haughney. 2007. *More People With Weak Credit Are Defaulting on Mortgages*. New York Times.Mr. Dallas, chief executive of Ownit Mortgage Solutions, acknowledges that standards were lowered, but he placed the blame at the feet of investors and Wall Street, saying they encouraged Ownit and other subprime

Of course mortgage brokers provide many benefits to both borrowers and loan originators. A broker-led system of mortgage originations provides the benefits of outsourcing, allowing the lending organization to meet increased demand without the associated increase in core operating expenses. By reducing search costs for consumers, mortgage brokers may help informed borrowers obtain less expensive mortgage credit than they would be able to get on their own. One recent study by Amany El Anshay, Gregory Elliehausen and Yoshiaki Shimazaki used detailed loan level data to argue that broker-originated loans are less costly than those originated by retail lenders.[28] Others note that while brokered loans may have higher rates, where mortgage brokers reach consumers that are more costly to serve, the existence of higher loan rates is not necessarily evidence of unfair treatment.[29]

Jackson and Berry challenge the notion that mortgage brokers reduce borrower costs, especially in situations involving the payment of yield spread premiums. They found that mortgage brokers received substantially more compensation in transactions with yield spread premiums, and that consumers receive only twenty-five cents of benefit for every dollar of yield spread premiums paid to brokers.[30] Critics also point to ongoing actions taken by regulators and law enforcement officials that allege widespread mortgage broker involvement in mortgage fraud.[31] Furthermore, when broker abuse claims are disproportionately concentrated in lower-income and minority markets, they add fuel to the already heated debate about racial differences in access to fairly priced mortgages.

lenders to make riskier loans to keep the pipeline of mortgage securities well supplied. "The market is paying me to do a no-income-verification loan more than it is paying me to do the full documentation loans," he said. "What would you do?"

[28] El Anshasy, Amany, Gregory Elliehausen, and Yoshiaki Shimazaki. 2005. *Mortgage Brokers and the Subprime Mortgage Market*. Paper presented at Promises and Pitfalls, The Federal Reserve System's Fourth Community Affairs Research Conference, 7-8 April, at The Capital Hilton, Washington, DC. See also McCoy, Patricia. 2005. "Banking on Bad Credit: New Research on the Subprime Home Mortgage Market" for an alternative view presented at the same conference.

[29] Avery, et al. 2005. 382.

[30] Jackson, Berry and Burlingame. 2002. The authors estimated the difference in costs to borrowers ranges from $800 to over $3000 per transaction.

[31] Engel, Kathleen C., and Patricia McCoy. 2002. A Tale of Three Markets: The Law and Economics of Predatory Lending. *Texas Law Review* 80. and Renuart, Elizabeth. 2004. An Overview of Predatory Lending. *Housing Policy Debate* 15.

Even as the number of empirical studies examining fairness and efficiency in today's mortgage market continues to grow, it is unlikely that such an emotionally charged debate will be resolved by empirical evidence alone. Further investigation is needed to better understand how both the supply and demand side of the mortgage market operates. On the supply side, this includes generating a better understanding of how the mortgage industry markets and sells mortgage products. On the demand side, greater understanding is needed about why consumers – and particularly lower-income and minority consumers – obtain loans that they don't understand, are unable to repay and/or are not fairly priced.

As noted earlier, the increasing complexity of the mortgage market can challenge even the most sophisticated consumer. With product proliferation and multiple origination channels, consumers often face information overload. In such cases, as the number of choices available rises, decision making performance declines due to the difficulties consumers have in ordering their own priorities and recalling relevant information.[32] Moreover, many consumers erroneously believe that the mortgage decision process is based on a set of standard criteria and that the loan officer's or broker's role is to determine whether the borrower meets these objective criteria to be eligible for a loan.[33]

The lack of understanding of market conditions leaves many consumers prone to simply paying too much for mortgage credit, or not understanding the benefits and costs of the loan they select. Such an outcome is understandable. Many consumers have little or no experience shopping for complex mortgage products. Unlike many goods and services that are sold for a readily apparent single price, mortgage products combine various price elements: monthly payments that extend over the life of the loan; onetime, upfront payments; and/or other payments due at loan repayment and/or termination.

[32] Eppler, M. and J. Mengis. 2003. A Framework for Information Overload Research in Organizations. Available from http://www.bul.unisi.ch/cerca/bul/pubblicazioni/com/pdf/wpca0301.pdf.
[33] Peter D. Hart Research Associates and the Coldwater Corporation. 2002. *The Growing Demand for Housing: 2002 Fannie Mae National Housing Survey*. Fannie Mae Foundation. This study found that over half of all African-American and Hispanic borrowers erroneously believed that lenders are required by law to provide the best possible loan rates.

Traditional Economic Theory Offers Limited Guidance on How Consumers Behave

Traditional economic theory characterizes the consumer choice process as one where consumers act "rationally." This view assumes that consumers have established preferences, face a transparent set of prices for each good or service, and have a fixed amount of income or other available resources to attain these goods or services. It also assumes that consumers are able to accurately rank the "utility" of the various options, given the prices and available resources, and make selections that are in their best interest over time.[34] This view assumes that consumers have the capacity to calculate the value of making large upfront fees in order to obtain lower monthly payments; the foresight to forecast their ability to meet future mortgage obligations of varying levels; and the knowledge of likely trends in home prices, mortgage interest rates, and other economic variables that affect the suitability of various mortgage products. Each of these assumptions, at best, represents an idealized view of how most consumers make choices.

In many cases simple concepts of rational consumer choice offer some insights as to how consumers respond to income shifts or changes in the prices of some goods. Yet often the presumption of rationality can provide a distorted view about how consumers behave and a misleading basis for generating effective policy approaches that can help consumers avoid falling victim to abuse in the mortgage market. The remainder of this section examines four findings from the behavioral economic literature that undermine the assumption of rationality in the mortgage market.[35]

(1) Consumer Preferences Are Malleable, Not Fixed

One of the core assumptions of traditional economic theory is that consumers enter into the market with a known and fixed set of preferences that enable them to make tradeoffs between the

[34] McCoy, Patricia. 2005. A Behavioral Analysis of Predatory Lending. *Akron Law Review*. 38 4: 726. McCoy describes in more detail the expected utility theory, loss aversion, reference dependence, framing effects and choice heuristics of consumer behavior in relationship to mortgage financing. Referencing Kahneman, Daniel, and Amos Tversky. 1979. Prospect Theory: An Analysis of Decision Under Risk. *Econometrica* 47: 263. McCoy states that "the rational actor assumption is grounded in expected utility theory, which has been the classic paradigm for decision-making under uncertainty for a half-decade or more. Neo-classical economics assumes that reasonable people seek to follow expected utility theory and that most of them actually do so".

[35] For a critique of the behaviorist approach, see Epstein, Richard A. (2006). *Behavioral Economics: Human Errors and Market Corrections.* University of Chicago Law Review, Winter 2006.

consumption of various amounts of particular goods or services (hereafter goods) depending on the relative prices of these goods and their available resources. Yet research suggests that in many cases consumers are unsure which product best meets their needs, or even whether they need the product at all.

Proponents of behavioral economics argue that preferences are not fixed, but rather depend on how choices are framed. Tversky and Kahneman coined the term “framing effects” to show that consumer choices often depend more on the way a problem is posed, than on its objective characteristics.[36] Later research by this team shows that preferences are also influenced by the context in which consumers express their preferences. Finally, other studies suggest that the order in which information is presented to consumers also matters. In particular, consumers may change their mind about their actions, or have preference reversals, depending on how consumers process the complex information needed to make a decision.[37]

For example, Richard Thaler presented examples of how consumers react differently when the same difference in market price is framed as a disadvantage rather than an advantage for particular options.[38] In one example, Thaler examined the ways that consumers are charged for the costs associated with a credit card transaction. The straight forward approach would be to describe the price differential as a *credit card surcharge*. But credit-card companies prefer that vendors describe the price differential as a *cash discount* rather than a *credit card surcharge*. The *cash discount* approach plays on consumers who view the foregone discount of cash as the opportunity cost of using the credit card, while viewing the surcharge as an out-of-pocket expense, hiding the fact that the use of credit cards adds to the cost of the transaction, and establishes as the norm the credit card alternative, even though it is more costly payment method for consumers.

[36] Kahneman, Daniel, and Amos Tversky. 1981. The Framing Decisions and the Psychology of Choice. *Science, New Series* 211 4481: 453-458. See also: Tversky, Amos and Daniel Kaheman. 1986. Rational Choice and the Framing of Decisions, Part 2: The Behavioral Foundations of Economic Theory. *The Journal of Business,* 59 4.
[37] For an overview of behavioral economics see: Camerer, Colin F. 2002. Behavioral Economics: Past, Present, Future**.** Caltech Working Paper. Available from http://www.hss.caltech.edu/~camerer/ribe239.pdf For more on preference reversals see: Tversky, Amos, Paul Slovic, and Daniel Kahneman. 1990. The Causes of Preference Reversal**.** *The American Economic Review* 80 1.
[38] Thaler, Richard. 1980. Toward a Positive Theory of Consumer Choice. J*ournal of Economic Behavior and Organization* 1: 45.

This example illustrates one of the problems with standard "rational" theory of consumer behavior, namely that it fails to account for the fact that context matters. Indeed, underlying rational theory is the assumption that consumers are concerned with ultimate choices and outcomes, not relative concerns such as gains or losses. Yet there are numerous examples showing that consumers' choices depend on whether they are asked to realize a gain or accept a loss, even though the actual dollars involved are the same.[39] Consider the situation where two consumers who just changed jobs are now deciding whether or not to sell their home and move to a new location. They both determine that the most likely sales price of their home is $250,000. Assuming everything else is equal – including the fact that as long as they purchase another home with the sale proceeds, neither would face a capital gains tax – traditional economics predicts that the two consumers would behave the same. Since they both face the same current economic choice, have the same resources, and same benefits of selling and relocating, either both consumers would sell or both would not sell.

Yet recognizing the importance of "framing effects," a behavioral assessment could help explain why the actions of the two consumers might differ. For example, one consumer may have purchased the home three years ago for $275,000, and agreeing to sell at $250,000 would generate a loss. If the second consumer purchased this home ten years ago at $225,000, this consumer would experience a gain if the home were sold for $250,000. To the extent that one consumer experiences the transaction as a gain and the other as loss can lead to different behavior. Indeed, the combination of "framing effects" and consumer's "loss aversion" often leads to consumer behavior that differs from that predicated by traditional consumer theory.

(2) Consumers Often Lack Awareness of Mortgage Prices

One key assumption underlying the notion of rational decision making is the idea that when making choices the consumer has and uses information about the price of alternative mortgage products. For this to be the case, sellers must reveal product prices, and consumers must be aware of these prices and use them in their decision making. Yet there is ample evidence to suggest that

[39] Kahneman, Daniel. 2003. A Psychological Perspective on Economics. *The American Economic Review* 93 2: 161-168.

this is often not the case. Research suggests that consumers are often unable to recall the price of recently purchased items and that the extent to which they are able to recall price varies significantly from one product to the next. However, much of this research focuses on the price awareness of simple consumer goods such as groceries and simple manufactured items.[40]

Understanding the price of mortgage credit is clearly more difficult than it is for simple consumer goods. Unlike simple products that typically have a single price component, loan pricing is a combination of interest rate, points, fees, prepayment penalties, and other factors. Moreover, features such as interest rates and prepayment penalties vary constantly in response to changing economic conditions. This makes it difficult for consumers to track, no less learn how the various components of price relate to one another. Consumer awareness is also limited by the fact that obtaining a mortgage is an infrequent event, and high transaction costs limit the ability of consumers to make adjustments post purchase, even if they have learned that their original choice was flawed.

Although lack of mortgage price awareness was probably an issue even when few types of mortgage products existed in the marketplace, as the complexity of mortgage products has increased, so have consumer difficulties in understanding mortgage pricing and hence the difficulty of shopping for a mortgage.[41] Susan Woodward explored the linkage between product complexity and pricing using a sample of 2,700 loans originated by a single national lender working through a broker network.[42] Woodward found that with everything else equal, consumers fared better when presented a single all inclusive mortgage payment that included the interest rate along with payment for any applicable closing costs and points. She attributed the relative ease of shopping across alternative loan products to the use of a single price measure as a guide. In contrast, given the difficulty of comparison shopping for mortgage products that contain two or more distinct price components, consumers on average paid more for complex mortgages. Much of this pricing differential went to the broker in the form of an increased payment of fees.

[40] Estelami, Hooman. 2005. A Cross-Category Examination of Consumer Price Awareness in Financial and Non-Financial Services. *Journal of Financial Services Marketing* 10 2.
[41] White, Alan. 2004. Risk-Based Pricing: Present and Future Research. *Housing Policy Debate,* 15 503. Also available at www.fanniemaefoundation.org
[42] Woodward, Susan. 2003. Consumer Confusion in the Mortgage Market. *Sand Hill Econometrics.*

The lack of pricing transparency further adds to the difficulty of shopping for the best mortgage. While consumers typically have access to basic information on an individual loan product, they frequently do not have access to a menu of prices (or rate sheets) concerning the range of products available.[43] Though rarely shared with consumers, rate sheets are widely used to inform mortgage brokers or loan officers about what combinations of interest rate, points, fees, prepayment penalties and other features the lender will charge a consumer given the credit grade and the loan-to-value ratio of the mortgage, as well as other factors. These rate sheets may vary across the organization's channels or geographic markets and may even change daily. Lenders may also use various price mechanisms such as a "sticker" price, minimum accepted price or an actual target price, and often loan officers or brokers may be rewarded with higher compensation for pricing the consumer above the rate sheet.[44] Rather than provide a wide range of options, brokers and loan officers often present just one or a small number of mortgages and associated pricing options for a consumer to consider.

Rather than assist consumers, the explosion of mortgage advertising through the internet, television, radio and telemarketing may actually distract consumers from the task at hand. Many advertisements today do not describe the full array of pricing and the related risks to consumers. To the extent that advertisers do provide information on the APR, this is often done in matter that is difficult for a consumer to understand. Moreover, the focus on specific loan dimensions like a low down-payment or limited documentation requirements may actually divert consumer attention away from the detailed information needed to assess both the benefits and the costs of alternative mortgage products.

Meanwhile, federally mandated pricing disclosures often come too late in the process for the consumer to make an informed decision. Federal statutes provide for price disclosure in two ways. The Real Estate Settlement Procedures Act (RESPA) requires that mortgage brokers and loan officers provide the consumer within three days after taking a mortgage application with a Good Faith Estimate (GFE) that includes estimates of the pricing of settlement services including origination fees, points and broker fees as well as third party fees such as appraisals. The Truth

[43] White, Alan. 2005. Price Discrimination in the Mortgage Market. *The Consumer Advocate,* 11 4.
[44] Avery, Robert B., Kenneth P. Brevoort, and Glenn B. Canner. 2006. Higher-Priced Home Lending and the 2005 HMDA Data. *Federal Reserve Bulletin* 25 September. A127.

in Lending Act (TILA) requires that the annual percentage rate, finance charge, amount financed and total amount of payments be disclosed at closing or the day before closing if requested.[45] While disclosures are intended to provide information for consumers to make the best choices in the marketplace, they do not ensure that the consumer receives the best price, nor does it overcome the lack of financial knowledge a consumer might have. Furthermore, the Good Faith Estimate is often not accurate and the TILA disclosure is typically not provided early enough for borrowers to easily change their mind.[46]

A recent Government Accountability Office (GAO) report concluded that these disclosures are not well designed to address complex products, specifically alternative mortgage products (AMPs) such as interest-only and payment-option adjustable-rate mortgages.[47] The recently published "Interagency Guidance on Nontraditional Mortgage Product Risks" (Guidance) acknowledges that consumers may enter into these transactions without fully understanding the product terms. To address this concern, it directs managers of banks, thrifts and credit unions to "ensure that consumers have sufficient information to clearly understand loan terms and associated risks prior to making a product choice."[48] As discussed in greater detail later in the paper, with the release of the Guidance, federal regulators are moving closer to requiring that all mortgage lending institutions, with the exception of non-depository mortgage companies, provide consumers with clear and balanced information about the relative benefits and risks of these products in all advertisements, statements, and promotional materials.

[45] To read more about the specific legal requirements, see Willis, Lauren E. 2005. *Decisionmaking and the Limits of Disclosure: The Problem of Predatory Lending* Legal Studies Paper no. 2005-14. Los Angeles: Loyola Law School.
[46] AARP. 2003. *The 2003 Consumer Experience Survey: Insights on Consumer Credit Behavior, Fraud and Financial Planning*. Washington, DC: AARP. This survey examined consumer knowledge of the mortgage lending process revealing that more than 20 percent were unaware that the lender is required to disclose the APR of the loan prior to closing.
[47] Government Accounting Office (GAO). 2006. *Alternative Mortgage Products: Impact on Defaults Remains Unclear, but Disclosure of Risks to Borrowers Could Be Improved*. Report to the Chairman, Subcommittee on Housing and Transportation, Committee on Banking, Housing, and Urban Affairs, U.S. Senate. 109th Cong., 2nd sess..
[48] Federal Reserve Board. 2006. *Interagency Guidance on Nontraditional Mortgage Product Risks*. Department of the Treasury, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Department of the Treasury and National Credit Union Administration. 29, September. 2.

(3) Consumers Struggle with Choices that Involve Risks and Payments over Time

Although much is written about how lenders and investors evaluate mortgage risk, mortgage lending ultimately involves risk sharing, as a portion of the mortgage risk is borne by the consumer. Given the complexity of today's loans, many consumers are unable to determine what actual risks they face over time. In their survey of alternative mortgage products, the GAO observed that many borrowers – particularly lower-income and less educated borrowers -- do not fully understand how much the monthly payments of adjustable rate mortgage products could increase over time. The consequences of this inability to assess the risk over time can be severe. Consumers may fail to meet the mortgage schedule or, even worse, lose their home and any accumulated home equity to foreclosure.

The inability of consumers to understand the risks inherent in adjustable rate mortgage products is just one example of the more general difficulty consumers have with making choices that involve payments over time. Standard expected utility theory assumes that consumers have the ability to assign probabilities to the likelihood of possible future events. Expected utility theory asserts that consumers then have the capacity to form expected values for their future income, the value of homes or other unknown future events. While mathematically there is a precise approach to solving this multi-period evaluation problem, present value discounting bears little resemblance to the ways consumers actually make choices in the marketplace.

Furthermore, consumers have a limited ability to assess the likelihood of future events. While consumers may know if they have plans to change jobs or economic circumstances, they know less about external conditions such as whether the value of the purchased property will rise or fall over time; whether mortgage interest rates will change; or if their income, employment, location, or household size will change unexpectedly.

Uncertainty can undermine the ability of both borrowers to assess the effective price of a mortgage and the ability of lenders to correctly estimate the effective return. In situations where consumers have more knowledge than the lender about their individual circumstances, the lender is exposed to the risk of adverse selection. For example, if a consumer knows he/she plans to

relocate, there is risk to the lender associated with an early mortgage prepayment. To mitigate this adverse selection, the industry has adopted the use of prepayment penalties. The presence of these penalties matter little to a household that can reasonably expect to remain in the home longer than the term for which the prepayment penalty is applicable without refinancing. In this situation, the consumer would benefit from any associated improvement in loan pricing for agreeing to obtain a mortgage with a prepayment penalty.

But the actual cost of carrying the loan over time will depend on the size and the nature of this penalty compared to the savings, if any, that are derived from this penalty concession. The use of prepayment penalties is most problematic in situations where the consumer does not share in the beneficial pricing associated with this concession.[49] Moreover, while the risk of adverse selection is present in all loans, prepayment penalties are typically found in non-prime loans, a fact that advocates suggest indicates an unfair utilization of this particular mortgage practice.[50]

Even if all the elements that govern the total cost of a mortgage (including likely duration of residency) are known, it is difficult to translate the various components of mortgage pricing into a single price for purposes of comparison shopping. When faced with these complex choices, research shows that consumers often resort to heuristics or 'short cuts' to guide decision making. While heuristics may be an economical and effective way to evaluate choices, they can also lead to systematic and predicable errors.

Research suggests that the use of heuristics is influenced by product complexity, time pressure, product knowledge and experience, involvement, need for cognition, socioeconomic status and demographics.[51] For example, University of Chicago MBA students were asked to consider the

[49] Ernst, Keith. 2005. Borrowers Gain No Interest Rate Benefits from Prepayment Penalties on Subprime Mortgages. A report by the *Center for Responsible Lending* showed that borrowers with subprime loans failed to receive lower interest rates than similarly situated borrowers with subprime loans without prepayment penalties. Available at www.responsiblelending.org

[50] Ibid. This report investigated over 1 million loans from the LoanPerformance ABS Database of securitized subprime loans from 2000-2002 and the found that 80 percent of subprime mortgage loans include prepayment penalties, in contrast to only two percent of prime mortgages.

[51] Lee, Jinkook, and Julia Marlowe. 2003. How Consumers Choose a Financial Institution: Decision-making Criteria and Heuristics. *International Journal of Bank Marketing* 21/2: 53-71.

best way to finance the purchase of a home dining room set.[52] To accomplish this task they were asked to choose between pairs of loan schedules which differed in length, the monthly payment, and the APR. Though mathematically there was an alternative that minimized the discounted present value cost of the loan, not all students were in agreement as to which product cost the least. Research found that the students employed a variety of alternative short cut methods to make their choices. For example, one method estimated the total loan payments (number of payments times the payment size) and chose the loan that minimized this total. If the loan terms being compared were held constant, this would be equivalent to finding the loan with the lowest interest rate. But the loan with the lowest total payments may not be the loan with the lowest APR. Some methods focused on minimizing the length of the loan term, while others prioritized minimizing monthly payments. Overall, the study found that many students focused on loan attributes other than APR.[53]

The difficulty consumers have with making decisions that involve payments over time goes beyond their limited ability to solve the relevant mathematical equations. Available research also demonstrates that consumers tend to give more weight to current as opposed to future costs. They work to avoid a loss more than they prioritize end results.[54] Consumers will therefore tend to choose a product that has immediate gain and future risk (i.e., interest-only mortgages, or loans with time-limited teaser rates) rather than realize a certain loss now (i.e., a larger downpayment or higher initial mortgage payment), even though that product may expose them to substantially higher costs over the life of the loan.

Consumer time preferences are changing overall as well, as many borrowers today approach their home as an equity building opportunity. The average life of a mortgage has decreased and the average borrower no longer has the mindset to pay off their mortgage as their central savings

[52] Shu, Suzanne. 2003. *Choosing for the Long Run: Making Tradeoffs in Multi-period Borrowing.* Working paper. Chicago: University of Chicago.
[53] Ibid. The author explains, "this is consistent with research that shows, when choosing from among a set of multi-attribute alternatives, people pick simplified, less than optimal decision strategies in a tradeoff of effort and accuracy" as described by Payne, J., J. Bettman, and E. Johnson. 1990. The Adaptive Decision Maker: Effort and Accuracy in Choice. In R. Hogarth, ed. *Insights in Decision Making: A Tribute to Hillel J. Einhorn*. Chicago: University of Chicago Press. 129-153.
[54] Kahneman, Daniel and Tversky, Amos. 1979. "Prospect theory" captures how consumers are vulnerable to framing effects and are particularly loss averse. McCoy. 2005. Patricia McCoy further explains consumer's loss aversion and their related susceptibility to predatory lending.

strategy. Some borrowers may even choose a loan with the lowest possible payment knowing that they will refinance or move, proving that this gamble is not inherently bad.

Many low cost tools, such as teaser rates, also carry the greatest risk for consumers who use these tools to stretch their finances, refinance out the bulk of their equity, or purchase more of a house than they can afford. The primary driver of reset sensitivity is the magnitude of the interest rate change. Therefore, borrowers with reduced teaser rate loans may suffer the most serious consequences, and currently carry the highest risk of default.[55]

The growing body of behavioral economics literature also suggests that consumers have differing and often inconsistent time preferences depending on how the choices regarding payment over time are framed.[56] Many of today's innovative loan structures are being driven by the nation's housing affordability problems that confront consumers. With limited ability to make a down payment and/or pay closing costs and various upfront fees, many consumers must repay these costs over the life of the loan – not only increasing the monthly payment but adding to total loan cost. More problematic is the loan which assumes improved financial status of the consumer over time. As noted, consumers often will overweight the value of dollars received today while downplaying future risks to income house prices and family stability. If the improvement in financial circumstances fails to materialize, the consumer is set up for future failure, including potential delinquency and foreclosure.

(4) Consumers Often Struggle With Mortgage Shopping

Standard economic theory assumes that the ability of consumers to shop for the best available price and terms plays a key role in preventing market suppliers from overcharging for their goods and services. Such thinking argues that in a market where people have the ability to comparison shop, loan originators, mortgage brokers loan agents will lose business if they push

[55] Cagan, Christopher, L. 2006. Mortgage Payment Reset, The Rumor and the Reality. *First American Real Estate Solutions*. Cagan utilized their subsidiaries LoanPerformance data and concluded that conservative figures suggest that the impact of reset sensitivity and subsequent default will be one percent or less of annual mortgage lending, yet the impact will hit those firms that are heavily involved in the riskiest loans.
[56] For a good summary of this strand of literature see Thaler, Richard H. and Cass R. Sunstein. 2003. B*ehavioral Economics, Public Policy and Paternalism: Libertarian Paternalism.* AEI Brookings Joint Center for Regulatory Studies. 173-179.

costs too high. Unfortunately, given the bewildering array of mortgage products available, even the most sophisticated borrower will find it difficult to effectively shop for mortgages. This may partially explain the fact that less sophisticated borrowers often do surprisingly little shopping for what arguably is their single most important shopping choice – the mortgage on their home.

At some level the failure to shop around is understandable. Available evidence suggests that "people do better on recurring everyday choices than on infrequent major decisions."[57] For example, when consumers shop for simple goods like groceries, they are able to evaluate products based on features like quality and price. With repeated activities, consumers more readily compare across brand and across different grocers to determine the best product to meet their needs, including making tradeoffs between such factors as price, quality and convenience.

What is most striking is the way homeowners often do not search for home loans, but rather respond to unsolicited offers from mortgage brokers. A 2003 AARP survey supports the notion that in many instances non-prime refinance loans are "sold, not sought," resulting from unsolicited outreach by mortgage brokers or loan agents. Kim-Sung and Hermanson found that some 56 percent of borrowers with broker-originated loans reported that brokers initiated the contact with them, compared with only 24 percent of borrowers with lender-originated loans.[58] Since they did not initiate the relationship, it is not surprising that a larger share of borrowers with broker-originated loans (70 versus 52 percent) "counted on lenders or brokers to find them the best mortgage."

Unfortunately, this confidence was often misplaced. For example, Darryl Getter analyzed the Survey of Consumer Finances and found that many borrowers who paid higher rates than others with the same characteristics said they did little shopping for a loan.[59] These findings are echoed in survey data presented in a study by Courchane, Surette and Zorn that suggested that non-prime borrowers are less knowledgeable about the mortgage process, are less likely to

[57] Zeckhauser, Richard. 1986. Comments: Behavioral versus Rational Economics: What You See Is What You Conquer. *Journal of Business*: 439.
[58] Kim-Sung, Kellie K. and Sharon Hermanson. 2003. Experience of Older Refinance Mortgage Loan Borrowers: Brokers and Lender Originated Loans. *AARP Public Policy Institute, Data Digest,* January.
[59] Getter, Darryl. 2002. *Are Credit Borrowers Credit-Constrained or Simply Less Creditworthy?* Working Paper Series, HF-016. Washington, DC: U.S. Department of Housing and Urban Development, Housing Finance.

search for the best mortgage rates, and are less likely to be offered a choice among alternative mortgage terms and instruments. [60]

Another 2003 AARP survey examined consumer knowledge of the mortgage lending process revealing that, when shopping for a home equity lender, most respondents made multiple inquiries concerning alternative home equity loan products; however, there were notable exceptions. African Americans were significantly less likely than the general population (36 versus 77 percent) to shop for a home equity loan at a bank, savings and loan or credit union.[61]

Using the same data deployed in the Courchane (2004) study, Ards, Ha, Mazas, and Myers present compelling evidence that the shopping behavior of African Americans can be explained in part by the fact that they systematically underestimate their credit worthiness, and higher income blacks are therefore less likely to apply for mortgage loans.[62] Their logic is confirmed by the observation that holding other factors constant, African Americans are less likely to refinance their home mortgages or otherwise apply for mortgage credit.[63] This in turn leads to a vicious circle where the best African American applicants do not apply for loans, lowering the average quality of those that do apply, reinforcing the tendency for mortgage lenders to both differentially reject African American applicants and to hold false perceptions about the racial differential of bad credit. These results are consistent with the findings discussed earlier that African Americans were significantly less likely than the general population to shop for loans at local banks, thrifts, and credit unions. They also are consistent with the finding that African Americans were more likely to obtain a loan after being "sold a loan" by a mortgage broker rather than as a result of "searching for a loan" from a wide array of loan sources.

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[60] Courchene, Marsha J., Brian J. Surette, and Peter M. Zorn. 2004. Subprime Borrowers: Mortgage Transitions and Outcomes. *Journal of Real Estate Finance and Economics* 24 4: 365-292.
[61] AARP. 2003. *The 2003 Consumer Experience Survey: Insights on Consumer Credit Behavior, Fraud and Financial Planning*. Washington, DC: AARP.
[62] Ards, Sheila D., Inhyuck Steve Ha, Jose-Luis Mazas, and Samuel L. Myers, Jr. 2006. The Effect of Bad Credit on Loan Denial Rates. February.
[63] The finding that African Americans are less likely to refinance their mortgages, even when mortgage interest rates drop is supported by several other recent empirical studies. See Van Order, Robert, and Peter Zorn. 2002. Income, Location and Default: Some Implications for Community Lending. *Real Estate Economics* 28 3: 385-404. See also Nothaft, Frank E. and Yan Chang. 2004. *Refinance and the Accumulation of Home Equity Wealth.* Cambridge: Harvard University.

MORTGAGE MARKETING AND SALES PRACTICES MAY ENHANCE CHOICE OR EXACERBATE THE LACK OF PRICE AWARENESS

Marketing and sales efforts are widely used by firms to convince consumers of the merits of their specific goods or services and to achieve favorable transaction outcomes by expanding sales, increasing profit margins or some combination of the two.[64] Marketing can help to improve consumer price awareness by providing information about alternative products and by helping consumers distinguish between products. In this way, it may reduce search costs and support the effective functioning of competitive markets.

Marketers pay attention to how consumers make choices drawing on insights from psychology and the social sciences. They seek to understand how consumers actually behave, and use this knowledge to sell products. While the result can be market enhancing, in many cases it is not. For example, in the mortgage market, aggressive sales and marketing campaigns build on the tendency of consumers to focus on low monthly payments and therefore direct them to overpriced loans that appear affordable. As marketers' understanding of decision making and psychology continues to improve, consumers will ultimately need not just a greater understanding of the mortgage terms, but greater levels of assistance to guide them to a "good loan" option.

Advertising Evokes Feelings, Frames the Transaction and Anchors Pricing

Advertising influences consumer choice through cognition (thinking), affect (feeling), and experience (memories).[65] Advertising product price, for example, can help consumers make informed decisions about their ability to afford a particular good or service. While price advertising may be difficult given the increasing complexity of mortgages, it is still common for prime lenders to advertise the interest rate for a standard 30 year fixed rate mortgage. In contrast, a report by HUD showed that with the price of non-prime mortgages varying according

[64] Bagozzi, Richard P. 1974. Marketing as an Organized Behavioral System of Exchange. *Journal of Marketing* 38: 77-81.
[65] Vakratsas, Demetrios, and Tim Ambler. 1999. How Advertising Works: What Do We Really Know. *Journal of Marketing,* 63 1: 26-43.

to various borrower, loan, and collateral risk characteristics, as well as origination compensation, "no one rate can be advertised that would be offered to all borrowers."[66]

Given the difficulty of providing pricing information, a substantial element of advertising in the non-prime arena focuses on the framing of values designed to evoke feelings, as opposed to facts alone.[67] One example is a mailing from Neighborhood Mortgage, Inc. to women who shop for baby clothes that says, "Why miss these precious days working? We offer a child-friendly mortgage. Now you can spend less time working and more time with your children."[68] If you go to the company's website, you won't find mortgage rates; you will find beautiful pictures of families with their babies. Whether it is romantic images of homes, or pictures of friendly mortgage brokers or loan agents chatting with happy families around a kitchen tables, the concept is to move the consumer beyond thinking about the loan costs and instead to evoke a feeling or memory to build a connection with the company.

Because consumers respond to the way that problems are posed, sequenced, and framed, advertisers frame the origination process as hassle free and virtually guaranteed, addressing the fear that many consumers have about being rejected. With taglines like, "Bad Credit OK, Need Cash? Fast Approvals -- Call 1-800," the upbeat message is that anyone can get a loan. Given the evidence that many consumers underestimate their actual credit score, particularly African-Americans,[69] such advertising may encourage consumers who would qualify for prime loans to apply for higher cost and/or riskier non-prime products, or pay more for non-prime credit.

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[66] Temkin, Kenneth, Jennifer E. H. Johnson, and Diane Levy. 2002. *Subprime Markets, the role of GSEs, and Risk-Based Pricing*. Report prepared for the United States Department of Housing and Urban Development. See also discussion by Willis, Lauren E. 2006. Decisionmaking and the Limits of Disclosure. *Maryland Law Review* 65 No. 3: 796-798.

[67] For more in the popular press about framing, see writings by Lakoff, George. 2006. Rockridge Institute. Available from http://www.rockridgeinstitute.org/research?Subject=Framing.

[68] Neighborhood Mortgage, Inc.'s Website. July, 2006. Available from www.PreciousTimeWithYourBaby.com

[69] Ards, Sheila D., and Samuel L. Myers, Jr. 2001. The Color of Money: Bad Credit, Wealth, and Race. *American Behavioral Scientist*. 45 2: 223-239. The authors examined the 1999 Freddie Mac research, which showed that Blacks with good credit underestimate their good credit. The authors show that while aggregate credit rates were different between Blacks and Whites, there were broad differences by income quintile, where high and low income groups were not significantly different, yet those in the middle were.

Many non-prime lending specialists also advertise the fact that they offer borrowers quick decision processes and the convenience of limited documentation requirements.[70] While this feature is attractive to some consumers, generally consumers do not understand that the loan is priced higher for this convenience. Further, there is evidence that these "stated income loans" are often based on unrealistic information. Indeed, the 2005 mortgage fraud case report to the MBA stated that, "the problems of loan application misrepresentations remain high," in part because "the industry's competitive forces are pressuring lenders to adopt new products, some of which have significantly more opportunities for fraud, due to their structure." While stated income and reduced documentation loans speed up the approval process, the authors believe they are open invitations for fraud. Review of a sample of 100 stated income loans by one lender found that 90 percent of these applications overstated income by 5 percent or more and almost 60 percent overstated income by more than 50 percent.[71]

Consumers may also be steered into products that take advantage of their tendency to overweight current expenses. A loan with a short-term teaser rate or with "2/28" terms may allow borrowers with less than perfect credit to rebuild their credit and then refinance at a better rate.[72] Yet, many of these nontraditional mortgage products can carry a significant payment increase or "payment shock" that can sink many borrowers when the interest rate resets.[73] These same loans may also

[70] Inside B&C Lending. (2006) *What Else is New? ARMs Dominate Subprime Mix*. Inside Mortgage Finance, Inc. reports that 37% of non-agency mortgage-backed securities were alternative documentation or no documentation loans in 2005.

[71] Mortgage Asset Research Institute, Inc. 2006. E*ighth Periodic Mortgage Fraud Case Report to Mortgage Bankers Association*. Reston, VA: Mortgage Asset Research Institute, Inc. 12. Available from http://www.mari-inc.com/pdfs/mba/MBA8thCaseRpt.pdf. MARI's information about mortgage fraud came from the FinCEN, which collects Suspicious Activity Reports from all federally insured financial institutions and their affiliates. 22,000 mortgage-related SARs were filed in fiscal 2005, compared to slightly fewer than 7,000 two years earlier. In addition, MARI collects information from major mortage lenders, agencies and insurers describing incidents of alleged fraud and material within the Mortgage Industry Data Exchange (MIDEX®). In addition, LoanPerformance has provided MARI with information about serious early payment defaults which closely track fraud trends.

[72] 2/28 Adjustable Rate Mortgages (ARMs) have an interest rate that is fixed for the first two years of the note date, after which the interest rate changes every six months to a year to the index value plus the margin, subject to the interest rate caps. Most 2/28 loans have prepayment penalty clauses that apply to the 2 year fixed timeframe. 2/28s have grown be to one of most popular products in the mortgage market place.

[73] According to Barron's, over the next two years 2/28 ARMs will reset on an estimated $600 billion of subprime mortgages. See Laing, Jonathon R. 2006. Coming Home to Roost, *Barron's.* New York, NY. February 13, 2006. To learn more about payment shock see the U.S. Senate. 2006. Committee on Banking, Housing and Urban Affairs, Subcommittee on Housing and Transportation, and Subcommittee on Economic Policy. *Hearing on Calculated Risk: Assessing Non-Traditional Mortgage Products*. Testimony of Michael D. Calhoun. 109th Cong., 2nd sess. 20 September. Further, Schloemer, et al. 2006. Losing Ground: Foreclosures in the Subprime Market and Their Cost to Homeowners. *Center for Responsible Lending*. The authors warn of increased foreclosures, particularly for

often have negative amortization, meaning that the consumer will have lower levels of home equity compared to traditional products.

The GAO observed that many advertisements for these nontraditional products, like interest only loans or payment option ARMs, do not always fully or effectively explain the costs, terms, features, and risks accompanying these products.[74] The GAO cited advertisements that emphasized the benefits of alternative mortgage products without explaining the associated risks, and suggested that some borrowers seemingly did not understand fully how much the monthly payment could increase. The GAO contacted state officials with concerns over advertising distributed by the nonbank lenders and independent brokers that they supervise. These advertisements clearly marketed a low monthly payment while specifying in tiny print that the offer is, in fact, interest-only. Others were outright misleading. New Jersey officials shared an advertisement that promised a low monthly "payment rate," and the ad suggested this rate was the actual interest rate for the full term of the loan.

Framing that focuses on the fact that "banks may have turned you down in the past," use the oft repeated phrase "Banks Say No, We Say Yes." Here, the effort may be to exploit the traditional antipathy that many African Americans hold against regulated depositories. Although banks' historical red-lining and discrimination against minorities is an unfortunate legacy, the Community Reinvestment Act, among other factors, has encouraged major banks to expand lending activities to historically underserved communities and subjects their practices to more scrutiny than that of mortgage companies that fall outside the reach of CRA. Even so, a recent report by AARP showed that lower-income minority borrowers appear more willing to obtain loans from a non bank lender, even though they would have qualified for a loan with better rates and terms at a CRA-regulated banking institution.[75]

minority households, due to the reset nature of the adjustable rate 2/28 products that have prepayment penalties, limited income documentation, and no escrow for property taxes and hazard insurance.

[74] Government Accounting Office (GAO). 2006. *Alternative Mortgage Products: Impact on Defaults Remains Unclear, but Disclosure of Risks to Borrowers Could Be Improved.* Report to the Chairman, Subcommittee on Housing and Transportation, Committee on Banking, Housing, and Urban Affairs, U.S. Senate. 109th Cong., 2nd sess.

[75] AARP. 2003. *The 2003 Consumer Experience Survey: Insights on Consumer Credit Behavior, Fraud and Financial Planning*. Washington, DC: AARP.

"Low Rates, Bad Credit OK, Immediate Approval, 1% Mortgage"; all of these marketing frames target consumers under duress, when they have even less capacity to make sound decisions. Consumers too often decide to switch to a risky loan product to resolve a current financial crisis – a move that may further undermine their financial situation. When consumers face losing their home, they are particularly vulnerable to marketing that presents the mortgage as an easy, convenient and possible solution to their financial difficulties. What the consumer may not understand is that by refinancing into another risky loan product, they may solve an immediate crisis, but in doing so may also face even greater mortgage payments, loss of home equity, and further erosion of their credit record.[76]

Aggressive Sales Tactics Can Prey on Consumer Weakness

Increasingly mortgage loans are "sold" to customers through networks of brokers or loan officers that identify and reach out to individual customers, take loan applications and process paperwork. Without the ability or time to gather information, consumers often rely on a broker or loan officer to gather the needed information and present the best choices. Reliance on third parties best serves the interests of the consumer when their interests are aligned. In some cases, these agents are able to help consumers select the best mortgage product for the consumer because the financial incentives of the two parties are aligned. For example, rather than push the product that generates the greatest gain for the broker or loan officer on that particular transactions, these agents may choose to advance their reputation for being a "fair and honest broker" to attract a larger customer base and generate future business.

However, misalignment between the third party agent and the borrower is often the case. Wholesale mortgage lenders often provide brokers with financial incentives to convince potential borrowers to accept more profitable products – namely loans that have higher rates and/or less favorable terms than the best loan for which the borrower would qualify. The focus on brokers reflects the fact that mortgage brokers dominate the non-prime delivery system.

[76] Querica et al. find that subprime ARMs carried 49% greater odds of foreclosure than that of fixed-rate subprime loans after controlling for differences in loan terms, creditworthiness and economic conditions. Quercia, Roberto G., Michael A. Stegman, and Walter R. Davis. 2004. *The Impact of Predatory Loan Terms on Subprime Foreclosures: The Special Case of Prepayment Penalties and Balloon Payments.* Chapel Hill: University of North Carolina at Chapel Hill.

However loan officers of banks, depending on how they are compensated, are subject to the same types of concerns.

Given the financial incentives to push specific products, mortgage product advertisers, mortgage brokers and loan officers alike often use their considerable knowledge about consumer behavior to enhance their own business and gain additional commissions. Poor price awareness makes consumers vulnerable to these efforts, especially in situations where it is difficult for a consumer to determine which mortgage price represents the best deal. As Estelami observed, "lack of price awareness can thus serve as a catalyst for creative and sometimes manipulative practices."[77]

Mortgage companies and banks may even develop specific sales techniques that take advantage of consumer vulnerabilities. Citing examples of broker training materials and testimony of former brokers, Lauren Willis documented how some brokers and loan officers engage in one-on-one sales efforts designed to manipulate borrowers into selecting higher-cost or otherwise abusive loans.[78] As summarized by Jack Guttentag, "a major determinant of profit per loan is the sophistication of the borrower relative to the sales skills of the loan officer."[79]

These comments are born out by the AARP survey discussed earlier. In this survey, borrowers with broker-originated loans were more likely to pay points (25 versus 15 percent) and more likely to have a loan with a prepayment penalty (26 versus 12 percent). A greater share of borrowers with broker-originated loans also believed that they did not get a loan that was "best for them" (21 versus 9 percent), received a loan with mortgage rates and terms that were "not fair" (23 versus 8 percent) and did not receive "accurate and honest information" (19 versus 7 percent). Many borrowers, especially elderly borrowers and borrowers in lower-income and/or minority areas, succumb to the marketing tactics of aggressive brokers.

[77] Estelami, Hooman. 2005. A Cross-Category Examination of Consumer Price Awareness in Financial and Non-Financial Services. *Journal of Financial Services Marketing* 10 2.
[78] Willis, Lauren E. 2006. Decisionmaking and the Limits of Disclosure. *Maryland Law Review* 65 No. 3: 796-798.
[79] Guttentag, Jack. 2000. *Another View of Predatory Lending*. Working Paper 01-23-B. Philadelphia: Wharton School, University of Pennsylvania.

Whatever the tactics, the fact is that consumers end up selecting loans that they don't understand, with monthly payments that they cannot meet.[80] This is not surprising, as aggressive advertising plays on consumers' cognitive biases. To the extent that these practices are consistent with applicable regulatory standards, the challenge rests with the loan originator and their ability to monitor their loan officers and broker channels.

As Federal Reserve Board Chairman Ben S. Bernanke noted in a recent speech, placing significant pricing discretion in the hands of financially motivated mortgage brokers or loan officers can be a prescription for trouble, as it can lead to behavior not in compliance with fair lending laws.[81] Implicit in this statement is that when loan originators place discretion in the hands of financially motivated third-parties, loan originators must also put in place monitoring activities to guarantee that this discretion is not abused.

[80] Bucks, Brian and Karen Pence. 2006. *Do Homeowners Know Their House Values and Mortgage Terms?* FEDS Working Paper 2006-03, Board of Governors of the Federal Reserve System (Washington, D.C.: January 2006)
[81] Bernanke, Ben S. 2006. Remarks by Federal Reserve Board Chairman at the Opportunity Finance Network's Annual Conference. 1 November. Washington, DC.

HELPING CONSUMERS MAKE BETTER CHOICES IN THE MARKETPLACE

It is important to understand how mortgage brokers, loan correspondents and retail loan agents engage consumers, and how consumers respond to loan marketing and sales. This understanding can help to generate effective interventions to improve the efficiency and fairness of the marketplace; enable consumers to obtain mortgage products at the best price for which they qualify; and help consumers avoid falling victim to deceptive practices. Everyone engaged in the mortgage market has a part to play in the solution. Because consumers have malleable preferences, lack price awareness, struggle with shopping and have difficulty making choices with time dimensions, new initiatives are necessary to overcome these consumer biases and counter today's aggressive marketing practices.

One way to address the above issues is to build on existing community-based infrastructure as well as national scale organizations and foundations committed to social justice. While more effective consumer assistance is an important tool, the mortgage industry must also police itself. Industry leadership is needed to overcome collective action challenges by adopting binding best practices, and affirmatively monitoring their mortgage brokers and loan agents. Further, some practices must be ended altogether through federal and state regulatory oversight and enforcement. Regulators must help the industry root out "low roaders" by mandating specific best practices, expanding oversight, and creating a level playing field that subjects all mortgage market participants to an effective and uniform set of rules and regulations.[82]

Moving beyond the current policy framework of "let the consumer choose," it is important to help consumers make durable choices that reflect meaningful understanding of both the advantages and disadvantages of available mortgage options. More proactive interventions are needed to steer vulnerable borrowers toward "good loan" options; loans that are fairly priced, easy to understand, and less likely to expose borrowers to unexpected foreclosure and default risk. Using the existing community-based and social justice infrastructure, some point-of-sale

[82] Kennedy, Duncan. 2003. *Cost Benefit Analysis of Debtor Protection Rules in Subprime Market Default Situations.* Presented at Building Assets, Building Credit: A Symposium on Improving Financial Services in Low Income Communities. Harvard University, Joint Center for Housing Studies. This paper suggests shifting subprime business from Low Road to High Road lenders by expansive and enforced non-waivable debtor protections.

initiatives could include: providing for second opinions, providing a "basic loan" product option, steering consumers toward "good loan" options, and marketing socially beneficial loans.

Guiding Consumers to "Good Loans"

The idea of individual choice is a deeply held value in the United States and has significant political appeal. Yet, as the research presented in this paper has demonstrated, "letting the consumer decide" has distinct limitations. In his paper "Ulysses and the Sirens: Studies in Rationality and Irrationality," Jon Elster recalls the story of the Greek hero Ulysses and his request to be bound to the mast of his ship in anticipation of the temptation of the sirens' call. Elster uses this analogy to illustrate the often irresistible lure of product marketing and the need for the consumer to have the foresight to resist immediate temptation in favor of wiser more sustainable choices. [83]

While further regulations addressing "push marketing" efforts may be necessary, it also remains important to help consumers refrain from making choices that are not in their own best interest, or choices that they will later regret. To accomplish this task, those concerned with helping consumers obtain "good loans" should seek to better understand consumer behavior – not as political ideology or rational choice models argue that consumers should behave, but, as experience suggests that consumers actually do behave. As discussed earlier in this paper, the social marketing field underscores what marketing and sales professionals already know, that consumers respond to positive messages, imagery and intuition. "Push marketers" move consumers to action by appealing to their emotions and framing the mortgage process as convenient and accessible.[84] Simply stated -- those concerned with the well being of potentially vulnerable borrowers must push back.

One place to apply a behaviorist approach is with ongoing efforts to help consumers make better mortgage choices. Although a network of Community Based Organizations (CBOs) running

[83] Kahneman, Daniel, and Amos Tversky. 1981. The Framing Decisions and the Psychology of Choice. *Science, New Series* 211 4481: 453-458. present an excellent summary of the Jon Elster example on p. 456.
[84] The seven steps to social change are knowledge, desire, skills, optimism, facilitation, stimulation and reinforcement found at: Social Change Media. 2006. *The Seven Doors Social Marketing Approach*. Available at http://media.socialchange.net.au/strategy/

homeownership information centers exists, many consumers continue to respond to push marketing practices because these mortgage marketing campaigns are well funded, widespread, and make the process seem easy and supportive. In contrast, CBO approaches often lack sufficient funding to provide counseling on a wide scale basis, and typically emphasize caution, prudence and sacrifice. Given the potential for consumers to accept mispriced mortgages, it is imperative that CBOs build from their successes and realign their approaches to the current world of mortgage finance, sales and marketing.

Providing for a Second Opinion through a Trusted Advisor Network

One new effort for CBOs, particularly a group with national reach, could be to create a network of 'trusted advisors' whose incentives are aligned with the borrowers. This network of second opinion counselors and buyer's brokers could include non-profit and for-profit organizations, both acting as independent agents that help consumers choose the most appropriate mortgage for their needs. This third-party advice system would therefore seek to counter the consumer's preference biases, difficulty in shopping and lack of price awareness.

When considering which mortgage to choose, many consumers seek a recommended course of action from someone they trust. The current network of certified, community based, counseling programs have high levels of social capital within their communities that could be leveraged into an expanded mortgage counselor service. Similarly, organizations with national reach and brand awareness such as AARP, Habitat for Humanity, the National Urban League or the United Way, could work through their local affiliates and direct consumers to counseling agencies in communities across the country. These counselors could establish up-to-the-minute expertise, and advise consumers on their offers and potential alternatives.

These same entities could help organize a for-profit 'buyer's brokers' network, where mortgage brokers agree to serve the interest of consumers in exchange for a fixed, transparent fee.[85] The buyer's brokers association could develop its own "seal of approval" and market this customer

[85] The concept of utilizing a fixed upfront fee by a for-profit firm was recently launched by Mortgage Grader, see: http://www.mortgagegrader.com

service to build market share.[86] Either of these networks could establish an 800 number to provide national coverage or develop shopping tools, such as an automated pricing guide, to both guide the consumer and draw them into the counselor's network.

Counselor Tools: A Second Opinion Hotline and On-line Pricing Guides

To ensure national coverage, a national organization such as Neighborworks® America could establish a phone-based second opinion hotline to encourage consumers to shop, avoid high pressure sales tactics, and be informed about their options. To publicize the hotline, federal agencies and responsible lenders could mount a public service ad campaign to encourage potential borrowers to use the hotline, establishing it as a source of trusted advice and guidance.

Recognizing the significant degree of consumer confusion in the mortgage market, an important role for a second opinion network would be to help consumers navigate through the complexity of both the mortgage process and available mortgage products and terms. For example, the second opinion hotline counselor could remind callers that the broker has no legal requirements to offer the best product, and encourage the consumer to push back with a counter offer or shop around to identify if they can secure a better alternative. In a few short minutes, an on-line service could ascertain key parameters of the caller's credit profile and identify the extent to which the consumer would qualify for better terms, and provide advice about where best to shop for better products.

In addition to offering advice about the mortgage lending process, a hotline could also provide information about specific mortgage products, including the associated risks and rewards. For example, the counselor could point out the likely reset rate of the adjustable features and ask the consumer to think about how they would meet this future obligation, whether from additional income or reduced expenses. The counselor could ensure that consumers evaluate the full set of product terms, features and pricing information as opposed to monthly payment alone.

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[86] This concept of an Upfront Mortgage Broker™, was developed by Jack Guttentag where the interest of the broker is fully aligned with the borrower. See Guttentag, Jack. 2006. Mortgage Professor. Available from http://www.mtgprofessor.com/upfront_mortgage_brokers.htm or visit the Upfront Mortgage Broker website. 2006. Available from http://www.upfrontmortgagebrokers.org/search_umb.asp

The second opinion hotline could prove especially useful in helping consumers negotiate through the intricacies of understanding how to assess the risks of payment shock arising from "interest only" and "payment option" mortgages. The Federal Reserve Board and the Office of Thrift Supervision have taken the lead by issuing a new and improved Consumer Handbook on Adjustable Rate Mortgage (CHARM). The hope is that consumers will turn to the CHARM booklet to both enhance their understanding of how loans typically work, as well the potential benefits and risks of the new products. The fear is that the new CHARM booklet will add to the information overload of consumers as yet another document in a stack of information provided to consumers. Rather than just requiring that mortgage originators provide a copy of CHARM to every consumer making an application for an adjustable rate mortgage, having counselors walk consumers through the CHARM information and customizing the examples to the consumer will likely have more success.

Although consumers may suffer from information overload, a web-based and interactive 'pricing guide' would assist consumers working with counselors and buyer's brokers. Just as "blue books" arm auto shoppers with information on baseline prices, a national scale organization could help create an up-to-the-minute pricing guide that would provide counselors with a competitive reference point to help guide consumers toward better choices. Price information on a range of products that appear to be a good fit for particular consumers would be helpful to counselors and consumers alike, given that mortgage prices change daily, and there are literally thousands of distinct mortgage products. This pricing guide could be structured as a database available to counselors, or to the general public, similar to the Orbitz and Expedia on-line websites that assist consumers in purchasing plane tickets and other services. Whether provided through community homeownership centers, or the national second opinion hotline, this guide would allow counselors and consumers on-line access to the best information available in the marketplace.

An automated pricing guide could be an especially effective way for counselors to help consumers understand the cost associated with specific mortgage options. Just as "blue books" enable consumers to identify the costs associated with purchasing an automobile of a specific make and model with a larger or smaller engine, a mortgage pricing guide could help consumers better understand the marginal impact of specific loan features on the price they pay. To

accomplish this task, the pricing guide could include working scenarios that compare three or four prototype mortgages with different terms. The counselors could then use these examples to help show the consumer the tradeoffs of prepayment penalties, interest-only options and other more exotic terms.

The marketing and sale of "no- and low-documentation" loans provides a good example of how directed counseling could work. For some consumers, submitting the required documents is a hassle and may feel like an invasion of privacy. Alternately, other consumers compile the documents, yet a broker may still steer the consumer into a no-documentation loan. Overall, borrowers are not aware that they generally pay a premium for the convenience of obtaining a "no-doc" loan product. Having counselors provide consumers with an estimate of mortgage pricing with an itemized no-doc option would help to reveal the marginal cost of this specific loan feature. Combined with an effort to guide consumers in the assembling of documentation, counselors could help consumers avoid unknowingly paying a high price for a "no-doc" option that may not be in the consumer's best interest.

Developing a second opinion counselor and buyer's broker network, coupled with a national database of representative daily rate sheets sorted by risk categories, would help reduce information asymmetries present in the market place.[87] It makes little sense for individual consumers to devote considerable resources to ferret out information that could, and arguably should, be readily provided by mortgage brokers and originators. Developing a third party network, with interests that are aligned with the consumer, would encourage consumer shopping, increase price transparency and highlight the tradeoffs present in alternative mortgage products: a worthy and doable objective.

[87] Durkin, Tom. 2002. Research Roundtable, Economic Perspectives on the Home Mortgage Market. Presented to *Federal Trade Commission.* 16 October.

Social Marketing Can Steer Consumers toward Better Choices

While there is broad consensus that consumer education and counseling can play an important role in protection efforts, [88] there is ample room for improvement. Implicitly adopting a rational view of consumer behavior, many counseling programs simply assume that by providing information about the mortgage process and the benefits and costs of alternative mortgage products, consumers will have increased decision making capacity to select the best mortgage. Yet the belief that education alone will prove sufficient to help many consumers resist the efforts of "push marketers" fails to fully appreciate the cognitive biases that consumers exhibit when mortgage shopping. Given the sophisticated and aggressive sales and marketing practices present in today's market, Engel and McCoy concluded that "education and counseling do little to redress the basic inequities in bargaining power that underlie many predatory loans."[89] This observation is confirmed by a recent Joint Center assessment of local non-profit counseling organizations. Though these agencies can point to many success stories, they nevertheless uniformly lament the fact that many counseled borrowers continue to fall victim to the pressures of aggressive push marketing and deceptive advertising practices. [90]

Individuals committed to helping consumers obtain good mortgage need to adopt more aggressive strategies that move beyond consumer education. The social marketing of "good loans" is one approach. The development of second opinion counselors, and buyer's brokers, supported by both a national hotline and on-line pricing guide, could also help consumers to better loan products. Realigning the advertising and outreach efforts of CBOs and high-road lenders can help pierce the message of "when others say no, we say yes," and proactively direct consumers to "good loan products."

An example of successful social marketing is the Neighborworks® America and Homeownership Preservation Foundation campaign for foreclosure avoidance. Consumers in

[88] Hirad, Abdighani and Peter Zorn. 2002. " Purchase Homeownership Counseling: A Little Knowledge is a Good Thing" in Nicolas Retsinas and Eric Belsky, eds. *Low-Income Homeownership: Examining the Unexamined Goal.* Washington DC: Brookings Institution Press.
[89] Engel, Kathleen C., and Patricia McCoy. 2002. A Tale of Three Markets: The Law and Economics of Predatory Lending. *Texas Law Review* 80. p. 74.
[90] Apgar, William C. 2004. Credit, Capital and Communities: The Implications of the Changing Mortgage Banking Industry for Community Based Organizations. Cambridge: Harvard University.

mortgage default often live in a state of denial, and among other things fail to contact their mortgage lender or servicer to identify potential workout options, even though in many instances these workouts can prove to be the best course of action. The campaign's Public Service Announcements seek to move distressed borrowers out of denial and into action with a simple message "Debt is more than just annoying, it could cost you your home." One ad features a 'bigmouth' character that follows the protagonist throughout his day continually making an annoying monotone sound. The ad annoys the viewer, but it also pierces through the clutter of competing advertising messages, and helps grab the consumer's attention by mimicking the frustration of continuing debt problems. Meanwhile, their hardcopy message sends a simple signal of hope, "Having trouble paying your mortgage? Don't wait another minute to find help. Call 888-995-HOPE." This campaign has helped thousands of Americans avoid foreclosure. Putting this same effort towards the marketing of "good loans" and away from predatory loans could save consumers from getting loans they cannot repay. [91]

Behaviorists' Principles Can Increase Effectiveness of Other Outreach Efforts

Behaviorists observe that often small changes in the context in which a decision is made can make a big difference in how consumers choose. In particular, the right context can help consumers make decisions that better reflect their long-term interests. For example, CBOs that offer housing counseling services could use the simple "opt-in/opt-out" framework to dramatically expand their capacity to steer consumers to good choices, given consumer needs, priorities, expected income, and risk tolerance. Some other examples of social marketing could include: providing pre-approval letters at homebuyer fairs, providing a basic good loan and actively marketing and advertising "good loan" options.

One classic example of the "opt-in/opt-out" framework involves efforts to encourage consumers to enroll in employer assisted savings programs. Despite the widespread agreement that people should save more, the evidence is that all too often they don't. Some firms may simply offer a number of plans and let employees choose to enroll, or "opt-in" to the program. Yet research

[91] In cooperation with a group of major lending organizations, the Homeownership Preservation Foundation, and the National Advertising Council, Neighborworks is preparing to launch a new advertising blitz to further encourage families at risk of foreclosure to call the hot line and get assistance.

shows that the enrollment rate increases dramatically when an employer automatically enrolls all eligible employees into a savings plan but allows them to "opt-out" at a later date. In each case, the consumer has the option of opting in or out. By setting the default as the "good loan," any inertia or confusion on the part of the consumer is resolved in favor of the better social outcome.[92]

CBOs could move beyond simply providing information about what constitutes a good choice in the marketplace at homebuyer classes and fairs, and provide streamlined ways for consumers to actually apply for "good loans." Having overcome inertia, consumers have taken the first step by attending a homebuyers' fair or class. It is therefore important that the CBO organize community events in a way that streamlines the process of getting into a "good loan." This could be accomplished by having prescreened loan officers and mortgage brokers accepting mortgage applications on the spot. After collecting basic consumer information, these lenders could offer pre-approval letters subject to verification of the information gathered. In effect, this allows potential borrowers to "opt-in" to a good product, while still preserving their right to change their mind and at a later time "opt-out."

Providing consumers with a pre-approval letter on the spot and before the consumer leaves the fair is seemingly a small change. Yet, as was the case in the employer-provided savings example, this practice changes the default option. The consumer therefore leaves with a solid option in hand for a "good loan" and still has the option to conduct additional shopping. Research suggests that consumers are likely to accept this initial offer, if only because it is the easiest course of action. Alternatively, the organization promoting the fair could send consumers home without a specific offer, but instead with literature on how to apply for a mortgage or information about good mortgage products. However, consumer research suggests that despite their initial best intentions, many consumers will not take the needed follow up action to apply for a loan.

In a similar manner, working to change the default options can enhance the effectiveness of on-line counseling or the second opinion hotline operations discussed earlier. One risk of an on-line counseling activity is that it is simply the high tech version of traditional counseling and provides

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[92] Madrian, Brigitte, and Dennis Shea. 2000. *The Power of Suggestion: Inertia in 401(K) Participation and Savings Behavior* Working Paper 7682. Cambridge: National Bureau of Economic Research.

the consumer with information but no specific course of action. Rather than let a consumer hang-up from the counseling session and consider the advice at a later time, an alternative strategy would be to provide the consumer with a binding offer for a specific loan product on the phone.[93] Again, the consumer still has the option to conduct additional shopping, but now the shopping will be guided by the knowledge that they already have access to a "good loan" product.

Community groups can increase the effectiveness of their outreach efforts by changing the default option, as can hotline or second opinion counseling operations. Notice that aggressively marketing "good loans" parallels the sales and marketing approach of "push marketers." Once a consumer responds to an advertisement, or calls a loan officer or broker 800 numbers, they typically make it easy to "close the deal." Similarly, a homebuyers' fair or on-line counseling operation run by a trusted third party can encourage potential homebuyers to make initial inquiries, but they too should move quickly to "close the deal." As with any loan, borrowers will have an opportunity to reconsider their choice, but the default to the "good loan" choice can substantially enhance the likelihood that the consumer does in fact get a "good loan."

[93] With support from the Ford Foundation and working in cooperation with a number of community based organizations, The Mortgage Grader system is one example on an on-line service that allows consumers to select from one of several prescreened mortgage products that have transparent prices, and clearly stated features and lender fees. More information available at www.mortgagegrader.com

REGULATION AND OTHER COLLECTIVE ACTION APPROACHES TO ENHANCE FAIR AND EFFICIENT LENDING

While expanding the range of consumer assistance mechanisms can be helpful, there is undoubtedly a need for strengthened efforts to eliminate the "bad actors," those industry participants who seek to gain competitive advantage by deploying illegal or unethical business practices. In particular push marketing practices that encourage borrowers to select mortgage products that they don't understand, have only limited ability to repay, and may come to regret later. Such practices not only take advantage of borrowers, they also threaten the safety and soundness of key elements of the national mortgage finance infrastructure.

Responding to concerns about deceptive market practices and related concerns about the growing delinquencies and defaults of nontraditional products, last fall federal regulators issued the "Interagency Guidance on Nontraditional Mortgage Product Risks." The Guidance identified several actions that individual lenders could initiate "to ensure that loan terms and underwriting standards for nontraditional mortgage loans are consistent with prudent lending practices, including credible consideration of a borrower's repayment capacity."[94] While the Guidance does not prohibit specific practices, it does discuss which practices generate the greatest problems. For stronger quality control and risk management, for example, the Guidance suggests that the lender consider a borrower's repayment capacity and exercise appropriate due diligence in their dealings with third party originators. Specifically, it recommends that monitoring of third-party originators track the origination source and borrower characteristics of loans to identify problems early with the potential for remedial action.

In many ways, the Guidance simply adds a federal voice to ongoing efforts to craft a set of industry best practices designed to ensure that consumers are able to access "good loans" on a fair and efficient basis. Even so, implementing the actions suggested by the new Guidance will not be easy. Among other issues, lenders are in a "prisoner's dilemma" where if any one lender aggressively embraces practices consistent with the Guidance, they stand to lose market share. Yet

[94] Department of the Treasury. 2006. *Interagency Guidance on Nontraditional Mortgage Product Risks*. Department of the Treasury, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Department of the Treasury and National Credit Union Administration. 29, September. 2. An updated version of the guidance is now in comment period. Proposed Statement on Subprime Mortgage Lending, Notice with request for comment, 72 Fed. Reg. 10533 (March 8, 2007).

without improved oversight of the "low-roaders," inappropriate originations will continue to hurt everybody in the system and create the basis for more restrictive regulatory policy at a later date.

What is needed is collective action at a broad industry level to address the issues identified by the Guidance. Industry "self regulation" can help, but it may prove difficult or impossible even for the most responsible industry players to discipline others who "break the rules" and gain financial advantage. The "prisoner's dilemma" problem provides a classic justification for collective action in the form of expanded regulation. This section presents some observations of how best to develop sensible solutions that balance the interests of the mortgage industry, mortgage borrowers, and the public at large.

Existing Consumer Protection Mechanisms Are Not Sufficient

One approach to addressing the collective action problem is to arm consumers with tools to better protect their own interests. This is the basic rationale for existing federal consumer protection regulations that attempt to give consumers access to timely and accurate mortgage pricing information. For example, disclosures required under the Real Estate Settlement Practices Act (RESPA) seek to inform borrowers about the wide range of mortgage fees and settlement costs. The TILA is designed to help borrowers understand the price of credit. For specific higher priced loans, the Home Owners Equity Protection Act (HOEPA) requires additional disclosures because it is particularly important that consumers who have agreed to very high-cost loans fully understand the price implications of various prepayment penalties and other loan provisions.

Unfortunately, existing disclosure mechanisms all too often prove ineffective in preventing consumer abuse. In particular, the information that is needed to engage in informed shopping is often not provided in a timely manner, nor in a manner which consumers can incorporate readily into their shopping behavior. For example, RESPA requires that, within three days after application, lenders and brokers provide borrowers with a Good Faith Estimate (GFE) disclosing a range of settlement costs including origination fees, points, and broker fees. While the goal of the GFE is to provide valuable information to the consumer, it is not necessarily accurate

information. As the name suggests, these figures are estimates and can differ significantly from the actual figures used at closing.

In an effort to help borrowers obtain more accurate information about the price of credit, TILA requires that brokers and lenders provide borrowers a precise accounting of the mortgage price, including the APR and the finance charge. Unfortunately, this information comes too late in the process to be useful to the consumer. Indeed for loans not covered by HOEPA, the TILA-mandated disclosure of the APR and finance charge need not be given until closing, or at most 24 hours prior. This is too late to influence the shopping process.[95] A recent article by Patricia McCoy suggests that to be helpful to consumers, this price revelation should come 3-7 days before closing.[96]

Though more accurate and timely pricing information may aid consumer decision making, the public policy rationale supporting the efficacy of price disclosures assumes the same degree of rational behavior that is often the source of consumer confusion in the first place. Worse still, these mandated disclosures may simply add to "information overload," creating a further impediment to shopping for the best deal. For example, disclosure documents are often signed without being read, much less understood. Yet the fact that these documents were in fact "signed" may have the perverse effect of supporting the lenders' claims that the borrower demonstrated informed consent. As a result, existing disclosures may inadvertently provide a shield that protects "push marketers" from being held accountable for any unethical behavior in the lending process.[97]

At the same time, providing consumer disclosures on a more accurate and timely basis could help improve the effectiveness of the "Second Opinion" networks discussed earlier. By further modifying applicable TILA regulations, it would also be possible to require certain borrowers (defined, for example, by credit score or ability to make a downpayment) to seek a second

[95] Arguably, the three day right of rescission could provide the consumer an opportunity to use the TILA provided disclosure to shop, yet after closing consumers are more likely to spend energy justifying the decision rather than second guessing their loan terms.
[96] McCoy, Patricia A. 2006. Rethinking Disclosure in a World of Risk-Based Pricing. *Harvard Journal on Legislation* 44.
[97] Willis, Lauren E. 2006. Decisionmaking and the Limits of Disclosure. *Maryland Law Review* 65 No. 3: 796-798.

opinion. To be effective, such a system need not mandate that the consumer select the alternative loan offered by the second opinion source – just that they consider the alternative. By expanding the timing of relevant disclosures, a second opinion system will simply confirm that brokers and loan officers are offering their best products, while at the same time pushing back on products that should be rejected by consumers entirely or modified to better fit consumer needs. Other options include requiring that the Good Faith Estimates be binding and provided earlier in the process, ensuring that consumers receive mandated TILA disclosures earlier in the process, or extending the "right of recision" period.

The Mortgage Industry Has an Opportunity to Drive Out Abusive Lending

While there is general agreement that misleading advertising and abusive practices persist, there is substantial disagreement about how best to drive these practices out of the marketplace. Many lenders and brokers are concerned that new regulations could stifle innovation and potentially limit access to loans for some borrowers. Yet, there is a need for the industry to respond to the growing public concern about the rise of delinquencies and foreclosures, the limitations of existing approaches, and the potential that ill-conceived regulations could make matters worse.

Self regulation is one possibility. By working to establish a set of "industry standards" or acceptable "best practices," industry leaders could hold all industry participants to account. At the national level, the Mortgage Bankers Association has developed a series of "best practices," as have individual mortgage companies, and state level associations that represent the interests of the mortgage lending community. For example, the California Association of Mortgage Brokers (CAMB) has expanded loan originator education, developed a code of ethics and accountability, and called for uniform licensing and mandatory broker education, criminal background checks, and updated disclosures. Much like the well known "Good Housekeeping Seal of Approval" or the recommendations provided by "Consumer Reports," the hope is that these efforts will help steer consumers toward those brokers that commit to the CAMB best practices and code of ethics.

Unfortunately, "best practice" approaches are often ignored by the "low-roaders" they seek to influence. What is needed is some way to sanction those who do not abide by the proposed "best

practices." While trade associations willingly promote the virtue of their members, they are more reluctant to explicitly criticize by name industry peers, yet there are exceptions. For example, a recent GAO report observed that in 2005, CAMB issued a mortgage alert to warn the public about a misleading advertisement for a payment-option arm product circulating in the state.[98] The difficulty of creating a system of "best practices" that is binding on all market participants is in fact one of the principal reasons that it can be in the industry's self interest to embrace sensible and binding regulations.

The Federal Government Should Expand and Strengthen the Guidance

Even as the industry moves to enhance its own capacity to "self regulate," Congress and the Federal regulatory agencies, in cooperation with consumer and industry representatives, should consider taking additional steps to drive out of the market those irresponsible market practices and practitioners that exploit the limitations of consumer decision making. While the recent Guidance is a step in the right direction, it does not address larger questions about enforcement and legal responsibility of the mortgage broker, loan officer, or originator to deal with the consumer in a fair manner, nor does the Guidance address the practices of non bank organizations and state regulated institutions and individuals.

Historically, federal regulation has played a central role in efforts to promote fair and efficient market functioning by clearly and explicitly defining acceptable industry and consumer practices. For example, by imposing sanctions on those that fail to honor basic norms, well structured regulations have the capacity to not just protect the interests of consumers, but also protect the interest of lenders from the adverse effects of destructive business practices that some competitors may resort to in pursuit of market share. Therefore, strengthening the Guidance and creating uniformity aligns the industry with the goal of promoting access to good loans.
In this spirit, several consumer advocates have suggested the creation of new "suitability standards" where regulated lenders and their loan agents would be required to act with the borrowers' best interest in mind. The most recent effort to create legal bounds for loan originator behavior is Ohio Senate Bill 185 enacted and signed in 2006. This legislation

[98] GAO. 2006. *Alternative Mortgage Products*. Report to the Chairman, Subcommittee on Housing and Transportation, Committee on Banking, Housing, and Urban Affairs, U.S. Senate.

prohibits non bank mortgage companies from engaging in a transaction, practice, or course of business that is “not in good faith or fair dealing,” or that commits a fraud upon any person.[99] The Act requires criminal background checks for licensed brokers and loan officers, as well as appraisers. Further, it addresses disclosure of information, fiduciary duties, prohibited acts, record keeping and pre-licensure examination.

How Ohio will implement these “fair dealing” requirements remains to be seen. As Engel and McCoy suggested, the concept of suitability is not new to mortgage lending as HOEPA already requires that loan originators take consumers’ current and expected income, obligations and employment status into account when assessing their ability to pay back their loan.[100] Further, “push marketers” are clearly not reined in by the current system, as they manipulate consumer choice and push “bad” choices on unsuspecting consumers and communities.

Something must be done. In particular, regulatory uniformity is critical to create a level playing field across the industry and clear enforcement mechanisms are needed as well. Regulators could use authority that already exists with the Federal Reserve Board under HOEPA to extend the Guidance to all mortgage lenders, not just the federally regulated deposit-taking organizations now covered. Federal regulators could use other existing authorities as well. For example, the Federal Trade Commission Act is a potentially powerful tool for oversight of both depository and non-depository organizations. The federal banking regulators have the authority to declare which practices are “deceptive” and violate the FTC Act, and in doing so effectively ban them industry wide.

Similarly, there must be mechanisms put in place to sanction those mortgage market participants that ignore the standards already articulated by the Guidance. By creating effective and adequately funded enforcement strategies and ensuring that all mortgage brokers, loan officers, and mortgage originators play by the same rules, regulators would ensure greater industry safety

[99] Ohio Senate Bill 185 was signed by the governor on June 19, 2006. Available at http://www.legislature.state.oh.us/analysis.cfm?ID=126_SB_185_&ACT=As%20Enrolled&hf=analyses126/06-sb185-126.htm

[100] Engel & McCoy. 2002. The authors provide an in depth proposal for how to create a suitability standard in their landmark article. The authors point out that suitability requirements currently exist in the sale of securities, where salespeople are required to take into account the consumer’s preferences and risk when recommending products.

and soundness, and redress existing problems resulting from information asymmetries and collective action challenges in the industry.

Absent expanded federal action, there is a clear role for individual states to insure that the new consumer protection measures embedded in the Guidance apply to all institutions and not just regulated financial institutions and their affiliates. This is underway, as the Conference of State Bank Supervisors (CSBS) and the American Association of Residential Mortgage Regulators (AARMR) have announced that as of February, 2007 twenty six states and the District of Columbia have agreed to adopt the Guidance. The goal is for all states to adopt the guidelines so that all consumers will be equally protected and all originators of residential mortgages will be subject to similar supervisory Guidance.

Unfortunately efforts to implement the proposed reforms at the state level have been slow, and many states still have not even committed to join in the effort to try. To the extent that the Federal Government continues to delegate to the states significant responsibility for regulating key elements of the mortgage market, the Federal government could still assist by providing funding to support the states in this role. This could come in the form of targeted grants to support state and local enforcement of mortgage fraud, or assistance in helping states and localities to better monitor the activities of mortgage brokers, appraisers and mortgage professionals that play such key roles in today's mortgage market.

The Federal Government Should Assume Responsibility for Broker Licensing

Adopting a federal mortgage broker licensing law to establish a minimum standard of broker behavior is critical for better monitoring of this important component of the overall mortgage market. Some states have passed licensing laws for mortgage bankers, mortgage brokers and mortgage loan officers and any new regulation should be done in conjunction with these state efforts. These state laws provide a framework for what an effective regulation could be. Some of the state requirements include; an application process, education and experience requirements, "bricks and mortar" requirements, and bond requirements. Further, some states may impose specific duties on mortgage brokers including making a reasonable effort to secure a loan that is

reasonably advantageous to the borrower and outlawing certain acts such as certain levels of broker incentives, outlawing excessive points and fees and outlawing misrepresentation and fraud.

Most importantly, an effective federal regulation would provide for even coverage across the marketplace of brokers and loan officers while adopting some mechanism for enforcement. For example, the North Carolina law also gives enforcement powers to the Commissioner of Banks to suspend licenses and impose penalties and begin investigations. Lastly, while broker licensing bills have been proposed in Congress in the past, it is important that any licensing requirement does not preempt good state laws and allows for states to continue innovating in this arena.

Creation of a Suitability Standard Represents Another Possible Approach

In an effort to expand existing consumer protections, some advocates argue in favor of the creation of a new "suitability standard."[101] Rather than continue to rely on consumers alone to "protect their own interests," proponents of this approach argue that lenders have considerably more knowledge than consumers concerning loan features, prices and performances, and that it is only fair that mortgage lenders be held legally accountable for making sure that consumers obtain "good loan products" that result from a "good loan process." The industry voices generally oppose mandating suitability standards arguing that there is wide variation in consumer needs, and lenders are not in a position to determine which product best serves the borrower's needs and ability to pay. [102]

Needless to say, many issues surrounding a new suitability standard remain unresolved. Among other things, there is no consensus as to what constitutes "good loan products" or "fair mortgage market practices." Most would agree that a "good loan product" is fairly priced in a manner that is consistent with the underlying loan risks and costs, provides consumers with "net benefits" in

[101] For initial discussion of this approach see Engel, Kathleen C., and Patricia McCoy. 2002. A Tale of Three Markets: The Law and Economics of Predatory Lending. *Texas Law Review* 80.
[102] Department of the Treasury. 2006. *Interagency Guidance on Nontraditional Mortgage Product Risks*. Department of the Treasury, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Department of the Treasury and National Credit Union Administration. 29, September. 2. In the cover letter the agencies summarize the comments they received and make the observation that lenders who commented on the new guidance argued that "lenders are not in the position to determine which products are most suitable for borrowers, and that this decision should be left to borrowers themselves."

that the loan is consistent with both the short- and long-run interests of the consumers, and that consumers have a reasonable prospect of being able to repay the loan. In addition, "fair mortgage market practices" must be in place to ensure that consumers receive simple and transparent mortgage pricing information, are informed of the relative costs and benefits of alternative mortgage features, have sufficient time to decide what product is best for them, and have access to an unbiased professional to help guide them to "good loan products."

Yet translating these general premises into workable rules and regulations remains illusive. This is understandable, since the discussion raises fundamental issues about the relative roles and responsibilities of individuals, business, and government in the fair and efficient functioning of a market economy. Recognizing the complexity of the issues involved, experience suggest that it is important to forge a broad consensus on what constitutes "a good loan," and a "fair process." Such a consensus building processes can be a useful first step in developing legislative and regulatory strategies that can command broad legislative support. Perhaps more significantly, failure to achieve this consensus risks moving forward with remedies that may harm the very individuals that the effort is designed to help, or generate new regulations that prove impossible to enforce.

Conclusion

Having now caught the attention of the Government Accountability Office, the Chairman of the Federal Reserve Board, the federal regulatory agencies, hundreds of policy analysts and opinion leaders, and hosts of other concerned organizations and individuals, the problem of abusive mortgage lending cannot be ignored or dismissed as the misguided efforts of a few "bad apples." Rather these abuses are rooted in the structure of the mortgage industry itself, particularly the incentives offered to mortgage brokers and loan officers to market and sell loans. Those concerned about the well-being of borrowers must take appropriate action to limit the damage caused by the current crop of complex non-prime mortgages.

Some may debate whether any particular product is suitable for a particular consumer. Certainly there remains considerable debate as to how best to proceed. However, it is important not to let the "perfect be the enemy of the good." Identifying new and innovative legislative and regulatory

approaches to improving the efficiency and fairness of the nation's mortgage markets is crucial. There can be no doubt that too many consumers are making ill-informed decisions by selecting mortgages products they will live to regret. The proposals presented here seek to combat the aggressive sales and marketing practices of some, while still recognizing the importance of involving consumers in important life choices. Rather than debate the false dichotomy between having more regulation or less regulation, it is far better to work to identify the appropriate level of market regulation and industry best practices and create sensible solutions that balance the important and sometime competing interests of both borrowers and lenders.

APPENDIX A: BLUE RIBBON ADVISORY COMMITTEE MEMBERS

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Ameriquest Mortgage Company

Steve Brobeck
Consumer Federation of America

Glenn Canner
Federal Reserve Board

James Garner
CitiGroup

Edward Gramlich
Urban Institute

Bill Longbrake
WaMu/
Financial Services Roundtable

Moises Loza
Housing Assistance Council

Patricia McCoy
University of Connecticut

Marc Morial
National Urban League

Samuel Myers
University of Minnesota

Sandy Samuels
Countrywide Financial Services

Ellen Seidman
ShoreBank Corporation/New America Foundation

Michael Staten
George Washington University

Eric Stein
Self-Help/Center for Responsible Lending

John Taylor
National Community Reinvestment Coalition

Terry Theologides
New Century Financial

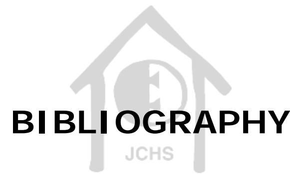
H. Robert Tillman
Federal Reserve Bank of Philadelphia

Susan Wachter
University of Pennsylvania

Ken Wade
Neighborworks America

Elizabeth Warren
Harvard University

Mark Willis
JPMorganChase



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