Making Mandatory Mortgage Disclosure Effective: Some Guidelines
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This article sets out some basic guidelines on how to make mandatory mortgage disclosure effective. It is largely based on the experience of the US, which has had extensive disclosure rules for several decades. Such guidelines should be useful to other countries that now face the need for mandatory disclosure, or will in the future.

Section I summarizes the basic case for mandatory mortgage disclosure. Sections II-VII set out some major guidelines for making disclosure effective.

I The Case For Mandatory Disclosure

Market-oriented economists opposed to all types of government regulation usually make an exception for markets characterized by extreme information asymmetry. It is well understood that markets don't work well when one party to transactions has vastly more information than the other.

Because mandatory disclosure is designed to make markets work better, it is viewed much more favorably than price controls, which distort the allocation of credit; or contract controls, which reduce the options available to consumers.

The home mortgage market is a textbook case of information asymmetry. One party is in the market continuously, the other very infrequently -- sometimes only once or twice in a lifetime. Furthermore, transactions can be extremely complex. There may be multiple instruments from which to select, multiple options with each instrument, complex pricing arrangements, and frequent price changes. For the borrower, there may be a lot to learn and very little time in which to learn it.

To be sure, complexity varies greatly from one country to another -- the US has the most complexity by far. Many other countries are moving in the same direction, however, propelled by the same forces that have operated in the US: the development of secondary markets and increasing competition. In the European Community, integration is intensifying these pressures. Countries moving rapidly toward greater complexity in their home loan markets, and therefore toward greater information asymmetry, will need to consider mandatory disclosure. Hopefully, the many mistakes made in the US can be avoided. Poorly designed disclosures can do more harm than good.

II Limiting Mandated Disclosures

Perhaps the most important principle for making disclosure policy effective is that the number of items that must be disclosed be limited to 10 per day. If the process extends over 2 or 3 days, the number of mandated items can be increased to 20 or 30. I will explain where these numbers come from shortly.

The rationale for this is that consumers have a limited attention span. If you feed them too much at one time, they can't absorb it. Disclosures in the US are so voluminous that for most borrowers they are useless. Disclosing everything has much the same effect as disclosing nothing, since most people will absorb nothing.

Beginning in 1998, I began writing a newspaper column on mortgages that invited questions from readers. I have fielded about 12,000 questions since then, and one recurs with amazing frequency: "Why wasn't I told about...?" The content of the question varies over time, e.g., in 2002 it was mostly about prepayment penalties. But the question usually applies to something that was in fact subject to mandated disclosure, as prepayment penalties are.

Every borrower in the US receives a Truth in Lending (TIL) disclosure that reveals whether or not the loan has a prepayment penalty. But this critical item is shown in the middle of a large form full of other information, some of it distracting, most of it useless. Further, the TIL is received by the borrower on the same day he receives multiple other disclosure forms.

As far as the regulator and the lender are concerned, disclosure about a prepayment penalty is made when the borrower receives the TIL. Yet a large percentage of borrowers in fact don't know whether or not they have one. Mandated disclosure is ineffective because of information overload.

Where did I get the 10 items of information referred to earlier as the limit on disclosed items? From my crystal ball. The correct number may depend on the nature of the disclosed item and many other factors, some of which will vary from country to country. I'm not trying to sell that particular number. I'm trying to sell the idea that there should be such a number.

Setting limits means setting priorities. As a general matter, setting the number low and selecting the most important items increases the probability that those items will be effectively disclosed. As the number of disclosed items increases to include items of less importance, the probability that the most important items will be effectively disclosed declines.

A reader has pointed out to me that some borrowers could extract what they need from the most overblown set of disclosures, suggesting that I have overstated the case. I don't agree. Borrowers who know what to look for don't need mandatory disclosure; they can get the information they want by asking for it. Mandatory disclosure is for borrowers who don't know what to ask for, and therefore don't know what to look for in voluminous disclosures.

III <u>Fixing Responsibility</u>

Responsibility for mandatory mortgage disclosures should be lodged in one agency. That agency can be held accountable for the results, whereas if there is more than one agency involved, none of them will be fully accountable.

With multiple agencies, furthermore, limiting the number of disclosure items will be extremely difficult. Neither agency is likely to consider the impact of the other on the borrower's capacity to absorb information. If the agencies are required to consult, expect a turf war in which each is convinced that its items should have priority. In addition, divided responsibility may lead to competing disclosure formats, which confuse borrowers.

The US experience, where responsibility has been divided between the Federal Reserve System (FRS), and the Department of Housing and Urban Development (HUD) illustrates all these problems. Each agency developed its own disclosure form, without any consultation with the other. The total number of items on the two forms is grossly excessive, with useful information on both forms intermixed with useless information. There is no way for a borrower to reconcile the information on the two forms. It is not at all clear, therefore, that borrowers are better off having both disclosures than having neither.

It is instructive to understand that divided responsibility seemed early on to be a completely logical solution to two different problems. One problem was a wide diversity in the way in which the cost of credit was calculated and reported between different types of credit, and by different lenders in the same market. The legislative remedy, called "Truth in Lending" (TIL), applied to all consumer loan markets, not just home mortgages. It was natural to delegate regulatory responsibility to the FRS which, as the central bank, had broad responsbilities for all loan markets.

The second problem was a series of abuses in connection with real estate settlement charges. The legislative remedy, called Real Estate Settlement Procedures Act (RESPA), pertained only to real estate markets. Hence, it was natural to delegate regulatory responsibility to HUD, which was the principal Federal housing agency.

However, if the application of TIL to the home loan market had been properly designed and administered, RESPA would never have been necessary. The FRS would have had sole responsibility for mandatory mortgage disclosure, and the disastrous results of overlapping jurisdiction would have been avoided.

IV Disclosing the Cost of Credit

The cost of credit is the centerpiece of mandatory disclosure. A critical requirement for effective disclosure of credit cost is comparability. A quoted credit cost of "6%" by lender A should mean the same thing as a 6% quote by lender B. Further, the true cost of a 6% mortgage should be identical to that of a 6% automobile loan and a 6% personal loan.

Conceptual uniformity: One requirement of comparability is conceptual uniformity. The most widely used concept for measuring interest cost is the internal rate of return (IRR). On a mortgage, the IRR is (i) in the equation below:

$$L - F = P_1 + P_2/(1 + i)^2 +\ldots (P_n + B_n)/(1 + i)^n$$

Where:

i = IRR

L = Loan amount

F = Upfront fees paid by the borrower

P = Periodic payment

n = Period when the balance is prepaid in full

B_n = Balance in period n

Expressing all interest cost quotes as an IRR creates comparability across a wide range of methods that have been used historically to calculate interest payments. For example, in the US a 6% home mortgage refers to an instrument on which interest each month is calculated by multiplying .5% (1/12 of 6%) by the balance in the preceding month. Assuming F is zero, the IRR on this mortgage is 6%.

A 6% 3-year consumer loan, however, refers to an instrument on which interest is calculated by multiplying 6% times the loan amount times 3. The IRR on such a loan, assuming monthly payments equal to the loan amount plus interest for 3 years divided by 36, is 11.09%. The quoted rates mean different things but the IRRs are comparable.

Similarly, in some countries, mortgage interest may be calculated quarterly, semi-annually or annually. The IRRs on 6% mortgages in these cases are 6.02%, 6.04% and 6.09%, respectively.

In administering Truth in Lending, the FRS adopted the IRR rule based on monthly interest payments.[1] It called the IRR the “annual percentage rate”, or APR. The APR provides a consistent method of calculating interest cost across a wide variety of instruments and practices. It was one important thing the FRS got right.

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[1] The APR is a “nominal” rate because it does not take account of monthly compounding. The “effective” APR on a 6% monthly payment mortgage with no fees, that does take account of monthly compounding, is 6.17%. In principle, it would be better to express all rates as effective rates because it would provide comparability between monthly and weekly or biweekly payment mortgages. As a practical matter, however, the differences are too small to justify the added complexities.

Period Over Which the IRR is Calculated: If a loan includes upfront fees, the IRR declines with the passage of time. For example, on a 6% 30-year loan of $100,000 with $4,000 in upfront fees, the IRR is 6.39% when calculated over the entire term. But if the balance is paid in full after 10 years, the IRR is 6.58%, and if full payment occurs after 5 years it is 6.98%. Which is the proper IRR?

This is not an academic question. Suppose a borrower was trying to choose between the loan above, and a 6.5% loan with no fees. The IRR on this loan is 6.5% regardless of when the loan is paid off, but whether this is higher or lower than the IRR on the first loan depends on when the other loan is paid off.

In mobile societies where few loans run to term, this is a major problem. The optimal way to handle it is to calculate the IRR over the period requested by the individual borrower. When generic IRRs are shown, as in media advertising, they could be shown at term and for 1 or 2 shorter periods, as in the example given earlier.

The FRS got this one wrong. It elected to calculate the APR at term, despite the fact that more than 90% of all home loans pay off before term. This has made the APR a misleading guide to borrowers with short time horizons.

Definition of Fees: The fees that should be included in the IRR are those that would not arise in an all-cash transaction. All fees associated with a refinance should be included, but on a purchase transaction fees that would arise if the borrower paid cash should not be.[2]

The fees should include payments to the lender of any type, plus payments to third parties providing services required by the lender as a condition for granting the loan. These include reporting on the credit history of the applicant, appraising the property, verifying and perhaps insuring the validity of title to the property, and insuring the mortgage.

[2] Another possible exception are fees paid to governments in connection with the loan, for example, a stamp tax or mortgage recording tax. Since these fees are outside of the lender's control, it doesn't make any difference whether they are included or excluded from the APR so long as treatment is uniform.

All such third party charges are part of the cost of credit and will be paid for, directly or indirectly, by the borrower. The biggest mistake made by the FRS was excluding most of them from the APR.

The prevailing market practice with regard to third party services was that lenders selected the service provider while borrowers paid for the service. This resulted in abusively high prices, even in the face of technology developments that would otherwise force prices down.[3]

Had the FRS defined the APR to include all third party services, competition among lenders would have obliged them to bundle all such services into their fees, and use their buying power to drive down the prices. Those that merely quoted prevailing high prices from third party service providers would find their APRs above the competition.

Because the Federal Reserve defined the fees included in the APR narrowly, they missed the opportunity to eliminate abuses in the markets for third partner services. This resulted in RESPA, which attempted (unsuccessfully) to curb abuses by making it illegal for third-party service providers to pay lenders for the referral of business.

V Disclosure of Other Contractual Provisions

Mandated disclosure also should include important provisions that may vary from loan to loan and that may be disadvantageous to the borrower. Examples include prepayment penalties, restrictions on assignability, late charges, and the right of the lender to call the loan. However, the list of such features is likely to vary greatly from one country to another.

Contractual provisions that are standardized by law or custom, or that benefit the borrower, need not be a part of mandatory disclosures.

VI Testing Disclosures With Borrowers

[3] Prices rise for two reasons. First, because lenders are the gatekeepers to the borrower, third party service providers attempt to curry favor with lenders by offering them kickbacks or free services. This is sometimes referred to as "perverse competition" because it increases the costs of service providers. Second, borrowers have little to no leverage because they must deal with the approved service provider, and because they usually do not know exactly what the charge is until it is too late to back out.

The agency with responsibility for mandatory mortgage disclosure should be required to test disclosure forms with borrowers for effectiveness. If not required to do this by law, the natural inclination of a disclosure agency is to check only its political constituencies. These might include, for example, lenders, developers, and community groups, but not borrowers.

Since the agency responsible for disclosures is not likely to have the skills needed for testing effectiveness, there is much to be said for mandating that the agency contract with a private firm to do this work. The firm would be charged with determining the extent to which borrowers understand and digest the information disclosed, and also whether the proper information is being disclosed. Since markets, instruments and contracts change over time, the review function should be repeated periodically.

VII Concluding Comment

The US experience provides some important lessons about mandatory disclosure: a) Disclosures should be limited to a specified number of items; b) Responsibility should be fixed in one agency; c) An IRR to measure interest cost can create uniformity across all loan types and markets;
d) When applied to the home loan market, the IRR should be calculated over multiple periods or borrower-specific periods; and e) Fees should be defined broadly to include all third party services required by lenders.