Protecting Mortgage Borrowers

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Why Do Borrowers Need Protection?

- **Transaction is Complicated**
  - » Lender writes the contract
  - » Borrower may not see it until closing
  - » The more complicated, the more the potential for abuse
- **Pricing Is Complicated**
  - » Multiple price dimensions
    - – Rate, lender fees (%), lender fees ($), third-party service fees
  - » Lender prices subject to change until they are locked
  - » Third party charges not covered by lock
- **Some Mortgages Are Complicated**
  - » Some are meretricious -- falsely attractive

Why Borrowers Need Protection (Continued)

- **Transaction is Time-Consuming**
  - » Home buyers reach a point of no-return where they can't back out
  - » Lender can take advantage to change the deal.
- **Borrowers Transact Infrequently**
  - » Little opportunity to learn from experience
  - » Gap between borrower knowledge and lender knowledge is very large
- **Transaction is Large, Therefore Important**

Some
Abusive Practices in the US

- ***Overcharge:*** Charge higher prices to borrowers who are naïve, trusting and don't shop alternatives.
- ***Price Low-Balling:*** Quote low price to "hook" borrower, raise price when it is too late for the borrower to back out.
- ***Price Omissions:*** Omit one or more price components in the quote, reveal it later when it is too late.
- ***Market Niche Misclassification:*** Classify borrower in a higher risk category that carries a higher price.
- ***Abusive Referrals:*** Refer borrower to high-price third party affiliate.
- ***Steer****:* Sell meretricious loans especially refinances.
- ***Contract Chicanery***: Slip something into the contract that disadvantages the borrower

The Most Important Principal of Borrower Protection

• DO NO HARM

- It is Much Easier to Hurt Than to Help
- Law of Unintended Consequences Has a Permanent Home in the Mortgage Market
- There Is Only One Way to Escape It: Learn From the Experience of Others
  - » The US has made most of the mistakes it is possible to make

Types of Protection

- **Price Controls**
  - » Government sets maximum prices
- **Contract Controls**
  - » Government rules what must be, and what cannot be in a loan contract
- **Underwriting Controls**
  - » Government sets limits on lending terms
- **Disclosure Rules**
  - » **What** information must be disclosed to borrowers
  - » ***How*** information must be disclosed to borrowers
  - » ***When*** information must be disclosed to borrowers

Price Controls

- **Mortgages Have At Least 3 Prices**
  - » Interest rate, lender fees, third party fees
  - » In US, also have "points"
  - » ARMs have many more price components
- **Each Price May Be Disclosed at Different Times in the Process**
  - – Even timely disclosures can be bewildering
- **This Creates Problems For Borrowers**
  - » What types of controls would help them?

Controls on Interest Rates

- Interest Rate Is the Most Important Price Component, Because it is Paid Over Loan Life
  - » Other prices are all paid upfront
- So Long as There Are Competing Lenders, the Interest Rate Should Not Be Controlled
  - » If Government sets rate too low, no loans will be made
  - » If it sets the rate too high, that rate will become the market rate, which otherwise would have been lower
- Objective: Allow Borrowers to Shop Rate Without Concern About Other Mortgage Price Components

Controls on Lender Fees

- **Objective is Uniformity of Lender Fees**
- **Government Should Set the Charge If Needed to Assure Uniformity**
- **Set as Fixed Amount, Not Percent of Loan**
- **Second Best Is to Require Every Lender to Post One Uniform Price**

Controls on Third Party Charges

- **Services Provided by Third Parties**
  - » Appraisal, credit report, title insurance, flood insurance, mortgage insurance, property survey
- **Golden Rule: Any Service Required by the Lender, Must Be Paid For by the Lender**
  - » The charges will then be covered by the rate
    - – They will cost the borrower less that way
  - » With this rule, and lender fees uniform, borrower needs deal only with the interest rate

Why Third Party Charges Cost Less When Purchased by Lenders

- Lenders Purchase Many, Borrowers Purchase One
- Lenders Are Knowledgeable, Borrowers Aren't
- If Lenders Purchase, Competition by Service Providers Reduces Prices
- When borrowers purchase, lenders select service provider and collect referral fees, raising costs
  - » "Perverse competition"
- If They Must Pay For a Service, Lenders Often Learn to Do Without It

Contract Controls

- **Is Product Feature Used to Abuse Borrowers?**
- **Quiz: Which of These Should Be Banned?**
  - » Lender right to demand immediate repayment for any reason
  - » Balloon provision
  - » Prepayment penalty
  - » Negative amortization
- **All But the First Have Valid Uses**
- **Avoid Contract Controls Until Experience Shows They are Needed**
- **Rule Is Needed on When a Borrower Sees Contract**
  - » Three days before closing is reasonable

Underwriting Controls

- **Examples**
  - » Minimum down payment
  - » Maximum term
  - » Required documentation
- **Two Objectives**
  - » Control lender risk
  - » Prevent borrowers from taking loans they won't be able to pay
- **Underwriting Controls Generally a Bad Idea**
  - » Usually lenders are conservative enough
  - » But not during a bubble!
    - – If a minimum down payment of 10% had been imposed in 2004, the worst excesses leading to the crisis would have been avoided.

Disclosure Requirements

- **One Major Advantage of Disclosure Over Other Types of Borrower Protection**
  - » The cost of doing it wrong is usually small
  - » Lender costs increased with no benefit to borrowers
- **Bad Contract Controls Reduce Options**
- **Rate Controls Can Reduce the Supply of Loans**
- **Still, You Want Disclosure Rules That Work**
  - » A long-run cost of poor mandatory disclosure: it discourages improved private disclosure

Making Disclosure Rules Work: Setting Limits

- **Limit Number of Items Subject to Rule**
  - » Regulators should set priorities
  - » Increases likelihood it will be done right
- **Borrowers Have Limited Attention Span**
  - » Excessive disclosure makes it less likely that the borrower will find what is important
  - » Disclosing everything is the same as disclosing nothing, because nothing will be absorbed
  - » Less of a problem if borrower sees documents before closing

Making Disclosure Rules Work: Fixing Responsibility

- **Divided Responsibility Is Likely**
  - » Construction is likely to be under one department, mortgages under another
- **Consequences**
  - » Excessive requirements in total, as neither agency considers requirements of the other
  - » Competing disclosure formats
  - » In the US, we have had both problems

Making Disclosure Rules Work: Disclosing the Interest Rate

- **A Uniform Method of Calculating the Interest Rate Is Critical to Effective Disclosure**
  - » A 6 % quote by lender A should mean the same thing as a 6% quote by lender B.
  - » A 6% mortgage loan should mean the same as a 6% automobile loan or a 6% personal loan.
- **Multiple Ways to Calculate Interest Rate Tend to Arise in a Free Market**
- **A Single Method Must Be Defined & Mandated**
  - » Payment calculation period
  - » Payment period
  - » Interest accrual period
  - » If interest accrual period<payment period, simple or compound

Making Disclosure Rules Work: Disclosing Other Contract Features

- **Important Features Vary With Loan Type**
- **Principles of Selection**
  - » Limit the number to avoid borrower overload
  - » Don’t mandate disclosure of:
    - – Provisions benefiting borrower
    - – Provisions that are standardized
  - » Do mandate disclosure of:
    - – Provisions that are disadvantageous to borrowers
    - – Provisions that may vary from lender to lender

Making Disclosure Rules Work: Role of Different Participants

- **There Are No General Rules Regarding Who Should Participate in Formulating Disclosure Rules**
- **Lenders**
  - » Have expertise, so their input is necessary
  - » But their objective is minimizing compliance cost
  - » Could be made responsible subject to approval
- **Gov't Officials**
  - » Usually don't have expertise, must rely on others
  - » Subject to political pressures from affected groups
- **Consumer Organizations**
  - » Ideally, have expertise and represent consumer interest
  - » In practice, they usually represent consumer groups

Making Disclosure Rules Work: Role of Different Participants (Con'd)

- **Legislature**
  - » Should authorize general structure, not details
  - » Avoid active involvement
    - – Usually won't act except in crisis
    - – In crisis, tend to act in haste
- **Consumers**
  - » Disclosures should be tested with consumers
  - » But consumers may not be good judges of the information they need
    - – See Will Early Disclosures Prompt Borrowers to Shop?
- Quasi-Public Body to Certify Lender Disclosures
  - » Charge would be to seek adequate and standard disclosures

How Not to Do It: The US as a Case Study

- **Overload the Borrower**
  - » Disclosing everything is the same as disclosing nothing
  - » Disclosures Under Four Federal Laws
    - – Truth in Lending Act – borrowing costs
    - – Real Estate Settlements Procedures Act – settlement costs
    - – Equal Credit Opportunity Act – fairness
    - – Gramm Leach Bliley Act -- privacy

How Not to Do It: The US as a Case Study

- **Involve the Legislature in Rule-Making**
  - » Congress has defined “finance charges”
  - » Congress has mandated specific disclosures
  - » Both done very badly
- **Divide Operating Responsibility Between Different Government Agencies**
  - » HUD & FRB have separate required disclosures on credit costs: Truth in Lending (TIL) and Good Faith Estimate (GFE)
    - – There is no way to reconcile them

How Not to Do It, Con'd

- **Leave Consumers Out of Rule-Making**
  - » Disclosures are never tested with consumers
  - » Only Government, lenders and consumer advocacy groups are involved
  - » When they were finally consulted, the Fed listened too carefully!
- **Leave no Scope For Better Private Disclosure**
  - » Providing better information than that in the Government-mandated disclosures would expose lenders to liability