

SUMMARY OF FINDINGS

Consumer Testing of Mortgage Broker Disclosures

Submitted to:

Board of Governors of the Federal Reserve System

Submitted by:



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Summary of Findings



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Executive Summary



Executive Summary

In January 2008 the Board of Governors of the Federal Reserve System (the Board) issued proposed amendments to Regulation Z, which implements the Truth in Lending Act (TILA) and the Home Ownership and Equity Protection Act (HOEPA).¹ The purposes of the amendments were to restrict home mortgage lending and servicing practices that the Board found to be unfair or deceptive; to ensure that mortgage loan advertisements are accurate, balanced, and not misleading; and to require that certain disclosures be provided to consumers earlier in the mortgage loan process. One of the Board's proposed amendments would prohibit creditors from paying mortgage brokers unless the mortgage broker disclosed to potential customers three things: a) the total amount of compensation that the broker will receive for arranging a loan; b) that the consumer will pay that entire amount, even if some or all is paid by the lender; and c) that such a payment from a lender could influence the broker to offer the consumer loan terms or products that are not the most favorable the consumer could obtain. Under the proposed rule, these disclosures would have to be provided early in the mortgage transaction, before the consumer submits a loan application or pays any fee.

The Board's proposed amendments included model language that was intended to provide the above disclosures in a manner that would be clear and understandable to consumers. The Board contracted with Macro International to test this model language through a series of cognitive in-depth interviews with consumers. The goal of these interviews was to assess how clearly the model language communicated the intended content, and to help the Board make any necessary revisions to make the language more effective.

Methodology

Macro conducted four rounds of consumer testing in March through May 2008: two in Washington, DC, and one each in Los Angeles, CA and Kansas City, KS. A total of 35 separate interviews were completed: 31 with individuals and 4 with couples who had jointly made mortgage decisions. Interviews lasted between 60 and 90 minutes. Participants for the interviews were recruited by telephone, and were selected because they had all obtained or refinanced a mortgage in the past two years. Potential participants were also screened to include a range of ethnicities, ages, and education levels. In an effort to ensure that interviews were conducted with subprime as well as prime borrowers, Macro and Board staff developed a series of three questions about participants' credit history and current mortgage interest rates which were used as a proxy for such borrowers.

For each round of testing, Macro and Board staff developed an agreement for a fictional broker that included the information about broker compensation as required in the Board's proposal. In the interviews, participants were asked to imagine that they had met with a broker who had given them this agreement to read and sign. As they read the agreement participants, were asked to communicate their reactions to it, including whether they found any information surprising and how they perceived the broker who had given it to them. After they finished reading, they were then asked a series of follow-up questions to test their understanding of what the agreement was trying to communicate.

¹ As of July 8, 2008, the Federal Register notice for this proposed amendment could be found at: <http://edocket.access.gpo.gov/2008/pdf/E7-25658.pdf>.

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Following each round of interviews, Macro and Board staff discussed what had and had not worked well. Macro then revised the agreement for use in the next round that was intended to address any comprehension problems that had become apparent. This iterative process continued through all four rounds of testing.

Findings

The agreements that were tested, particularly later versions that were revised based on results from early interviews, were successful at communicating certain pieces of information to participants. For example:

- ▲ The language used in all rounds successfully communicated the amount of the broker's commission to participants, as well as the fact that they would have to pay that commission. Some participants in early rounds incorrectly believed that they would have to pay this commission regardless of whether they closed on a loan through that broker; this misconception was addressed through revisions in the language.
- ▲ Participants in the first round of testing did not understand a key implication of the agreements—that the best way to ensure that they received a loan with favorable terms was to shop among different brokers and lenders. Because Board staff identified this as an important communication goal, an explicit statement about the importance of shopping was added to the agreements that were tested in later rounds. These later versions were more effective in communicating to participants the importance of shopping for a mortgage.

However, Macro's testing showed that several other comprehension issues remained, despite repeated attempts to address them through revisions of the agreement. These misunderstandings included:

- ▲ Most participants who read the agreements did not understand how lender payments to brokers created a financial incentive for brokers to provide loans with higher interest rates. While some initially understood that brokers receive more compensation for providing loans with a higher interest rate, this fact was extremely counter-intuitive to participants—many of whom had previously assumed that a broker would work in their best interest. As a result, a significant number had difficulties comprehending and rationalizing the conflict of interest described in the agreement.
- ▲ A key reason that participants had difficulty understanding this conflict of interest is that many did not understand how the interest rate on their loan is determined, and thus did not realize that brokers have influence over the rates they offer their customers. Some participants assumed that the interest rates that brokers provided were set by the lender based on creditworthiness alone, and did not know that the broker could have latitude in deciding which loans and what interest rates to offer.

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- ▲ In some cases, the broker agreement seemed to bias participants against working with a broker—particularly those who learned for the first time that brokers' compensation depends on the interest rates of the loans they offer. To address this bias, an explicit statement was added to the agreement that loan officers who work for lenders have the same conflict of interest as brokers, and that as a result borrowers would not necessarily save money by working directly with a lender. Despite this statement, however, some participants still believed that they would pay less commission when working directly with a lender.
- ▲ In some cases, the agreements being tested also led to an additional bias against brokers that was unrelated to any conflict of interest. Some participants were uncomfortable that a broker would discuss his or her commission in such detail before providing any services, and felt that this showed the broker was overly concerned with his or her own compensation.
- ▲ Several participants in different rounds commented that they found the broker agreement internally inconsistent in that it seemed to fix the commission at a certain amount but then stated that the broker received greater compensation for providing loans with higher interest rates. When asked how they would resolve this perceived contradiction, participants either ignored the text about increases in broker compensation and assumed that the amount was fixed, or assumed that the broker would receive a separate payment from lenders in addition to the amount shown. This latter belief—that the broker would receive two separate payments—often led to bias against the broker.
- ▲ Participants in the first three rounds did not understand that if a lender paid all or some of the broker commission, it would mean that the interest rate on their loan was higher than it otherwise could be. Most thought that language about lender payment of the commission was simply informing them that they could "roll" the fee into their loan. In the final round of testing in Kansas City this comprehension issue was addressed by explicitly stating in the broker agreement the different ways that a borrower could pay the commission. However, even when it was explained that their interest rate would be higher if the lender paid the broker's commission, participants did not connect this to the conflict of interest mentioned elsewhere in the agreement.

Introduction



Introduction

Background

On January 9, 2008, the Board of Governors of the Federal Reserve System issued proposed amendments to Regulation Z, which implements the Truth in Lending Act (TILA) and the Home Ownership and Equity Protection Act (HOEPA).² The purposes of the amendments were to restrict home mortgage lending and servicing practices that the Board found to be unfair or deceptive; to ensure that mortgage loan advertisements are accurate, balanced, and not misleading; and to require that certain disclosures be provided to consumers earlier in the mortgage loan process.

One of the Board's proposed amendments would prohibit creditors from paying mortgage brokers unless the mortgage broker disclosed to potential customers three things: a) the total amount of compensation that the broker will receive for arranging a loan; b) that the consumer will pay that entire amount, even if some or all is paid by the lender; and c) that such a payment from a lender could influence the broker to offer the consumer loan terms or products that are not the most favorable the consumer could obtain. Under the proposed rule, these disclosures would have to be made before the consumer submits a mortgage application or pays any fee in connection with the transaction. The rationale for this proposed rule was that consumers are not aware that brokers receive payments from lenders that are based on the interest rate of the loan or other loan features. Moreover, the Board stated in its proposal, many consumers incorrectly assume that brokers are working "in their best interest"—that is, that the loans brokers arrange have the best terms available to the consumer. As a result, consumers may not see any need to shop with other lenders or brokers to find the best loan.

The Board's proposed rule included model language that was intended to provide the disclosures described above to consumers in a clear and easily understandable manner. In order to test the effectiveness of this model language, the Board contracted with Macro International to conduct a series of cognitive in-depth interviews with consumers. The goal of these interviews was to assess how clearly the model language communicated the intended content, and to help the Board make any necessary revisions to the language to make it more effective.

As part of this project, Macro conducted a total of four rounds of testing. A total of 35 separate interviews were completed. In most cases these interviews were with individuals—however, in four cases, couples who had jointly made a mortgage decision were interviewed together (Table 1).

² As of July 8, 2008, the Federal Register notice for this proposed amendment could be found at: <http://edocket.access.gpo.gov/2008/pdf/E7-25088.pdf>.

Introduction

Table 1: Interviews of Participants

Location	Date of Interviews	Total Interviews	Dyad Interviews (Couples)
Washington, DC	March 4 & 6, 2008	7	0
Los Angeles, CA	March 25-26, 2008	7	1
Washington, DC	April 30 & May 1, 2008	10	0
Kansas City, KS	May 13-14, 2008	11	3
Total		35	4

Recruitment of Participants

Interview participants were recruited by telephone using a structured screening instrument developed by Macro International and Board staff. Participation was limited to people who had obtained or refinanced a mortgage in the past two years and were the primary mortgage decision-maker in their households. Participants were screened out if they worked for a bank or other financial institution, or if they worked in the real estate or mortgage industry. Other questions ensured the recruitment of participants with a range of ethnicities, ages, education levels, and mortgage behavior. The recruiting screener used for the final round of interviews in Kansas City is provided as Appendix A; while the screener for other rounds varied slightly, the intent of the screening questions was essentially the same.

Table 2 provides a summary of information about the interview participants and their mortgage history. A more detailed table, which includes the breakdown for each round of testing, is provided in Appendix B.

One of Board staff's recruiting goals was to ensure that interviews were conducted with both prime and subprime borrowers. Because many consumers do not know their credit scores or are reluctant to share them, it was determined that credit score could not be used as a screening variable for the purposes of recruiting. Therefore, participants were defined as "subprime" if they had: a) suffered a "financial hardship" such as bankruptcy, foreclosure, repossession, or a tax lien in the past seven years; b) been denied credit or discouraged from applying for credit in the past two years; or c) received an interest rate higher than 8 percent on their most recent first mortgage (or 10 percent on their most recent second mortgage). These cutoff points on the interest rate screening questions for borrowers with subprime loans were set to be roughly consistent with the Home Mortgage Disclosure Act (HMDA) APR-based thresholds for reporting higher-priced loans over the 2006-2007 period. Twelve of the 35 interviews qualified as "subprime" using this proxy definition.

Introduction

Table 2: Summary of Participant Background Information (N=35)^{3,4}

Personal Information	
Gender	
Male	13 (37%)
Female	22 (63%)
Age	
18-35	11 (31%)
36+	24 (69%)
Race	
Caucasian	16 (46%)
African-American	15 (43%)
Hispanic	4 (11%)
Education Level	
High school or less	4 (11%)
Some college or more	31 (89%)
Current Number of Mortgages on Primary Residence	
One	31 (89%)
Two or more	4 (11%)
Adjustable Rate Mortgage in Past 5 Years?	
Yes	22 (63%)
No	13 (37%)
Financial Hardship (e.g., bankruptcy, foreclosure) in Past 7 Years?⁵	
Yes	1 (3%)
No	34 (97%)
Denied Credit or Discouraged From Applying in Past 2 years?⁵	
Yes	7 (20%)
No	28 (80%)
Information About Most Recent Mortgage Loan	
Reason for Loan	
Refinance	20 (57%)
Home purchase	15 (43%)
Method of Obtaining Loan	
Through broker	9 (26%)
Directly from lender	24 (69%)
Don't know	2 (6%)
FHA or VA Loan?	
Yes	5 (14%)
No	30 (85%)
First-Time Home Buyer?⁶	
Yes	7 (47%)
No	8 (53%)
Current Interest Rate Above the Threshold?^{5,7}	
Yes	4 (11%)
No	31 (89%)

³ Percentages may not add to 100 because of rounding.

⁴ In the case of dyad interviews, the information shown in Table 2 is from the member of the dyad who was recruited and screened by telephone.

⁵ Participants' responses to these three questions were used to identify them as likely prime or subprime borrowers.

⁶ Only respondents whose most recent mortgage was for a home purchase (as opposed to a refinance) answered this question.

⁷ Respondents were classified as "subprime" if they reported having an interest rate higher than 8 percent for a first mortgage and 10 percent for a second or third mortgage. These cutoff points were set to be roughly consistent with the Home Mortgage Disclosure Act (HMDA) APR-based thresholds for reporting higher-priced loans over the 2006-2007 period.

Introduction

Structure of Report

In the remainder of this report, each of the four rounds of testing is addressed in a separate chapter. Each chapter reviews the goals of that round, as well as the structure of the interview protocol and changes that were made to the documents that were tested. It then provides a summary of the findings from that set of interviews. At the conclusion of the report, we provide an overall summary of findings from all four rounds combined.

Round One of Testing

Washington, DC

March 4 & 6, 2008



Round One of Testing

Washington, DC / March 4 & 6, 2008

Goals and Structure of Testing

The first round of testing consisted of seven in-depth interviews in Washington, DC. The goal of this round of testing was to evaluate how successfully the proposed language communicated to participants that:

- a. The borrower will be responsible for paying the broker the fee shown on the agreement;
- b. If the lender pays this fee the borrower will end up paying it back to the lender through a higher interest rate; and
- c. If the broker receives this payment from a lender, the broker has an incentive to arrange a loan with a higher interest rate.

At the beginning of the interview each participant was asked to describe his or her experience shopping for and obtaining mortgages in the past two years. The purpose of this section of the interview was to learn more about how participants made decisions related to their mortgage, as well as their understanding of the loan application process.

Two different broker agreements were used in this round of testing. Version A was for a fictional broker named "Home Safe Loans" and was based on a model broker agreement that originally was developed by industry. Variations of this agreement have been used widely in a number of states. For comparison purposes, a second agreement (Version B, for a fictional broker named "EZ Loans") was used that contained elements of another agreement in use in the market. Both were titled "Mortgage Loan Origination Agreement," and began with two paragraphs describing the nature of the relationship between the applicant and the broker. The most important difference between the two agreements was the section titled "Our Compensation." In both cases, this section indicated that the brokers' fee would be \$3,100 for arranging a loan and noted that if the lender paid a portion of this fee, the interest rate on the loan would be higher.⁸ However, the wording of the agreements was significantly different; Version A included the Board's proposed model disclosure text in this section, while Version B used alternative language to describe the same content.

Participants were shown an agreement and asked to read it just as they would if they were given the document by an actual broker. The participant was asked to "think aloud" while reviewing the document—that is, to verbalize what they were thinking as they read, and comment if they saw anything that surprised or confused them. After the participant finished reading, the interviewer asked several follow-up questions designed to measure comprehension of key concepts.

On the first day of testing, each participant was then given the second version of the disclosure, and the same protocol was repeated. The order in which participants were shown the two agreements was rotated to minimize learning effects and order bias. However, Macro found that when comparing the two agreements, participants focused almost exclusively on the differences in how the agreements broke out the amount of the commission. Since this difference was not relevant to the testing and was distracting, on the second day each participant was only shown Version A. The interviewer's guide for this round of testing is provided as Appendix C. The two agreements that were tested are provided as Appendix E.

⁸The amount of the fee that was listed on the agreements used in testing was adjusted for different testing locations, and was determined according to the median loan amount in that region (derived from Home Mortgage Disclosure Act data). The estimated fee was based on anecdotal information that broker compensation is often 1 to 2 percent of the loan amount.

Round One of Testing

Washington, DC / March 4 & 6, 2008

Findings

Understanding of the Role of Brokers

- ▲ Most participants had some level of understanding of the difference between “brokers” and “lenders.” However, there were some participants who were less clear on the difference and used these terms interchangeably. Similarly, a few participants were unsure of whether they had used a broker or a lender when procuring their most recent mortgage. This pattern was consistent throughout all rounds.

Understanding of Broker Compensation

- ▲ All participants were able to identify the amount of the broker fee, regardless of which agreement they were reading.
- ▲ Version B separated the broker fee into three components (an application fee, a processing fee, and a broker fee equal to 1 percent of the loan amount), while Version A provided a single dollar amount without additional detail. Participants consistently preferred Version B’s treatment of the broker fee, because they felt it provided more explanation as to how the amount was determined. When asked to compare the two agreements, this was the only difference that was important to participants; some indicated that this difference alone would make them more likely to work with the broker described in Version B.
- ▲ When reading the agreements, most participants focused their attention almost exclusively on the dollar amounts shown and often ignored the details of compensation described in the narrative agreement; participants were most interested in the amount of the fees.
- ▲ Several participants incorrectly assumed that they would have to pay the dollar amount shown on the agreement to the broker regardless of whether they closed on a loan arranged by that broker.

Conflict Between Broker Compensation and Best Possible Loan Terms

- ▲ After reading both agreements, about half of participants understood that brokers would not necessarily provide a loan with the lowest rate. In most instances, however, they did not understand why this was the case. Participants’ concern seemed to arise from phrases in the disclosure referring to “loan products and terms...which may not be in your best interest or may be less favorable than you could otherwise obtain.” However, it was not clear that participants understood exactly why the broker would provide terms that were less favorable.
- ▲ Most participants were surprised to read that the broker did not guarantee the lowest interest rate, because they had previously assumed that a broker’s responsibility was to provide the best possible loans for his or her customers. One participant reflected this view by saying after reading the agreements, “It should be guaranteed that they will try to find the best loans...Why can’t they guarantee it?”

Round One of Testing

Washington, DC / March 4 & 6, 2008

- ▲ Several participants felt more negatively towards brokers upon learning that brokers would not necessarily provide the best possible loan. One such participant commented about the fact that a broker might not provide the loan with the lowest interest rate “makes me suspicious.”

Payment of Compensation by Lender

- ▲ Neither agreement effectively communicated the relationship between interest rate and broker compensation. Even after reading both agreements, few participants understood that if the lender paid any part of the broker’s commission it would mean an increase in the interest rate for the borrower. Nearly all participants—even those that understood that brokers’ compensation depended on the interest rate of the loan—were confused by phrases like “the lender will increase your interest rate if the lender pays any part of this amount” on Version A, or by the reference to “points” in Version B.

Conclusions

The agreements that were tested in the first round successfully communicated to participants the amount of the commission the broker would receive. However, a number of other important concepts were not clearly communicated to participants, including:

- ▲ The situation in which the participant would have to pay a broker commission (i.e., only if they closed on a loan the broker arranged);
- ▲ The reasons why a broker might not provide the best possible loan; and
- ▲ The relationship between interest rate and broker compensation.

Based on these findings, a number of revisions were made to the language about broker compensation that was being tested. In addition, changes were made to the testing protocol to focus participants’ attention more directly on the language being tested. These changes are described in the following section of this report.

THE FULL DOCUMENT IS AVAILABLE IN THE OIRA DOCKET LIBRARY
