When Does Economic Research Influence Public Policy? Lessons Learned from Two Decades at the Federal Trade Commission

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Disclaimer

The views presented here are those of the author and do not necessarily represent the views of the Federal Trade Commission or any individual Commissioner.

Summary of Joint Work

- Much of this was developed with my colleague James Lacko and has been summarized in various presentations and policy comments

Goals

I. FTC and Economics of Consumer Information Policy Background

I. FTC Staff Research Examples

I. Research & Public Policy Outcomes

I.
Economics of Consumer Policy
Background

Federal Trade Commission

- Only federal agency charged with protecting consumers and promoting competition in broad sectors of the economy.

- Have studied consumer information in many markets.

  – Markets work better if consumers understand what they are buying and how much they are paying.
  – Although disclosures can help consumers understand product offerings and prices, they must be carefully crafted to ensure they will work as intended.

Consumer Policy Tools

- Inform Consumers

- Educate Consumers

- Regulate Product Characteristics

Relevant Academic Literatures

- Traditional Economics
  - Household Production
  - Economics of Information
- Marketing Research
- Behavioral Economics

FTC Staff Research

- *While economists exert influence on policy through their work on individual cases, their primary influence often results from their research. The influence of FTC research might be felt soon after a study is published (as illustrated by the FTC's recent study on mortgage broker compensation disclosures) or a decade later (as illustrated by FTC research on health claims in advertising).* (Froeb, Hosken, & Pappalardo, 2004)

II.

Examples of FTC Staff Research

Bottom Line

- Many lawyers, economists, and legislators believe that they can devise effective consumer disclosures
- Many believe that disclosures will at worst, do no harm
- Our research shows that well-intentioned disclosures can mislead consumers
- Consumer research – solid quantitative research– can substantially affect public policy

Potential Benefits of Mandatory Disclosures are Substantial

- Educate consumers and prevent deception
- Reduce search costs and facilitate comparison shopping
- Improve consumer decisions
- Promote efficient markets

But Disclosure Policy Is Tricky

- Is the disclosure really needed?
  - Would the information improve consumer decisions?
  - Why isn’t market voluntarily supplying information?
- Is the disclosure feasible?
  - Does a valid metric exist to impart information?
  - Can the information be effectively communicated?
- Will the disclosure work as intended?
  - How will consumers interpret and understand it?
  - How will it affect consumer decisions?
  - Will it help some consumers but harm others?

Broker Disclosure Study

- *Lacko and* Pappalardo, *The Effect of Mortgage Broker Compensation Disclosures on Consumers and Competition*, FTC Bureau of Economics Staff Report (2004) at www.ftc.gov/os/2004/01/030123mortgagefullrpt.pdf.

Proposed Mortgage Broker Compensation Disclosure

- Part of new Good Faith Estimate proposed by HUD in 2002
- Prominent disclosure of compensation paid to the broker by the lender
  - Primarily yield spread premium (YSP) paid for above-par loans
- Direct lenders exempt

Comparison of Broker and Direct Lender Disclosures

Proposed origination charge disclosures for a hypothetical loan offered by a broker

A. Origination Charges (HUD-1 800 Series)* $ 4,000.00

See Attachment A-1 listing origination charge subtotals for the lender and the broker.

B. Interest Rate Dependent Payment (200, 900)***

Until you lock in your interest rate these payments may change.

(1) (+) Borrower Payment to Lender for Lower Interest Rate: $_______

(2) (-) Lender Payment to Borrower for Higher Interest Rate: - $ 2,500.00

NET LOAN ORIGINATION CHARGE DUE FROM BORROWER (Sum of A and B): $1,500.00

Proposed origination charge disclosures for the same loan offered by a direct lender

A. Origination Charges (HUD-1 800 Series)* $ 1,500.00

See Attachment A-1 listing origination charge subtotals for the lender and the broker.

B. Interest Rate Dependent Payment (200, 900)***

Until you lock in your interest rate these payments may change.

(1) (+) Borrower Payment to Lender for Lower Interest Rate: $_______

(2) (-) Lender Payment to Borrower for Higher Interest Rate: $_______

NET LOAN ORIGINATION CHARGE DUE FROM BORROWER (Sum of A and B): $1,500.00

FTC Staff Concerns about the YSP Disclosure

- Unnecessary
- Unlikely to benefit consumers
- May confuse consumers (lead to a focus on compensation rather than costs)
- Result in worse loan choices
- Disadvantage brokers
- Harm competition

FTC/BE Study Objectives

Examine the impact of YSP disclosures on:

- Consumer ability to compare loan costs
- Consumer loan choice
- Competition in the mortgage loan market

Test Setting

- Respondents shown cost information about two mortgage loans
- Asked two main questions:
  - Identify the less expensive loan
  - Loan choice if shopping for a mortgage

Test Loans

- Respondents shown 2 loans
  - One treated as a “broker” loan
  - One treated as a “direct lender” loan
- Followed proposed disclosure policy in YSP disclosure groups
  - Broker loan – YSP disclosed
  - Direct lender loan – YSP not disclosed
- Loans not identified as broker or lender loans

Tests Conducted Twice

- Two loan cost scenarios
  - Broker loan less expensive
  - Both loans cost the same

Five Test Groups

- 3 versions of YSP disclosure tested
  - Differed in wording of disclosure
  - Two different disclosure form formats
- 2 control groups
  - One for each format
  - YSP disclosure omitted

Consumer Sample

- 517 recent mortgage customers
  - Obtained a mortgage in the previous 3 years or currently shopping for a mortgage
  - 103-104 in each of 5 test groups
- 8 locations across the country

Results

Broker Loan Less Expensive
Identification of Less Expensive Loan

- Percentage of respondents correctly identifying the less expensive loan
  - Without YSP disclosure: 89-90%
  - With YSP disclosure: 63-72%

Results

Broker Loan Less Expensive
Loan Choice If Shopping

- Percentage of respondents choosing the less expensive loan
  - Without YSP disclosure: 85-94%
  - With YSP disclosure: 60-70%

Results

Identical Cost Loans
Identification of Less Expensive Loan

- Percentage of respondents:

	Both same	Broker loan	Lender loan
– Without YSP:	95-99%	1-2%	0-3%
– With YSP:	49-57%	5-11%	30-45%

Results

Identical Cost Loans
Loan Choice If Shopping

- Percentage of respondents:

	Either loan	Broker loan	Lender loan
– Without YSP:	78-83%	1-7%	3-7%
– With YSP:	25-30%	5-17%	46-57%

Conclusions

Broker compensation disclosures:

- Reduce the proportion of consumers correctly identifying the less expensive loan
- Reduce the proportion of consumers choosing the less expensive loan if they were shopping
- Lead to a significant anti-broker bias that may have anti-competitive effects on the mortgage loan market

Potential Impact

- Difficult to estimate actual impact on the market, but it could be quite large.
- In the experiment, the YSP disclosure led about 20% of respondents mistakenly to choose a loan that was $300 more expensive than the alternative.
- If a similar result occurred across all mortgage customers, that would result in hundreds of millions of dollars in added costs paid by consumers each year.

This Does Not Mean that Disclosure Policy Cannot Work

- Simple, clear disclosures can be very effective in conveying important information to consumers
- Illustrated by our control group results
  - About 90% of respondents correctly identified the less expensive loan when one loan had lower costs
  - No bias when loans had identical costs
- Focus on cost to consumer not compensation to retailer

Current and Prototype Disclosure Study

Lacko and Pappalardo, *Improving Consumer Mortgage Disclosures: An Empirical Assessment of Current and Prototype Disclosure Forms*, FTC Bureau of Economics Staff Report (2007) at www.ftc.gov/os/2007/06/P025505MortgageDisclosureReport.pdf

Motivation

- Long history of mortgage disclosure requirements
  - Truth in Lending Act – TILA statement (1968)
  - Real Estate Settlement Procedures Act – GFE (1974)
- Also long history of concern over the effectiveness of the disclosures
- FTC experience in deceptive lending cases has shown that current disclosures do not prevent deception

Motivation

- Despite these concerns, there had been little empirical evidence on consumer understanding of
  - Current disclosures
  - Mortgage terms
  - Terms of their own loans
- Virtually no evidence on whether better disclosures could actually improve consumer understanding

Study objectives

- How consumers search for mortgages
- How well consumers understand
  - Current mortgage disclosures
  - Terms of their recently obtained mortgages
- Whether it is possible to develop better disclosures
  - Two FTC economists developed and tested a prototype alternative to current disclosures

Methodology

Two part study:

- In-depth consumer interviews
  - Detailed picture of real consumer experience
  - Use of the current forms in real mortgage transactions
  - Assess accuracy of consumer knowledge of own loan terms
- Quantitative consumer testing
  - Test actual performance with the disclosures in a controlled, experimental environment

Consumer interviews

- 36 interviews
- About an hour each
- Homeowners in Montgomery County, MD
- Obtained a mortgage within the previous four months
- Approximately half prime, half subprime (based on HUD lender list)
- Most interviews included a review of loan documents from the consumer’s recent mortgage

General observations

- Most respondents began the interview happy with their mortgage experience; not a sample of complainers
- Many respondents' attitudes deteriorated during the interview as they recalled problems, or realized they did not understand their loans as well as they thought
- Subprime respondents were more likely to be experiencing financial difficulties

Understanding of recent mortgage

- Most respondents appeared to understand the general type of mortgage they had obtained
- Some also had clearly matched the loan type to their circumstances

Understanding of recent mortgage

- But many were unaware of, did not understand, or misunderstood key costs or features of their loans, including
  - Payment of up-front points and fees
  - Lack of escrow for taxes and insurance
  - Large balloon payments
  - Adjustable interest rates
  - Prepayment penalties

Understanding of recent mortgage

- Misunderstandings were present among:
  - Both prime and subprime respondents
  - Both those who had done extensive comparison shopping and those who had not done any

Understanding of current disclosures

- In some respects the disclosures were worse than ineffective, and actually created consumer misunderstandings
  - Many believed that the “amount financed” disclosed in the TILA statement was their loan amount, rather than the loan amount minus prepaid finance charges
  - Many believed that the “discount fee” disclosed in the GFE was a discount they had received, rather than a fee they had paid

Reaction to prototype disclosures

- Overwhelmingly positive
- Viewed as significant improvement over current forms

Consumer testing methodology

- Test consumer understanding of current and prototype mortgage disclosures
- Experimental setting
- 12 locations across the country
- 819 recent mortgage customers
- Approximately half prime, half subprime (based on HUD list)

Testing procedure

- Respondents given disclosure forms for two hypothetical loans
  - Half given current forms, half given prototype forms
- Instructed to examine the forms as they would if they were shopping for a mortgage
- Asked series of questions about a dozen different loan terms
- Able to continue examining forms during questioning

Loan scenarios tested

- Simple loan
  - Fixed-rate purchase loan
- Complex loan
  - Fixed-rate refinance loan
  - Interest-only payments
  - Balloon payment
  - Optional credit insurance
  - No escrow for taxes and insurance
  - Prepayment penalties
  - Zero cash due at closing

Percentage of questions answered correctly

	Disclosure Form		
	Current	Prototype	Difference
Both Loans	61%	80%	19 pct points **
Simple Loan	66%	82%	16 pct points **
Complex Loan	56%	78%	22 pct points **

** Statistically significant at the one percent level

Prime and subprime borrowers

Percentage of questions answered correctly

	Borrower Type		
	Prime	Subprime	Difference
Both Loans	71.5%	69.0%	-2.5 pct points *
Simple Loan	74.8%	72.9%	-2.0 pct points
Complex Loan	68.3%	65.0%	-3.2 pct points

* Statistically significant at the five percent level

Current forms fail to convey key loan costs

Pct. of respondents not correctly identifying loan cost

- 87% Total up-front charges
- 74% Charges for optional credit insurance
- 68% Presence of prepayment penalty
- 51% Loan amount
- 33% Presence of financed settlement charges
- 32% Interest rate
- 30% Balloon payment

Improvements provided by the prototype form

Percentage point improvement over current forms

- 66 Total up-front charges
- 43 Charges for optional credit insurance
- 37 Loan amount
- 24 Presence of prepayment penalty
- 16 APR
- 15 Settlement charges
- 12 Interest rate
- 9 Presence of financed settlement charges

Findings - improved disclosures

- It is possible to create new disclosures that significantly improve consumer recognition of the costs and terms of a mortgage
- Improved disclosures can provide significant benefits to both prime and subprime borrowers

Recent Changes to EnergyGuide Label

- 2007 FTC announced new EnergyGuide label design
- Effort followed two-year rulemaking
- Consumer research of various label designs

Based on standard U.S. Government tests

ENERGYGUIDE

Refrigerator-Freezer
With Automatic Defrost
With Side-Mounted Freezer
With Through-the-Door Ice

XYZ Corporation
Model ABC-L
Capacity: 23 Cubic Feet

Compare the Energy Use of this Refrigerator with Others Before You Buy.

This Model Uses
580 kWh/year

Energy use (kWh/year) range of all similar models

Uses Least Energy	Uses Most Energy
539	698

kWh/year (kilowatt-hours per year) is a measure of energy (electricity) use. Your utility company uses it to compute your bill. Only models with 22.5 and 24.4 cubic feet and the above features are used in this scale.

Refrigerators using more energy cost more to operate.
This model's estimated yearly operating cost is:

$57

Based on a 2006 U.S. Government national average cost of 9.81 cents per kWh for electricity. Your actual operating cost will vary depending on your local utility rates and your use of the product.

Important: Removal of this label before consumer purchase violates the Federal Trade Commission's Appliance Labeling Rule (16 C.F.R. Part 305).

Consumer Research

- Examined several different label designs - 10 label conditions
- Respondents answered a series of questions and tasks related to the label designs
- Questions included ranking tasks, perceived quality, willingness to pay, perceived usefulness of disclosures, etc.

U.S. Government

Federal law prohibits removal of this label before consumer purchase.

ENERGYGUIDE

Refrigerator-Freezer

- **Automatic Defrost**
- **Side-Mounted Freezer**
- **Through-the-Door Ice**

XYZ Corporation
Model ABC-L
Capacity: 23 Cubic Feet

Estimated Yearly Operating Cost

$67

$57 **$74**

Cost Range of Similar Models

630 kWh

Estimated Yearly Electricity Use

Your cost will depend on your utility rates and use.

- Cost range based only on models of similar capacity with automatic defrost, side-mounted freezer, and through-the-door ice.
- Estimated operating cost based on a 2007 national average electricity cost of 10.65 cents per kWh.
- For more information, visit www.ftc.gov/appliances.

III.
Economic Research and Policy Outcomes

Glass Half Empty or Half Full?

- Effect of Broker Compensation Study on Policy
- Effect of General Mortgage Study on Policy
- Applied work can effect policy, but many competing interests affect outcomes –
  - we still do not have comprehensive disclosure reform for real consumers, but will continue research and dissemination

Role of Academic Research at FTC

- Improves FTC Staff Research
- Applied to Competition Advocacies
- Applied to Case Analysis
  - Expert Witness Opportunities
- FTC Conference Invitations
  - Mortgage Conference (2008)
  - Carbon Offset Conference (2007)

Making Research Relevant

- Economic staff need to find the research
  - Where published?
  - Key words?
  - Contact with FTC economists
    - Keep FTC staff informed of new findings

Tips for Applied Researchers

- Identify hot topics
  - FTC website: www.ftc.gov
  - Talk to FTC staff
- Become a subject expert
- Collect new data
- Research should

– Meet professional peer-review standards

– Yet, be accessible to non-economists