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ONE HUNDRED YEARS OF INEPTITUDE: THE NEED FOR MORTGAGE RULES CONSONANT WITH THE ECONOMIC AND PSYCHOLOGICAL DYNAMICS OF THE HOME SALE AND LOAN TRANSACTION

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OVER three million American families bought homes in 1982, and the overwhelming majority paid for their homes by borrowing money.¹ Home mortgage loans are the largest extensions of credit that most consumers ever obtain. For this reason, society has long been concerned that mortgagors be treated fairly, and has expressed this concern through laws governing residential mortgages.

The form of this protection has radically changed in the last hundred years, as Part I of this article demonstrates. Before 1968, state usury ceilings were the primary means of protecting mortgagors against abusive loan practices. Developments in the real estate market between 1920 and 1980, however, rendered this form of regulation largely obsolete. Today, the first residential mortgage transaction is deregulated, except for federal requirements that the lender disclose the annual interest rate, the anticipated settlement charges, and other contractual terms before lending the money. In theory, this new regulatory regime should provide better consumer protection because uniform credit information generates comparison shopping for loans and loan-related services, thereby assuring a competitive price without the market distortion caused by fixed usury ceilings.

Part II of this article examines whether these federal disclosures adequately protect consumers. The dynamics of the mortgage transaction and consumer decisionmaking suggest that homebuyers seeking mortgage loans are in a very vulnerable position. The typical homebuyer is not very knowledgeable about the market for homes, financing, and settlement services and tends to defer to more sophisticated intermediaries (homebuilder, real estate broker, or lender), who are more interested in closing transactions than in obtaining the best deal for the buyer. Federally mandated disclosures do little to protect many homebuyers from these problems; they are made too late in the decision process to generate significant comparison shopping and are often incomplete, inaccurate, or incomprehensible to consumers. Moreover, because the industry is highly interdependent and cooperative, market mechanisms do not necessarily protect the homebuyer. As a result, the homebuyer is often misled about the terms and hidden costs of the mortgage, pays a high price for mortgage-related charges, or incurs unreason-

¹ See Mortgage and Housing Update, *Real Est. Q.*, Summer 1983, at 3-4.

able risks when entering into an alternative mortgage (one with graduated payments, an adjustable rate, or early repayment of the full principal). In short, a regulatory gap exists in this post-usury law era.

Part III examines potential reforms: (1) better disclosure rules (requiring more accurate comparative information to be made during the shopping process); (2) standardization of mortgage instruments, including preformulated risk protections for alternative mortgage instruments; and (3) reduction in the distortions caused by the shopping process and anticompetitive patterns of cooperation within the real estate industry, both by assuring higher fiduciary standards for those who advise the homebuyer and by attacking these patterns of cooperation.

Obviously, policymakers will not pursue all of these reforms at once. The most immediate problem is the confusing array of often risky alternative mortgages; the most direct remedy is the standardization of these alternatives and the provision of consumer protections against excessive risk. The second priority should be revising disclosure rules so that they cannot be used, as they are now, to deceive homebuyers. A third priority—encouraging the use of buyers' agents or developing fiduciary standards for sellers' agents—confronts the structural problems of educating the homebuyer and cannot be accomplished quickly. This reform should be a long term priority, however, because it may ultimately be a useful way to help consumers with this inherently complex transaction. Other long term priorities are redefining the focus of disclosure rules (as to what is disclosed and when) and reviewing and changing anticompetitive patterns of market cooperation.

I. STATE USURY LAWS' REIGN OF ERROR AND THEIR DISPLACEMENT BY FEDERAL DISCLOSURE RULES

From colonial times through most of the twentieth century, state usury ceilings were the primary means of regulating the home mortgage transaction in the United States. Traditionally, these ceilings limited the amount of interest a lender could charge to a "just price" falling somewhere between 6% and 10%.² These ceil-

² For an early history of usury laws in the United States, see J. Blydenburgh, *A Treatise on the Law of Usury* (1844) (reproducing the 28 state usury laws in effect in 1844 and tracing their evolution); S. Homer, *A History of Interest Rates* (2d ed. 1977); F. Ryan, *Usury*

ings reflected at least three implicit policy assumptions: that "interest" could be reliably determined, that credit regulation was best left to local rulemakers, and that fixed ceilings of 6% to 10% were workable and just. Residential mortgage lending grew and changed substantially after 1920, however, so that by 1980 mortgage financing bore little resemblance to anything that state usury ceilings were designed to regulate. Financing included numerous hidden or ancillary charges tied to the sales transaction, was national and not local, and was characterized by high and fluctuating interest rates. Because of these market changes, national disclosure rules eventually displaced state usury ceilings as the means to protect homebuyers.

A. The Integrated Home Sale and Loan Transaction and the Resulting Difficulty in Defining "Interest"

In this century, the mortgage transaction has become much more than just the simple loan that states intended usury laws to regulate. Two fundamental changes in the transaction have been the growth of loan-related charges paid by the buyer and the increased role of the seller or its agents in arranging financing and closing costs. As a result of these changes, it became far more difficult to determine the true interest costs of any transaction.

Loan-related charges have increased significantly because of the lender's increased risk of loss. The lender's anticipated return on a mortgage loan includes interest payments plus any up front or subsequent administrative charges (minus administrative expenses), discounted by the risk of loss on the loan. Before the 1930's, risk of loss was typically low because the loan-to-value ratio was small (due to large buyer downpayments) and loan terms were short.

To stimulate the housing market after the Depression, federally

and Usury Laws (1924). In the early 20th century, many states passed special laws to regulate small loans and other transactions. See B. Curran, Trends in Consumer Credit Legislation (1965) (American Bar Foundation study of the increasing specialization of usury rules and exceptions). In most states, however, usury ceilings remained the primary regulation for mortgage loans.

Usury ceilings were traditionally justified as the community's assurance that lenders would charge a "just price" for credit. See F. Bacon, Of Usurie, in *Essays* 171 (West ed. 1896) (lending money should be allowed, especially in commercial transactions, but overreaching should be controlled); 1 A. Smith, The Wealth of Nations 353-62 (J. Rogers 2d ed. 1880) (interest rate limits needed to curb the excesses of entrepreneurs).

insured Federal Housing Administration (FHA) and Veterans Administration (VA) mortgages adopted higher loan-to-value ratios (lower downpayments) and longer terms (lower monthly payments).³ Although these changes made more Americans eligible for mortgage loans, they also increased the risk of loss. Since the 1940's lenders have tried to reduce this risk by ensuring that mortgagors will make timely payments, that the property will not be subject to third party claims, and that the property is worth more than the mortgage debt.⁴

To ensure timely payments, lenders will generally not make loans where total monthly payments (principal, interest, taxes, and insurance) exceed 25% to 33% of the borrower's gross monthly income, where all debt payments exceed 34% to 40% of this income, or where the borrower has either a poor credit history or an unstable future earnings stream.⁵ Moreover, the lender may require the borrower to buy either private mortgage insurance to reimburse the lender for the expenses in the event of foreclosure⁶ or health or life insurance to assure that payments are made notwithstanding calamity to the borrower.⁷ Finally, the loan agreement usually penalizes delinquent payments and technical default by assessing special fees in the event of either.

For protection against third party claims and inadequate security for the loan, the lender has other protections. Thus it commis-

³ See generally P. O'Donnell & E. Maleady, *Principles of Real Estate* 329-30 (1975) (discussing the history of home loans).

⁴ For a more elaborate explanation of "loan risk analysis," see H. Hoagland, L. Stone & W. Brueggeman, *Real Estate Finance* 206-18 (6th ed. 1977). The FHA in the 1930's (and the VA in the 1940's) would guarantee loans only if they contained such risk protections, and lenders adopted similar requirements for mortgages that the government did not insure. See *id.* at 506-08, 523-30.

⁵ See *id.* at 207-08. These figures are simply "guidelines" that underwriters developed through statistical studies showing historically what the average household comfortably spends on housing. See Reppe, *Why Residential Lenders Like Mortgage Guaranty Insurance*, *Real Est. Rev.*, Fall 1973, at 58. Lenders can depart from these guidelines in specific cases, and there is evidence that they have done so in recent years. See Letter from Dean Dale A. Whitman to Professor William N. Eskridge, at 2 (Sept. 11, 1984) (copy on file with the Virginia Law Review Association) [hereinafter cited as Whitman Letter].

⁶ About 18% of the residential first mortgage loans in May 1983 included private mortgage insurance. See *Mortgage Finance and the First-Time Homebuyer*, *Real Est. Q.*, Summer 1983, at 8, 9. This insurance is generally not required when the downpayment is 20% or more (or when the loan principal is reduced to 80% of the property's value), nor is it required in FHA and VA loans.

⁷ See H. Hoagland, L. Stone & W. Brueggeman, *supra* note 4, at 230-31.

sions a survey and appraisal of the property to determine whether its market value exceeds the mortgage amount.⁸ And the lender requires the borrower to obtain the opinion of an attorney or title company that the seller had good title to the property, and usually a title insurance policy as well.⁹ The lender may also require that one or more attorneys review the sale and loan documents to assure their legality and that the borrower insure the mortgaged property.

Although the fulfillment of these requirements reduces the lender's risk, the homebuyer-borrower pays for most of them.¹⁰ Thus, these payments effectually constitute a surrogate for a higher interest rate.

The integration of the home sale and loan transaction further complicated the determination of true interest costs. After World War II, homebuilders realized that they could sell more houses through package deals. That is, packaged with the home were loan and settlement services required by lenders. One type of package deal involves a loan commitment at a local bank. For a nonrefundable 1% "commitment fee," the institution agrees to hold a line of credit open for purchasers of homes in the housing development, and might also agree to arrange for the necessary settlement services.¹¹ The developer may also pay the lender to reduce, or "buy down," the interest rate that can be advertised. (Like commitment fees, buydown fees are typically calculated as a percentage of the home price and paid by the seller, thus their popular name "seller's points.") In the last decade or so, builders have begun to form their own mortgage banking subsidiaries that originate loans for the builders' customers at below-market rates and then sell the

⁸ See *id.* at 211-18.

⁹ See *id.* at 231; Whitman Letter, *supra* note 5, at 2.

¹⁰ At or before closing, the buyer usually pays fees for the credit report, the survey, the title examination and insurance certificate, the appraisal, the administrative expenses of originating the loan (origination fee), and the attorney or notary. Typically, the lender is also the agent for collecting taxes and insurance premiums, and an escrow fund of several months' advance payments will be established. Thus, the lender makes these payments to third parties as they fall due. Private mortgage insurance premiums are sometimes paid as a lump sum at settlement, but most insurance premiums are paid out over time (either to the lender or directly to the insurer) after settlement. On settlement fees and practices, see generally H. Hoagland, L. Stone & W. Brueggeman, *supra* note 4, at 228-32 (explaining various closing costs).

¹¹ See generally H. Hoagland & L. Stone, *Real Estate Finance* 437-38 (3d ed. 1965) (developers find lenders willing to take over mortgages).

loans to other lenders at a discount (for which builders reimburse them by paying points).¹²

Similarly, the resale market has seen the rise of full-service brokerage firms. As part of its effort to market homes, the firm or the individual broker guides homebuyers to available financing (increasingly through preexisting loan commitments) and arranges for settlement services.¹³ Merrill Lynch and Coldwell Banker, for example, have acquired mortgage-banking subsidiaries that arrange mortgage commitments for their customers and have controlling or participatory interests in title or mortgage insurance companies. Although the main reason for broker integration of the resale transaction is to facilitate the marketing of homes, a consequence of this integration is that firms have opportunities to profit through origination and servicing fees and settlement charges in addition to the resale commission.¹⁴

The integrated home sale and loan transaction has thus developed logically, and the accepted wisdom is that it has made home ownership more accessible. This development also caused problems for usury laws because it was not clear whether the charges were interest. Lenders could charge a nominally low rate of interest yet obtain a high return by charging points to the buyer or the seller, by overcharging for settlement services, by requiring the buyer to pay to reduce the lender's risk, and by including costly future charges in the mortgage agreement. State judges and legislators re-

¹² The largest national homebuilders usually have their own subsidiaries. See Breckenfeld, *The Other Way Builders Make a Buck*, *Fortune*, Oct. 4, 1982, at 121, 122. Smaller builders have pooled their resources to form mortgage companies that can obtain large-scale commitments. See California BIA Forms Own Mortgage Access Organization, *Prof. Builder*, *Ap't Bus.*, Jan. 1984, at 13; Colorado Builders Form Their Own Mortgage Company, *Builder*, Aug. 1982, at 39; Pennsylvania Builders and Brokers Join to Form Mortgage Corporation, *Builder*, May 1983, at 99.

Recently, the Home Mortgage Access Corporation (HOMAC) was formed. It is a nationwide mortgage conduit that negotiates master commitments for mortgage money on behalf of its builder participants. See generally Nat'l Ass'n of Home Builders, *Home Mortgage Access Corporation Information Sheet and Master Builder Participation Agreement* (Sept. 28, 1982) (explaining the terms for purchases of mortgage money) (copy on file with the Virginia Law Review Association)

¹³ See Haney, *Real Estate Heavyweights in the Eighties*, *Real Est. Rev.*, Summer 1980, at 35, 36-38; Miller, *The Changing Structure of Residential Brokerage*, *Real Est. Rev.*, Fall 1978, at 46; Fannie Mae Plan Allows Direct Access to Mortgage Funds, *Housing Fin.*, June 1983.

¹⁴ See Haney, *supra* note 13, at 36-38; *Mortgage Power*, *Forbes*, Feb. 1, 1982, at 122-23 (describing Citibank commitment offered to New York City brokers).

sponded by expanding the definition of "interest" to include some of these ancillary or hidden charges. Nonetheless, the process of redefining interest was slow and sometimes yielded rules based on inaccurate assumptions.

1. *Closing Costs*

The common-law rule was that closing costs paid out immediately to third parties (e.g., survey fees, title charges, and taxes) are not includable as interest because they are not compensation to the lender. Although some of the charges are incurred at the lender's insistence, courts reasoned that it is ultimately in the borrower's self-interest to be certain of boundaries and the title's validity.¹⁵ This theory fails to justify not allocating at least part of those lender-required fees to the interest rate; nor is it persuasive when applied to payments for property appraisal, credit checks, and attorney review of loan agreements. The benefit of these latter tasks inures almost entirely to the lender. Despite these objections, state legislatures ratified the common law when they drafted detailed usury law definitions of interest after 1966.¹⁶

Under the common law, charges that the lender retains to pay for its own performance of loan-related services are also not interest, as long as these charges are "reasonable."¹⁷ Because courts rarely found lender charges unreasonable, this rule effectively excluded lender-retained closing costs from classification as interest.

¹⁵ E.g., *Pushee v. Johnson*, 123 Fla. 305, 166 So. 847 (1936); see *Prather, Mortgage Loans and the Usury Laws*, 16 *Bus. Law.* 181, 188-89 (1960) (customary loan expenses not considered interest). One flaw in this argument is that given the very low incidence of error in title examination, many rational homebuyers would not find it in their interest to have title insurance. If required by the lender, and not necessarily the rational choice by the homebuyer, it is reasonable to conclude that this risk insurance is "compensation" to the lender. Thus, it should have been "interest" under usury law.

¹⁶ See, e.g., Ill. Ann. Stat. ch. 17, § 6406(a) (Smith-Hurd 1981); Md. Com. Law Code Ann. § 12-105 (1983); Miss. Code Ann. § 75-17-1(9) (Supp. 1984); Tenn. Code Ann. § 47-14-113(4) (1979); see also Unif. Commercial Credit Code § 3.202(1)(a) (1968) ("loan finance charge" does not include official fees and taxes); id. §§ 1.301(5), 3.202(3) (for disclosure purposes, "loan finance charge" does not include "reasonable closing costs," which are typically paid to third parties).

¹⁷ See *Starkovich v. Southwest Sav. & Loan Ass'n*, 14 Ariz. App. 382, 384-85, 483 P.2d 795, 797-98 (1971); *Abramowitz v. Barnett Bank*, 356 So. 2d 329, 330 (Fla. Dist. Ct. App.), cert. denied, 364 So. 2d 880 (Fla. 1978); *Ferdon v. Zarriello Bros.*, 87 N.J. Super. 124, 130-31, 208 A.2d 186, 189-90 Law Div. (1965).

Nevertheless, this rule was followed by legislative codifications in the 1960's and 1970's.¹⁸

2. Points

Courts usually held that buyer-paid points (mainly fees covering administrative expenses of originating loans) are interest,¹⁹ even though other "reasonable" fees paid to the lender for loan-related services were not considered interest.²⁰ Seller-paid points were not often challenged because homebuyers were not aware that they were paid. When they were challenged, they posed difficult questions. The common-law authorities generally agreed that bona fide commitment fees are not interest because the fee is not paid for the use of money, but only for the option of later using it.²¹ In the

¹⁸ See, e.g., Ill. Ann. Stat. ch. 17, § 6406(a) (Smith-Hurd 1981); Unif. Commercial Credit Code §§ 1.301(5), 3.202(3) (1968) (for disclosure purposes, "loan finance charge" does not include "reasonable closing costs," even if retained by the lender). But see *Tri-County Fed. Sav. & Loan Ass'n v. Lyle*, 280 Md. 69, 371 A.2d 424 (1977) (disallowing the collection of interest on money retained by lender); Md. Com. Law Code Ann. § 12-105(c) (1983) (lender may collect "actual expenses" which will not be considered interest "if not retained" by lender). The Maryland position is subject to the obvious objection that it should make no usury law difference whether the lender retains an outside attorney to prepare loan documents or prepares them through its own counsel. See Casenote, *Usury—Maryland Annotated Code, Article 49—A Lender's Retention of Loan Related Costs, Unless Exempted, Constitutes Interest—Unpaid Balance is that Sum Actually Owed by a Borrower to a Lender*. *Tri-County Fed. Sav. & Loan Ass'n v. Lyle*, 280 Md. 69, 371 A.2d 424 (1977), 7 U. Balt. L. Rev. 361, 365 (1978). The rule may rest, however, upon the suspicion that the lender will tend to overcharge for services it provides and that a reasonableness test assures insufficient protection for consumers.

¹⁹ See, e.g., *Vee Bee Serv. Co. v. Household Fin. Corp.*, 51 N.Y.S.2d 590 (N.Y. Sup. Ct. 1944), *aff'd*, 269 A.D. 772, 55 N.Y.S.2d 570 (1945); *First Fed. Sav. v. Norwood Realty Co.*, 212 Ga. 524, 93 S.E.2d 763 (1956); see *Real Estate Trustee, Inc. v. Rebhan*, 153 Md. 624, 139 A. 351 (1927); *Russell v. Lumberman's Mortgage Co.*, 27 Ohio Misc. 171, 172, 273 N.E.2d 803, 804 (C. P. 1968); see also *Hershman, Usury and the Tight Mortgage Market*, 85 *Banking L.J.* 189, 206-09 (1968) (discussing the differing treatment of origination charges as overhead expenses or as a commission for placing the loan).

²⁰ Some legislatures recognized this anomaly, though they tended to resolve it by permitting a loan origination fee that did not count as interest. See, e.g., Md. Ann. Code art. 58A, § 22 (1951) (permitting 4% inspection fee); Va. Code § 6-348.3 (1966) (organizations principally engaged in making mortgage loans for resale may make an initial processing charge); W. Va. Code § 31A-4-30 (1982) (bank may charge borrower, in addition to the maximum interest rate, "a reasonable amount to cover the expenses incurred in procuring reports and information respecting loans and the value of and title to property offered as security therefor").

²¹ See *People v. Central Fed. Sav. & Loan Ass'n*, 46 N.Y.2d 41, 46-47, 385 N.E.2d 555, 557, 412 N.Y.S.2d 815, 818 (1978); *Gonzales County Sav. & Loan Ass'n v. Freeman*, 534 S.W.2d 903, 906 (Tex. 1976); *Op. Att'y Gen. No. OAG 9-80* (Wis. Feb. 4, 1980), reprinted in [1974-1980 Transfer Binder] *Consumer Cred. Guide* (CCH) ¶ 97,553; *Prather, supra* note 15,

integrated home sale and loan transaction, however, this "option" is almost always exercised, as the homebuyers will use most or all of the precommitted mortgage money. After 1966, a few states did redefine interest to include mortgage commitment fees under some circumstances.²²

Courts also failed to understand the true nature of buydown fees. Some judges and commentators suggested that these fees are not interest when paid to an originating lender to reimburse it for the discount it offers in selling the loan to other lenders.²³ Their rationale was that two separate transactions are involved—the loan and then the sale of the note—and that the only charges includable as interest are those formally paid in connection with the loan. Functionally, however, when the loan is made by one lender who acts as a conduit by immediately signing over the loan to a second lender according to a prearranged commitment, there is only one transaction. The loan is actually the entire two-step transaction, and the compensation for the loan logically includes the discount or buydown fees.²⁴ After 1966, legislative revision of usury laws often included discount and buydown fees in the definition of interest.²⁵

at 188; Sintenis, *Current Treatment of the Non-Refundable Commitment Fee and Related Problems*, 86 *Banking L.J.* 590, 604-11 (1969).

²² See, e.g., *Arkansas Sav. & Loan Ass'n v. Mack Trucks, Inc.*, 263 Ark. 264, 566 S.W.2d 128 (1978). Compare 56 Op. Att'y Gen. 285 (Md. 1971) (fee paid to a lender for a commitment to make a loan to a future purchaser is interest) with 57 Op. Att'y Gen. 319 (Md. 1972) (commitment fee to assure mortgage money for indeterminate number of future purchasers is not interest where it is unclear what each purchaser's pro rata share of such fee would be).

²³ See *Hershman*, *supra* note 19, at 212-13; see also *Lake Hiwassee Dev. Co. v. Pioneer Bank*, 535 S.W.2d 323 (Tenn. 1976) (usury statutes applicable only to loans and not to the sale of commercial paper); *Nosari & Lewis, How Usury Laws Affect Real Estate Development*, 9 *Real Est. L.J.* 30, 33 (1980) (a loan discounted to another at an effective rate higher than usury limits is not generally considered usurious).

²⁴ See *Hare v. General Contract Purchase Corp.*, 220 Ark. 601, 249 S.W.2d 973 (1952) (prospectively overruling prior decisions distinguishing loan from immediate sale at a discount); *Glaire v. La Lanne-Paris Health Spa, Inc.*, 12 Cal. 3d 915, 927, 528 P.2d 357, 364-65, 17 Cal. Rptr. 541, 548-49 (1974); *Brown v. Pilini*, 128 Vt. 324, 331-32, 262 A.2d 479, 483 (1970) (10% handling charge assessed in sale of commercial paper was interest because the integrated transaction was a loan).

²⁵ See, e.g., Ill. Ann. Stat. ch. 17, § 6406(d) (Smith-Hurd 1981) (points, discounts, commissions limited to 3% of mortgage principal and included as interest); Md. Com. Law Code Ann. § 12-101(e) (1983) ("interest" includes "any amount payable as a discount or point"); Minn. Stat. Ann. § 47.20(7)(1) (West Supp. 1984) (similar); Miss. Code Ann. § 75-17-1(9) (Supp. 1983) (finance charge includes "discount points"); Neb. Rev. Stat. § 45-101.02(3)

3. Other Charges for the Lender's Benefit

Common-law courts were reluctant to find that lender-mandated insurance against default, the debtor's poor health, or casualty of the secured property constitutes interest.²⁶ This insurance is a surrogate, however, for a higher interest rate because it lowers the risk of default. Some legislatures in the 1970's recognized this relationship and stipulated that insurance premiums are interest unless the buyer agrees to incur the insurance and chooses the insurance provider, subject to reasonable objections of the lender.²⁷

Because the buyer can avoid delinquency fees, default expenses (including counsel fees), and prepayment penalties, the common law also did not include them in interest.²⁸ This position is sensible, except to the extent that lenders might charge borrowers much more than is needed to cover administrative expenses. After 1966, usury laws were amended to stipulate that delinquency, default, and prepayment charges are excluded from the definition of interest if they fall within certain limits. Typically, delinquency charges are not interest if the borrower is given fifteen days beyond the due date to make proper payment and delinquency charges are 5% or less of the amount of payment in arrears.²⁹ Similarly, some laws

(1978) (discount points are interest and are amortized over the life of the loan); N.M. Stat. Ann. § 56-8-9(E) (1978) (points added to interest to determine compliance with the usury ceiling); Unif. Commercial Credit Code § 3.109(1)(a) (1968) ("loan finance charge" includes discounts and points). But see Ala. Code § 5-19-1(1) (1981) (finance charge does not include points and discounts paid by seller).

²⁶ Again, the rationale was that the borrower also benefits from the added risk protections, an argument that seems unpersuasive. See *supra* note 15.

²⁷ See, e.g., Unif. Commercial Credit Code § 3.202(2)(a) (1968) (premiums for loss/damage/liability concerning property are not part of "loan finance charge" if lender gives borrower written statement setting forth the cost and the borrower's right to choose the insurer); *id.* § 3.202(2)(b) (premiums for life/accident/health coverage of borrower are not part of "loan finance charge" if insurance is not required and borrower gives written indication of his desire to have the insurance).

²⁸ See *Abbot v. Stevens*, 133 Cal. App. 2d 242, 247-48, 284 P.2d 159, 162 (1955); *Feldman v. Kings Highway Sav. Bank*, 278 A.D. 589, 102 N.Y.S.2d 306, *aff'd*, 303 N.Y. 675, 102 N.E.2d 835 (1951) (prepayment penalties); *Prather*, *supra* note 15, at 191-92 (prepayment penalties and costs of default and foreclosure).

²⁹ See, e.g., Md. Com. Law Code Ann. § 12-105(b)(3) (1983) (delinquency fee not interest if imposed only after 15-day delinquency and does not exceed 5% of late payment); see also Unif. Commercial Credit Code §§ 3.109(1)(b), 3.203 (1968) ("loan finance charge" does not include "delinquency charges," but the latter can only be assessed when an installment has not been paid within 10 days of its due date and cannot exceed 5% of the delinquent installment).

exempt prepayment fees from usury ceiling calculations only if the penalty is less than a designated percentage of the outstanding loan amount and is assessed only if the loan is repaid quickly (usually within three to five years).³⁰

B. The National Mortgage Market and the Rise of Federal Disclosure Rules

The home mortgage market has become increasingly national in the twentieth century. Because of this development, the utility of state usury laws diminished and regulatory efforts have shifted to federal disclosure rules.

Before 1900, home mortgage lending was largely concentrated in the hands of a few banks in each community. By the 1920's, competition from savings and loan associations, large life insurance companies, and mortgage companies eroded the local bank monopoly and its isolation from national capital markets.³¹ Another significant change resulted from federal intervention into the finance market. In response to the credit shortage during the Depression, the federal government created federally funded banks to extend credit to lenders so that they could refinance mortgages and meet withdrawal demands.³² More important, the government established a "secondary mortgage market" in which lenders could sell mortgages they originated.³³

With regard to the secondary mortgage market, the National Housing Act³⁴ authorized the establishment of private mortgage

³⁰ See, e.g., Md. Com. Law Code Ann. § 12-105(b)(4) (1983) (prepayment fees not interest in real estate mortgage loans if imposed within three years from the date of the loan and do not exceed two months' advance interest).

³¹ See M. Bodfish, *Savings and Loan Principles* (1940); J. Ewalt, *A Business Reborn* 3-15 (1962).

³² See generally J. Ewalt, *supra* note 31, at 14-17 (discussing the effect of the Depression on savings and loan associations); *The Federal Home Loan Banks, The Federal Home Loan Bank System* (1961) (describing the origins and operation of the FHLB system).

³³ The secondary mortgage market is, most broadly defined, "the aggregate of all purchase and sale transactions of residential mortgage instruments." *The Federal National Mortgage Association, Background and History* 6 (1973). Other authors "exclude transactions from the secondary market that were preceded by the buyer's promise to purchase the loans prior to the acquisition by the seller." D. Jones & L. Grebler, *The Secondary Mortgage Market* 4 (1961).

³⁴ Pub. L. No. 73-479, 48 Stat. 1246 (1934) (codified as amended in scattered sections of 12 U.S.C.). The Home Owners' Loan Act of 1933, Pub. L. No. 73-43, § 4, 48 Stat. 128, 129 (codified as amended at 12 U.S.C. §§ 1460, 1464 (1982)), had earlier established the Home

dealers³⁵ and created a mortgage insurance pool to be administered by the FHA, which also insured lenders against the risk of borrower default.³⁶ The Federal National Mortgage Association (FNMA) was created in 1938 to buy and sell FHA-insured (and, in the 1940's, VA-insured) loans.³⁷ Because they were standardized and virtually riskless, FHA and VA loans were routinely originated by mortgage bankers in the 1950's and 1960's and sold to FNMA and other buyers. By 1970, over one-quarter of the outstanding home mortgage loans had been sold on the secondary market.³⁸

In 1968, Congress created the Government National Mortgage Association (GNMA) to purchase VA and FHA loans and shifted FNMA to private ownership.³⁹ Two years later, Congress created the Federal Home Loan Mortgage Corporation (FHLMC) and authorized it and FNMA to buy and sell conventional loans.⁴⁰ Although FNMA, FHLMC, and GNMA are primarily mortgage buyers, national mortgage sellers have also emerged. For example, the mortgage-banking subsidiaries of homebuilder and brokerage firms sell mortgages nationally to FNMA and other buyers pursuant to multimillion dollar loan commitments. As a consequence of these and other developments, well over half of the mortgages originated in the 1980's have been sold on the secondary market.⁴¹

Owners' Loan Corporation to purchase and refinance defaulted mortgages as a temporary emergency measure.

³⁵ See 12 U.S.C. § 1716(a) (1982).

³⁶ Id. §§ 1708-1709 (\$10 billion mortgage insurance pool administered by FHA). FHA would insure lenders against loss due to borrower default if the loan conformed to standard FHA requirements—interest rate maxima, a long loan term, full amortization of the principal, and borrower qualification standards needed to minimize the risk of default.

³⁷ In 1935 the Reconstruction Finance Corporation (RFC) was established, in part, to purchase FHA mortgages. Acting under power implicitly granted by the National Housing Act Amendments of 1938, Pub. L. No. 75-424, § 211, 52 Stat. 8, 23 (codified as amended at 12 U.S.C. § 1716 (1982)), the President directed the Chairman of RFC to establish the FNMA and vest it with initial capital. The Act of July 1, 1948, Pub. L. No. 80-864, § 301, 62 Stat. 1206, 1207 (codified as amended at 16 U.S.C. § 1717 (1982)), was the formal congressional authorization for FNMA's activities.

³⁸ See Wetmore, *FHA Operation Now Vital to Secondary Mortgage Market*, *Mortgage Banker*, Dec. 1973, at 24, 27.

³⁹ Housing and Urban Development Act of 1968, Pub. L. No. 90-448, § 801, 82 Stat. 476, 536 (codified at 12 U.S.C. § 1716b (1982)).

⁴⁰ Emergency Home Finance Act of 1970, Pub. L. No. 91-351, §§ 301-310, 84 Stat. 450, 451 (codified as amended at 12 U.S.C. §§ 1451-1459 (1982)). The FHLMC is a subsidiary of the Federal Home Loan Banking System and specializes in buying and selling mortgages that savings and loans originated.

⁴¹ *Secondary Mortgage Market*: Hearing Before the Subcomm. on Housing and Commu-

These developments have significantly influenced regulatory theory and practice. Since the Depression, home mortgages have become a federal concern as national or regional actors have increasingly dominated the market. FNMA, FHLMC, GNMA, and most private mortgage buyers do so on a nationwide or regional basis. Financial institutions selling the mortgages are often national, as are the builders of homes. Even the institutional mortgage insurers—the government agencies (FHA and VA) and private insurers—are national. Because the mortgage instrument has incorporated standard features to minimize risk and is now routinely traded on a national market between sophisticated buyers and sellers, the problem of local monopolies gouging homebuyers with high rates has been radically curtailed.⁴² Thus, the need for usury ceilings diminished.

The growth of a nationally competitive mortgage market has also fostered the view that regulations most helpful to the consumer are those that improve the mortgage market's competitiveness. Disclosure rules are therefore preferable to usury ceilings. Theoretically, if there is uniform disclosure of credit charges and terms, buyers will be more aware of the cost of credit and will flock to the best credit opportunities, thus eliminating bad deals and making the mortgage market even more competitive. State disclosure laws enacted in the 1960's reflect this philosophy,⁴³ as does the

nity Development of the House Comm. on Banking, Finance and Urban Affairs, 98th Cong., 2d Sess. 89, 162 (1984) (home mortgages sold as percent of mortgage originations increased from about 30% in 1971 to an average of 57% between 1980 and 1982) [hereinafter cited as 1984 Secondary Mortgage Market Hearing].

⁴² Although the market rate does vary, it varies from region to region (not state to state) and does not vary nearly as much as it did 40 years ago. Recent studies have found that, notwithstanding the supposedly "unifying" force of the secondary mortgage market, "local credit conditions continue to be an important determinant of regional mortgage rates in the existing house market," and "regional mortgage market insulation persists in spite of the unifying effects of the Federal credit agencies." Ostas, *Regional Differences in Mortgage Financing Costs: A Reexamination*, 32 J. Fin. 1774, 1778 (1977); accord Rudolph, Zumpano & Karson, *Mortgage Markets and Inter-Regional Differences in Conventional Mortgage Terms*, 10 Am. Real Est. & Urb. Econ. A. J. 94 (1982). Although the evidence suggests that interregional mortgage differentials may persist (generally higher the further the region is from the financial centers of Boston and New York), the range among all SMSAs for new house loans was 88 basis points (less than 1%) in 1963, and 88 basis points again in 1972. See Ostas, *supra*, at 1778.

⁴³ See, e.g., Conn. Gen. Stat. §§ 36-393 to -417 (Supp. 1983); Ky. Rev. Stat. §§ 360.210-.991 (1970 & Supp. 1984); Tenn. Code Ann. § 47-14-125 (1979).

Uniform Consumer Credit Code.⁴⁴ Not surprisingly, however, the most important disclosure legislation was passed at the federal level.

Seeking "to assure a meaningful disclosure of credit terms so that the consumer will be able to compare more readily the various credit terms available to him and avoid the uninformed use of credit," Congress passed the Truth-in-Lending Act in 1968.⁴⁵ Before extending credit in a closed-end loan such as a mortgage loan, the lender must supply the borrower with specified information, including the principal sum of the loan, the amount of credit extended, the "finance charge" expressed as an "annual percentage rate" (APR), the payments scheduled, the amount not calculated in the finance charge, default and delinquency assessments, prepayment penalties, and the security for the loan.⁴⁶ The Federal Reserve Board's Regulation Z, which implemented the Act, requires APR disclosure in advertisements that state an interest rate or other triggering facts.⁴⁷

⁴⁴ At least 11 states have substantially adopted the 1968 or 1974 Uniform Commercial Credit Code (UCCC): Colorado, Idaho, Indiana, Iowa, Kansas, Maine, Oklahoma, South Carolina, Utah, Wisconsin, and Wyoming. 7 U.L.A. 322, 377 (Supp. 1984). Two of the UCCC's basic assumptions are that (1) competition to determine prices is a good way to protect borrowers, see Prefatory Note to 1968 Revised Final Draft, *id.* at 242 (1978), and (2) competition to assure fair prices for credit requires easy entry into credit markets and "uniform disclosure of the costs and terms of credit to permit informed judgments as to whether or not to use credit, to facilitate 'shopping for credit' and to enable the forces of competition to work freely." *Id.* at 243. A third assumption is that usury ceilings are not the best form of regulation. See *id.* at 242-43. Thus, the UCCC defines "consumer loan" to include loans "primarily secured by an interest in land" for purposes of its disclosure and remedies section, but not for other UCCC sections unless (*inter alia*) the interest rate exceeds 10%. Unif. Commercial Credit Code § 3.105 (1968). Most of the states adopting the UCCC have a higher floor to exclude first mortgage loans. See 7 U.L.A. 403 (1978); *id.* at 350 (Supp. 1984).

⁴⁵ 15 U.S.C. § 1601(a) (1982). The Truth-in-Lending Act is part of the Consumer Credit Protection Act, Pub. L. No. 90-321, 82 Stat. 146 (1968) (codified as amended at 15 U.S.C. §§ 1601-1665 (1982)).

⁴⁶ 15 U.S.C. § 1638(a)-(b) (1982). Compare *id.* with Unif. Commercial Credit Code § 3.306(2) (1968) (similar disclosure requirements). As defined in the Truth-in-Lending Act and the UCCC, the APR is the rate that, when applied to the unpaid balance of the principal (calculated according to the actuarial method), would yield a sum equal to the finance charge.

⁴⁷ Section 144(b) of the Act, 15 U.S.C. § 1664(b) (1982), provides that the Act's truth-in-advertising rules do not apply to real estate advertisements, except to the extent that the Federal Reserve Board requires. Regulation Z currently provides that advertisements for closed-end credit shall use the APR when they state a rate of finance charge, 12 C.F.R. § 226.24(b) (1984), and that if advertisements state the amount of any downpayment, payment, or finance charge, they must also state the APR, the terms of repayment, and the

Although the Truth-in-Lending Act did not preempt state regulation,⁴⁸ it has had the practical effect of dictating the format of state disclosure laws.⁴⁹ The Act does not affect state usury ceilings and, indeed, borrows heavily from state law in defining "finance charge," which includes discounts and points, service charges and loan fees, and various insurance premiums.⁵⁰ Excluded from the definition are taxes and other fees required by law and paid to public officials, delinquency and default charges, title examination and insurance fees, escrow funds, notary fees, appraisal and survey expenses, and charges for credit reports.⁵¹ Early Federal Reserve Board interpretations of the Act excluded commitment fees from the definition and included buydown fees only if the seller raised its price to pay them.⁵²

The Truth-in-Lending Act covered only the extension of credit in loan transactions. In the 1970's, however, it was revealed that homebuyers were paying exorbitant prices for closing services, notwithstanding usury law "reasonableness" rules. In 1974, after considering several reform proposals,⁵³ Congress enacted the Real Es-

amount or percentage of the downpayment. *Id.* § 226.24(c).

⁴⁸ The Act preempted state credit disclosure laws only to the extent that they were inconsistent with the Act or Regulation Z, 15 U.S.C. § 1610(a) (1982), and authorized the Board to exempt from federal regulation any class of credit transactions within states whose regulation of those transactions "is subject to requirements substantially similar to those imposed [by the Act and where] there is adequate provision for enforcement." *Id.* § 1633; see 12 C.F.R. pt. 226, app. B. (1984) (describing exemption application procedures).

⁴⁹ For example, the 1974 revised version of the UCCC simply provides that compliance with the Truth-in-Lending Act constitutes compliance with any state disclosure requirements. Unif. Commercial Credit Code § 3.201 (1974). "[A]ctual experience from 1968 to the present time has demonstrated that in substantially all cases, creditors engaging in consumer credit look to the federal law and Regulation Z as the controlling law in the area of disclosure." Commissioners' Prefatory Note, 7 U.L.A. 583, 598 (1978); see Va. Code §§ 6.1-330.6, .17 (1983) (compliance with Truth-in-Lending Act is automatic compliance with Virginia law).

⁵⁰ 15 U.S.C. § 1605(a)-(c) (1982).

⁵¹ Compare *id.* § 1605(d)-(e) with Unif. Commercial Credit Code § 3.202 (1968) (similar charges excluded from "loan finance charge" in consumer loans under UCCC).

⁵² See 35 Fed. Reg. 17,029 (1970) (formerly codified at 12 C.F.R. § 226.406(b) (1980)) (finance charge includes discount fee "to the extent it is passed on to the buyer through an increase in the selling price"); Interpretative Decision FC-0033 (Dec. 22, 1976), reprinted in 12 C.F.R. at 635 (1980) (commitment fees are not finance charges "unless they are in fact imposed by the seller/developer only on the credit customer").

⁵³ In 1971, Senator Proxmire introduced a bill to require lenders to bear settlement costs, and hearings were held in March 1972. See S. 2775, 92d Cong., 1st Sess. (1971), reprinted in *Mortgage Settlement Costs Including a Bill, S. 2775, Which Would Reduce Certain Charges and Expenses in Connection with the Purchase of Residential Real Property, and for Other*

tate Settlement Procedures Act (RESPA),⁵⁴ prohibiting kickbacks and referral fees to lenders and requiring disclosures of closing expenses.

As amended, RESPA requires that within three days after a loan application to finance the purchase of residential real estate is made, the lender must give the borrower a "good faith estimate" of the amount of settlement charges and a special information booklet that HUD prepares explaining the various settlement costs and escrows, the rights and choices open to the buyer, and unfair practices or charges that lenders must avoid.⁵⁵ The lender also must complete a HUD-developed form itemizing closing costs and other charges and make it available to the borrower at or before settlement.⁵⁶ By guaranteeing early disclosure of settlement charges and practices, Congress hoped that consumers would become more aware of abuses and would shop for the best prices.

The Truth-in-Lending Simplification and Reform Act of 1980⁵⁷ cut back on the mandated disclosures for loans. Congress shifted the emphasis of disclosure to five key factors: total amount financed, total finance charge, APR, total of all payments, and total

Purposes: Hearings Before the Subcomm. on Housing and Urban Affairs of the Senate Comm. on Banking, Housing and Urban Affairs, 92d Cong., 2d Sess. 3 (1972). The bill went nowhere. In February 1972, the HUD/VA Mortgage Settlement Cost Report was transmitted to Congress, suggesting disclosure and anti-abuse rules to regulate settlement costs. In July 1972, HUD proposed dollar limits for settlement services in six metropolitan areas. Although some members of Congress were receptive to the HUD proposal, it drew such a firestorm of protest that HUD abandoned it. See Oversight of the Real Estate Settlement Procedures Act of 1974: Hearings Before the Senate Comm. on Banking, Housing and Urban Affairs, 94th Cong., 1st Sess. 4-5 (1975) (opening statement of Sen. Tower).

⁵⁴ Pub. L. No. 93-533, 88 Stat. 1724 (1974) (codified as amended at 12 U.S.C. §§ 2601-2617 (1982)); see Real Estate Settlement Costs: Hearings Before the Subcomm. on Housing of the House Comm. on Banking and Currency, 93d Cong., 1st & 2d Sess. (1973-1974) (FHLBB, HUD, other federal agencies prefer disclosure and anti-abuse provisions over direct price controls). For commentary on RESPA, see Steppello, *Federal Regulation of Home Mortgage Settlement Costs: RESPA and Its Alternatives*, 63 Minn. L. Rev. 367 (1979); Wallace, "Explicit Pricing," *Fraud and Consumer Information: The Reform of RESPA*, 12 Rut.-Cam. L. Rev. 183 (1981); Whitman, *The Real Estate Settlement Procedures Act: How to Comply—Problems and Prospects*, 4 Real Est. L.J. 223 (1976).

⁵⁵ 12 U.S.C. § 2604 (1982); see 24 C.F.R. §§ 3500.6-7 (1984).

⁵⁶ 12 U.S.C. § 2603 (1982).

⁵⁷ Pub. L. No. 96-221, tit. VI, 94 Stat. 32, 168 (1980) (amending 15 U.S.C. §§ 1601-1665 (1982)). For commentary on the Act, see O'Connor, *Truth in Lending Simplification*, 35 Bus. Law. 1221 (1980); Shank, *Truth in Lending Simplification and Reform Act: Changes Affecting Disclosure Requirements in Home Mortgage Transactions*, 12 St. Mary's L.J. 1130 (1981).

sale price.⁵⁸ Each item must be accompanied by a plain language explanation of its nature and scope. The consumer is referred to the contract for identification and explanation of terms relating to delinquency, default, right to accelerate, prepayment penalties, and rebates.⁵⁹

Other Simplification Act reforms were intended to facilitate creditor compliance with the Act. The Federal Reserve Board was charged with developing model forms that lenders could use to ensure technical compliance. The Board promulgated a revised Regulation Z, mandatory in October 1982, which simplifies the required disclosures, explains the disclosures in an interpretive appendix, and presents various model disclosure forms.⁶⁰ New Regulation Z made other changes not specifically directed by the Simplification Act, including a rule excluding seller's points from the finance charge.⁶¹

C. The Market and Regulatory Response to High and Volatile Interest Rates

Usury ceilings work best when interest rates are stable. Between 1921 and 1966, market rates for first mortgages were relatively stable, fluctuating between 2% and 6%. After 1966, these rates increased substantially and fluctuated over a larger range. They went up to 7% in 1966-1967, climbed to 9% in 1970, reached 10% in 1974-75, and shot beyond 10% in 1978 (exceeding 20% in 1981 and hovering between 12% and 15% in 1982-1984). This volatile upward trend in interest rates has led to major changes in the way

⁵⁸ See 15 U.S.C. § 1638(a)(8) (1982); 12 C.F.R. § 226.18(c)-(e), (h), (j) (1984); S. Rep. No. 73, 96th Cong., 2d Sess. 2 (1979), reprinted in 1980 U.S. Code Cong. & Ad. News 280, 280-81. Background debate may be found in Truth in Lending Simplification and Reform Act: Hearing Before the Senate Comm. on Banking, Housing and Urban Affairs, 96th Cong., 1st Sess. (1979) [hereinafter cited as 1979 Simplification Act Hearing]; Simplification of the Truth in Lending Act: Oversight Hearings Before the Subcomm. on Consumer Affairs of the House Comm. on Banking, Finance and Urban Affairs, 95th Cong., 2d Sess. (1978) [hereinafter cited as 1978 Simplification Act Hearings].

⁵⁹ 15 U.S.C. § 1638(a)(12) (1982); see 12 C.F.R. § 226.18 (1984).

⁶⁰ 46 Fed. Reg. 20,848 (1981). Though effective April 1, 1981, compliance with revised Regulation Z was optional until April 1, 1982, a date later extended to October 1, 1982. 47 Fed. Reg. 755 (1982).

⁶¹ See 46 Fed. Reg. 20,848, 20,855, 20,894 (1981) (codified at 12 C.F.R. § 226.4(c)(5) (1984)).

bankers, brokers, and builders do business, and to federal preemption of state usury laws.

1. Adjustable or Variable Rate Mortgages

In the 1970's, the investment portfolios of savings and loans and other mortgage lenders consisted predominately of fixed-rate long term (thirty-year) mortgages, but their source of funds was short term deposits. When interest rates increased after 1966, savings and loans were forced to offer better terms on deposits to prevent a massive savings shift to money market and other high-interest funds. Their income remained tied, however, to fixed low-rate, long term mortgages. The disparity between low-rate income and high-rate outflow threatened the solvency of the traditional holders of home mortgages, and some firms went bankrupt in the 1970's. The Federal Home Loan Bank Board (FHLBB), which regulates federally chartered savings and loans, proposed that these institutions be permitted to offer "variable rate mortgages" (VRMs), later called "adjustable rate mortgages" (ARMs).⁶² Under such mortgages the interest rate and the monthly payment would rise or fall in conformity with a market index. This type of mortgage shifts at least part of the risk of rising rates from savings and loans to homebuyers.

Although rebuffed by congressional opposition in 1969 and 1975, the FHLBB authorized VRMs in 1978, subject to specified consumer protections relating to the frequency and size of adjustments.⁶³ The Board later revised that regulation to permit greater market experimentation, and its current rules permit a great variety of mortgage instruments and impose virtually no substantive consumer protections.⁶⁴ The main protections remaining are dis-

⁶² See *Variable Rate Mortgages: Hearings Before the Senate Comm. on Banking, Housing and Urban Affairs, 94th Cong., 1st Sess. 27-83 (1975)* (statement of FHLBB on its proposed VRM regulations).

⁶³ The Board originally authorized VRMs and other instruments in FHLBB Resolution No. 78-708, 43 Fed. Reg. 59,336, 59,338-40 (1978) (formerly codified at 12 C.F.R. § 545.6-2 (1979)) (amended in significant respects by 44 Fed. Reg. 32,199, 32,201-02 (1979)). Under these regulations, only one index could be used for rate adjustments, 12 C.F.R. § 545.6-2(c)(3) (1979); only one change in rate was allowed per year, id. § 545.6-2(c)(4)(i); no rate change could exceed 1%; and increases over the life of the loan were limited to 2.5%. Id. § 545.6-2(c)(4)(iv). When the rate increased, moreover, the borrower had the option of extending the loan maturity, or prepaying the loan without penalty, or accepting an increased monthly payment. Id. § 545.6-2(c)(4)(v).

⁶⁴ Lenders argued that the 1978 VRM Regulation was too restrictive, and in 1980 the

closure rules requiring that the lender give a "full explanation" of how the interest rate, the monthly payment, the loan balance, and the term may be adjusted and how the adjustment of one item may affect the others; a description of all contractual contingencies under which the loan may become due or which may result in a forced sale of the home; and an example of the interaction of the variable features of the loan.⁶⁵ Other federal regulators followed the FHLBB in permitting their regulated lenders to use ARMs and other novel instruments after 1979.⁶⁶

State usury laws also began a gradual process of accommodation to VRMs in the late 1970's.⁶⁷ In the Garn-St. Germain Depository Institutions Act of 1982 (the Garn Act),⁶⁸ however, Congress preempted state regulation of alternative mortgage instruments. The Act permits state-chartered lenders to originate and enforce ARMs and other alternative mortgages secured by residential real property, but only to the extent permitted by federal regulations applicable to analogous institutions regulated under federal law.⁶⁹ The

Board issued its "RRM Regulation," which permitted short term loans with long term amortization in which interest rates and payments are periodically renegotiated. 12 C.F.R. § 545.6-4a (1981). In 1981, the Board's "Alternative Mortgage Loan Regulation" further liberalized that set of rules. See 46 Fed. Reg. 24,148 (1981) (as amended by 47 Fed. Reg. 36,612 (1982)) (currently codified at 12 C.F.R. § 545.33 (1984)). For a detailed history, see Wallaser, *Balancing the Interest: The Changing Complexion of Home Mortgage Financing in America*, 31 Drake L. Rev. 1 (1981).

⁶⁵ 12 C.F.R. § 545.33(f)(7), (9), (11) (1984). For a more complete list of FHLBB-required disclosures, see *infra* note 165.

⁶⁶ See 46 Fed. Reg. 18,932 (1981) (amended by 48 Fed. Reg. 9506 (1983)) (codified as amended at 12 C.F.R. §§ 29.1-9 (1984)) (Comptroller of the Currency's rules for commercial banks).

⁶⁷ Usury common law was relatively hostile to ARMs throughout most of the 1970's. See, e.g., *Ryder Truck Rental, Inc. v. Kramer*, 263 Ark. 169, 563 S.W.2d 451 (1978); *Sailboat Apartment Corp. v. Chase Manhattan Mortgage & Realty Trust*, 363 So. 2d 564 (Fla. Dist. Ct. App. 1978). Many states adopted laws or regulations permitting ARMs, however, if they contained specified consumer protections. See, e.g., Kan. Stat. Ann. § 16-207(b) (1981); La. Rev. Stat. Ann. § 9:3504(D) (West 1983); Md. Com. Law Code Ann. § 12-118 (1983); 41 Pa. Cons. Stat. Ann. § 301(e) (Purdon 1971 & Supp. 1983); Tenn. Code Ann. § 47-14-202 (Supp. 1983); Vt. Stat. Ann. tit. VIII, § 1256 (Supp. 1981).

⁶⁸ Pub. L. No. 97-320, tit. VIII, 96 Stat. 1469 (1982) (codified in scattered sections of 12 U.S.C.). Title VIII does not apply to financings offered by individual homeowners in the sale of their houses, but is otherwise very expansive with regard to lenders and mortgage instruments to which its preemption applies. Rudolph, Schmelzer & Weiner, *Federal Legislation Affecting Mortgage Credit*, 38 Bus. Law. 1311, 1319-20 (1983). States may override the preemption within three years. Garn Act § 805(a), 12 U.S.C. § 3804(a) (1982).

⁶⁹ Specifically, state-chartered commercial banks are authorized to use alternative mortgages conforming to the Comptroller's rules for national banks. 12 U.S.C. § 3803(a)(1)

substantial deregulation of alternative mortgage instruments has permitted them to dominate the mortgage market. It is estimated that two-thirds of the home mortgages originated in 1983 were ARMs, and over \$175 billion in ARMs are anticipated in 1984.⁷⁰

2. *New Seller Strategies*

High interest rates also dampened demand for homes by increasing mortgage loan costs and by decreasing homebuyers' ability to qualify for these loans. In response to these problems, sellers have tried to avoid high rates—or at least avoid their appearance. Thus, although the apparent market rate for home mortgages in April 1982 was 17%, the average rate advertised and charged in major cities was between 12% and 14%.⁷¹

One reason for below-market rates has been the use of "creative financing" to sell old homes. Under such financing the buyer may "assume" the seller's existing low-rate mortgage and finance the difference between the selling price and the balance on the loan through a second mortgage provided by a financial institution or the seller.⁷² Even though the second mortgage bears the current interest rate, the "blended" rate is substantially below market.

(1982); see 12 C.F.R. pt. 29 (1984). State-chartered credit unions may use alternative mortgages permitted by the National Credit Union Administration. 12 U.S.C. § 3803(a)(2) (1982); see 12 C.F.R. § 701.21-6B (1984). State-chartered savings and loans, mortgage banks, and other creditors may avoid state restrictions by following the FHLBB's rules for federal savings and loans. 12 U.S.C. § 3803(a)(3) (1982); see 12 C.F.R. § 545.33 (1984).

⁷⁰ E. Gray, Statement Before the Subcommittee on Housing and Community Development of the House Committee on Banking, Finance and Urban Affairs 4 (June 21, 1984), reprinted in *Adjustable Rate Mortgages (ARMs): Hearings Before the Subcomm. on Housing and Community Development of the House Comm. on Banking, Finance and Urban Affairs*, 98th Cong., 2d Sess. (1984) (forthcoming) (statement of Chairman, FHLBB) [House hearings hereinafter cited as 1984 ARM Hearings]; H. Snyder, Statement on Alternative Rate Mortgages 2 (July 31, 1984), reprinted in 1984 ARM Hearings, *supra* (statement of Director, W. Coast Regional Office, Consumers Union). Many of these ARMs are sold on the secondary mortgage market. See Browne, *The Development and Practical Application of the Adjustable Rate Mortgage Loan: The Federal Home Loan Mortgage Corporation's Adjustable Rate Mortgage Loan Purchase Program and Mortgage Loan Instruments*, 47 Mo. L. Rev. 179, 197 (1982).

⁷¹ See New First Mortgages!, *Housing Fin.*, Aug. 1982, at 1, 2 (average initial rate for first mortgage loans in 1982 was 13.4%).

⁷² See Case, *Creative Financing Instruments*, 48 Real Est. Appraiser & Analyst, Spring 1982, at 45; Jaffee, *Creative Finance: Measures, Sources and Tests*, 3 *Housing Fin. Rev.* 1 (1984); Selling Creative Financing, *Housing Fin.*, May 1982, at 1 (by Oct. 1980, 40% of single-family home sales involved creative financing; in Apr. 1982 the proportion was 70%).

This technique is thwarted, however, if the mortgagee inserted a "due-on-sale clause" entitling it to accelerate repayment in the event of a sale.⁷³ In that case the seller might accept the first mortgage at a below-market rate.⁷⁴ Generally, seller first or second mortgages are short term: a big "balloon" payment is due after three to ten years, consisting of the principal and the interest not covered by prior monthly payments.⁷⁵

A second way to avoid the appearance of high interest rates has been seller buydowns: the seller pays the lender several points so that the advertised interest rate is below market.⁷⁶ Buydowns help sales both by making the interest rate look less frightening and, in some cases, by helping purchasers qualify for loans. Because lenders require that the first year's monthly payments be no more than a certain percentage of total family income, sellers can buy down the interest rate for only the first few years (partial buydowns) and still enable a marginal homebuyer to qualify for a loan.⁷⁷ Even without seller buydowns, lenders often offer ARMs for low initial rates.

Finally, some of the new loan instruments that lenders devel-

⁷³ In the late 1970's, several states, either by statute or judicial decision, voided due-on-sale clauses in mortgage deeds of trust. See Rudolph, Schmelzer & Weiner, *supra* note 68, at 1315-16. Title III of the Garn Act, however, preempts these restrictions and permits a broad range of "lenders" to enter into contracts with due-on-sale clauses. 12 U.S.C. § 1701j-3(a)(2), (b)(1) (1982). The Act sets forth nine circumstances where lenders are prohibited as a matter of federal law from accelerating a loan. *Id.* § 1701j-3(d) (as amended by Act of Nov. 30, 1983, Pub. L. No. 98-181, tit. IV, § 473, 97 Stat. 1153, 1237). The Act permits acceleration, however, in the event of a sale of the home.

⁷⁴ In April 1982, 77% of assumed mortgages, 79% of seller first mortgages, and 75% of seller second mortgages were three points or more below market. See *Selling Creative Financing*, *supra* note 72. New imputed-interest rules with tax laws might discourage below market creative financing. See *infra* note 189.

⁷⁵ See *Balloon Mortgages*, *Housing Fin.*, Dec. 1982, at 1-2 (in 1982, balloon mortgages were used in 20% of resale transactions, most of them involving seller financing; average term of a seller loan was 6.4 years).

⁷⁶ See J. Guttentag, *Recent Changes in the Primary Home Mortgage Market* 8-14 (Apr. 1984), reprinted in 1984 ARM Hearings, *supra* note 70; *New First Mortgages!*, *supra* note 71, at 2 (in 1982, 38% of new first mortgages provided by institutional lenders had seller buydowns of the interest rate; the interest rate was bought down an average of 4.0 percentage points); *Marketing Strategies to Sell Homes*, [Economics Dep't Nat'l Ass'n of Home Builders] Econ. News Notes for the Building Indus., Mar. 1982, at 2 (in 1982, 60% of builders used buydowns as part of their strategy).

⁷⁷ See Jones, *Buying a lower interest rate sells houses*, *Builder*, July 1, 1980, at 22; FNMA Expanded Buy-Down Mortgage Option, in *FNMA Affordability Plus: New Programs Tailored to the Needs of Today's Builders* 2-7 (1982).

oped have been used to help buyers meet initial qualification requirements or to avoid high institutional interest rates. Graduated payment mortgages (GPMs) have low monthly payments for the first several years of the loan and then increase over time. The advantage of these loans is that more homebuyers can qualify for loans because more have an income of four times the *initial* payments.⁷⁸ Graduated payment adjustable mortgage loans (GPAMLs), shared appreciation mortgages (SAMs), and other loan instruments share the GPM features of low initial payments, which help first-time homebuyers qualify for loans.⁷⁹

3. *End of Usury Ceilings*

Another consequence of rising interest rates was that they compelled regulators to reconsider state usury ceilings. In each of four periods of sharply increasing national interest rates (1966-1967, 1968-1971, 1974-1975, 1979-1981), the market rate hit or exceeded the usury ceilings of several states.⁸⁰ During these periods lenders, brokers, and homebuilders warned their legislatures that if they refused to lift the ceilings, mortgage money in the state would dry up and flow to areas that allowed higher interest rates.

State legislatures responded in three ways. At first, believing that rate increases would be only temporary, many states increased their ceilings to just above the prevailing rate.⁸¹ As rates continued

⁷⁸ See McTernan & Nagle, *The GPM/VRM: A Mortgage for Inflationary Times*, Mortgage Banking, Oct. 1981, at 39; Personal Business, Home-Buying Help from a Graduated-Mortgage Plan, Bus. Wk., Jan. 29, 1979, at 113; see also Smith, Wiest & Field, *Demographic Study of Potential Demand for AMIs*, in 1 *Alternative Mortgage Instruments Research Study* ch. IV (1977) (GPMs can increase overall homeownership potential by 1.5% to 5%) (FHLBB, publisher).

⁷⁹ See FTC, *The Mortgage Money Guide: Creative Financing for Home Buyers* (1982).

⁸⁰ Cf. McNulty, *A Reexamination of the Problem of State Usury Ceilings: The Impact in the Mortgage Market*, Q. Rev. Econ. & Bus., Spring 1980, at 16 (discussing market rate in Georgia in 1974-1975).

⁸¹ In 1965, before rates started to rise, the usury ceilings of 10 states were at 6%, six states were at 7%, and 12 states (plus D.C. and Puerto Rico) were at 8%. See Fand, *Mortgage Market Impediments and Uniform State Transaction Laws*, in *Housing for the Poor* 68 (D. Reeb & J. Kirk eds. 1973) (Table 4.6); Hershman, *supra* note 19, at 198 (listing states). Between 1968 and 1970, when national market rates increased to over 9%, states having low usury ceilings increased their rate maxima. By 1969, no state ceiling remained at 6%, four were at 7%, three were at 7.5%, and 15 were at 8%. See Report of the Commission on Mortgage Interest Rates 115-16 (1969). By late 1973, only the Vermont's ceiling was less than 8%. See Matthews, *Housing Squeeze Spurs State Legislators to Act on Usury Laws*, Mortgage Banker, Jan. 1974, at 40, 44-47. Nonetheless, mortgage rates reached the ceilings

upward in the 1970's, many states simply abolished usury ceilings, at least for residential first mortgage loans.⁸² Finally, some states adopted a "floating" ceiling set several points above an objective market index, such as long term U.S. bonds.⁸³

Reconsideration of state usury ceilings also occurred at the federal level. In 1979, congressional hearings found experts and federal regulators virtually unanimous in criticizing state usury ceilings for cutting off credit to high-risk homebuyers, discouraging home loan and construction activity, and disrupting the secondary mortgage market.⁸⁴ In December 1979, Congress temporarily preempted state ceilings on first residential mortgage loan charges.⁸⁵

After further hearings in 1980, Congress concluded that where usury laws required below market interest rates, mortgage funds would be unavailable and would instead flow to states where market yields were available.⁸⁶ As part of its plan to deregulate financial institutions in 1980, Congress passed the Depository Institu-

of 19 states by September 1973. See *The High Cost of Money*, Newsweek, Sept. 10, 1973, at 62.

⁸² Six states did so in the mid-1970's—Kentucky, Maine, North Carolina, Oregon, Pennsylvania, and Virginia. At least eight other states abolished ceilings for home mortgage loans after 1979—Arizona, Hawaii, Illinois, Nebraska, South Carolina, South Dakota, Vermont, and Wisconsin.

⁸³ Four states adopted floating ceilings by 1978—Alaska, Minnesota, Ohio, and Pennsylvania. At least 13 more adopted floating ceilings in the next two years—California, Delaware, Georgia, Kansas, Mississippi, Missouri, Montana, Nevada, New Jersey, New Mexico, New York, Tennessee, and West Virginia.

⁸⁴ Usury Lending Limits: Hearing Before the Senate Comm. on Banking, Housing, and Urban Affairs, 96th Cong., 1st Sess. 28 (1979) (statement of Jay Janis, Chairman, FHLBB); see *id.* at 20 (statement of J. Heimann, Comptroller of the Currency) (usury laws "fail to accomplish their desired objectives, have an adverse impact on production and employment, distort allocation of credit among markets and among States," and harm medium-income savers and borrowers); *id.* at 25 (testimony of H. Black, Board Member, Nat'l Credit Union Administration); *id.* at 34-35 (statement of F. Schultz, Vice-Chairman, Board of Governors, Fed. Reserve Board Sys.) (usury ceilings are useless or counterproductive). Chairman Janis gave similar testimony before members of the House on January 24, 1980. Regulation Q and Related Measures: Hearings Before the Subcomm. on Financial Institutions Supervision, Regulation and Insurance of the House Comm. on Banking, Finance and Urban Affairs, 96th Cong., 2d Sess. 14-95 (1980) [hereinafter cited as Regulation Q Hearings].

⁸⁵ Pub. L. No. 96-161, § 105(a)(1), 93 Stat. 1233, 1234 (1979) (codified at 12 U.S.C. § 1735f-7 (1982)). Section 105(a)(1) preempted state usury laws governing most residential first mortgages for the period December 28, 1979 to March 31, 1980. *Id.* § 104.

⁸⁶ S. Rep. No. 368, 96th Cong., 1st Sess. 19 (1979), reprinted in 1980 U.S. Code Cong. & Ad. News 236, 254 ("This artificial disruption of funds availability not only is harmful to potential homebuyers in states with such usury laws, it also frustrates national housing policies and programs.").

tions Deregulation and Monetary Control Act,⁸⁷ Title V of which preempts state usury regulation of first mortgages on homes.⁸⁸ Section 501(a)(1) preempts the "provisions of the constitution or the laws of any State expressly limiting the amount of interest, discount points, finance charges, or other charges" paid or received in connection with federally related residential first mortgage loans made after March 31, 1980.⁸⁹ The preemption does not apply to second mortgages,⁹⁰ but is quite broad as to first mortgages: there is no requirement that the borrowed funds be used to buy the residential property or that the debtor live in the house purchased.⁹¹ The preemption is also subject to specific state override and reinstatement of its usury law between April 1, 1980 and April 1, 1983.⁹² The FHLBB is the agency that Congress charged with the

⁸⁷ Pub. L. No. 96-221, 94 Stat. 161 (codified as amended in scattered sections of 12 U.S.C.). For commentary on this Act, see Ahearn, *The Depository Institutions Deregulation and Monetary Control Act of 1980 and Its Effect on the Mortgage Market*, 1981 *Ariz. St. L.J.* 211; Burke & Kaplinsky, *Unraveling the New Federal Usury Law*, 37 *Bus. Law.* 1079 (1982); Climo & Evans, *Interest Rate Deregulation*, 37 *Bus. Law.* 1381 (1982).

⁸⁸ 12 U.S.C. § 1735f-7 note (1982). Section 501(c) preempts state usury regulation of "residential manufactured homes," but conditions that preemption upon lender compliance with the FHLBB's regulations limiting prepayment penalties, balloon payments, late charges, and deferral fees, 12 C.F.R. § 590.4(d)-(g) (1984); upon requiring a refund of precomputed finance charges on prepayment, *id.* § 590.4(c); and upon requiring the lender to give the borrower 30 days notice of default and a right to cure the default before accelerating the debt or repossessing the mobile home. *Id.* § 590.4(h). Lenders must also comply with any existing state consumer protection laws (apart from usury ceilings), except those that overlap with and are no more protective than the Board's consumer protections. *Id.* § 590.4(b).

⁸⁹ 12 U.S.C. § 1735f-7 note (1982). The Act specifies six classes of first mortgage transactions that qualify for preemption, including virtually all residential first mortgage loans by institutional creditors and loans by individuals financing the sale of residential real estate owned and (at one time) occupied by the individual as his principal residence. See 12 C.F.R. § 590.2(b) (1984); Burke & Kaplinsky, *supra* note 87, at 1082-83.

⁹⁰ 12 U.S.C. § 1735f-7 note (1982).

⁹¹ See Op. FHLBB Gen. Counsel No. 37 (Sept. 22, 1980) (borrower need not expect to reside in the dwelling); Op. FHLBB Gen. Counsel No. S-12 (Feb. 20, 1981) (similar).

⁹² 12 U.S.C. § 1735f-7 note (1982); see 12 C.F.R. § 590.3(b) (1984). At least fifteen states and Puerto Rico have opted out. 1981 Alaska Sess. Laws ch. 107, § 2 (effective July 1, 1980); Act of June 10, 1981, ch. 294, 1981 Colo. Sess. Laws 1178 (effective July 1, 1981); Act of March 29, 1983, § 7, 1983 Ga. Laws 1151-52 (codified at Ga. Code § 7-4-20 (Supp. 1984)) (effective Mar. 31, 1983); Idaho Code § 28-49-105 (Supp. 1984) (effective Mar. 31, 1983); 1980 Iowa Acts 547-48; Act of May 14, 1980, ch. 76, § 1, 1980 Kan. Sess. Laws 387 (effective May 17, 1980); Me. Rev. Stat. Ann. tit. IX-A, § 1-110 (Supp. 1984); 1981 Mass. Acts ch. 231 (effective Sept. 2, 1981); Act of Dec. 31, 1981, ch. 604, § 4, 1980 Minn. Laws 1156 (codified at Minn. Stat. § 47.203 (Supp. 1984)); 1982 Neb. Laws 623 (effective July 17, 1982); 1981 Nev. Stat. S.B. 101 (effective June 14, 1981); 1983 N.C. Sess. Laws ch. 126 (effective Mar. 31, 1983); Act of June 14, 1980, Act 3, § 1, 1980 P.R. Laws 871-72 (effective June 24, 1980);

implementation and interpretation of section 501.⁹³

II. THE POST-USURY LAW REGULATORY GAP: MORE TRIAL AND ERROR

Through preemption and substantive rulemaking, federal law has largely displaced state law as the main guidance for bankers, builders, and brokers engaged in residential first mortgage transactions. The premise of federal policy is that consumers are best protected when they are well-informed and the mortgage market is competitive.

In theory, federal intervention increases market competitiveness in two ways. First, the federally encouraged secondary market should give local financial institutions easy access to a national supply of mortgage money, while permitting new firms to enter the local market and offer a nationally competitive rate. Second, disclosure rules should ensure that consumers have complete information about all alternatives, thus enabling them to compare competing offers. Advertisements indicating finance terms must give the standardized APR for a home loan for easy comparison during the shopping process. Upon deciding to buy a specific home, the consumer can also shop for financing. He will receive a Truth-in-Lending Act statement of the finance charge, a good faith estimate of closing costs, and a HUD guide explaining closing costs from each lender to which he submits an application. If the consumer is interested in an alternative mortgage instrument, the lender must disclose more detailed information. Armed with information received at every point in the shopping process, the decisionmaker supposedly shops for the optimal mortgage and settlement deal by comparing alternatives and chooses a mortgage only after he is persuaded that further search would not be worth the effort. At settlement, a HUD form maps out the dollars-and-cents details of the transaction for the homebuyer.

Based on this ideal situation of a competitive market combined

Consumer Protection Code Revision Act of 1982, No. 385, § 1, 1982 S.C. Acts 2289 (effective June 30, 1982); S.D. Codified Laws Ann. § 54-3-15 (Supp. 1983); Act of Oct. 31, 1981, ch. 45, 1981 Wis. Laws 571 (effective Nov. 1, 1981).

⁹³ 12 U.S.C. § 1735f-7 note (1982). The Board has implemented § 501 through a regulation (12 C.F.R. pt. 590 (1984)), official Board interpretations, and unofficial opinion letters that the General Counsel issues in response to lender queries. See Burke & Kaplinsky, *supra* note 87, at 1079-80.

with readily available consumer information, an impressive body of literature suggests that further government intervention is unjustified.⁹⁴ Professors Schwartz and Wilde, for example, argue that government intervention to increase information is justified only if a market is noncompetitive. Where there are many active shoppers for a relatively homogeneous product, the competitive pressures will generally assure market-efficient prices and practices.⁹⁵ Yet there is considerable evidence that unfair dealing does occur during the home sale and loan transaction.

This Part examines the evidence and suggests an explanation for the persistence of unfair dealing. First, analysis of the transaction in light of psychological decisionmaking theory reveals that homebuyers are often imperfectly informed about mortgages and related costs, in part due to their own tendency not to shop and compare deals effectively, and in part due to the role of the sales process in influencing, and sometimes distorting, consumer choice. Second, existing disclosure rules do not necessarily ameliorate these information imperfections because the mortgage-related disclosures are usually given to the homebuyer only after the decision has been made, are sometimes inaccurate, and are often hard to understand or are otherwise useless. Third, market forces, such as commercial reputation and the existence of many active shoppers, afford insufficient protection because sellers and their agents can profit by segmenting the market. Because of these shopping and market imperfections, home mortgagors frequently are deceived, pay excessive mortgage-related charges, or assume excessive risk.⁹⁶

⁹⁴ By analyzing the need for government intervention from the perspective of this market-analysis literature, this article does not assume that there are not other justifiable bases for intervention. See Kelman, *Choice and Utility*, 1979 *Wis. L. Rev.* 769.

⁹⁵ Schwartz & Wilde, *Intervening in Markets on the Basis of Imperfect Information: A Legal and Economic Analysis*, 127 *U. Pa. L. Rev.* 630 (1979) [hereinafter cited as Schwartz & Wilde, *Intervening in Markets*]. Professor Eisenberg argues that seller exploitation of the buyer's distress, transactional incapacity, susceptibility to unfair persuasion, or price-ignorance can only occur when the relevant market deviates from perfect competition. Eisenberg, *The Bargain Principle and Its Limits*, 95 *Harv. L. Rev.* 741 (1982); see also Craswell, *Tying Requirements in Competitive Markets: The Consumer Protection Issues*, 62 *B.U.L. Rev.* 661 (1982) (analyzing tie-ins and their regulation); Schwartz & Wilde, *Imperfect Information in Markets for Contract Terms: The Examples of Warranties and Security Interests*, 69 *Va. L. Rev.* 1387 (1983) (analyzing the behavioral consequences of imperfect consumer information) [hereinafter cited as Schwartz & Wilde, *Imperfect Information*].

⁹⁶ It might be argued that once market imperfections have been identified, then regulatory policy ought to attack the structural market problems rather than the imperfect infor-

A. *Structural Information and Shopping Imperfections in the Integrated Home Sale and Loan Transaction*

Systematic study of the home sale and loan transaction is still rudimentary, and even the leading empirical work is disappointing in its analytical approach and methodology. Conceding the interim nature of conclusions based upon such work, it is still possible to discern some of the structural features of the home sale and loan transaction. Even this tentative picture of the process and its participants suggests inherent problems with relying on existing federal disclosure rules as the only protection of homebuyers. Homebuyers often do not approach the mortgage decision rationally; they want to complete the sale quickly, and frequently make elementary cognitive mistakes in evaluating what little data they uncover. In addition, the market recognizes and takes advantage of the inability or unwillingness of many consumers to shop. The homebuyer is typically educated, not by reading complicated disclosures, but by talking to bankers, builders, and brokers—intermediaries who often benefit from giving advice.

1. *Homebuyer as Imperfect Shopper and Decisionmaker*

A wealth-maximizing decisionmaker searches for information until the search costs appear to outweigh the benefits. More important problems require a greater search effort, because the risk of loss in the event of a suboptimal decision is greater. Most of the literature on consumer behavior and disclosure rules seems to assume that homebuyers act as rational wealth-maximizers who can

mation. This article's response is that imperfect information itself can create structural market problems by allowing sellers profitably to segment less sophisticated consumers in the market and exploit them. A substantial body of economic literature suggests that the presence of imperfect information gives firms market power. See, e.g., Nelson, *Information and Consumer Behavior*, 78 J. Pol. Econ. 311 (1970); Stigler, *The Economics of Information*, 69 J. Pol. Econ. 213 (1961). Steve Salop concludes that "if information is costly, each small firm obtains market power, and the equilibrium (if one exists) is characterized by prices above competitive levels and sometimes price dispersion as well. *The relevant market structure with imperfect information is not perfect competition but rather monopolistic competition.*" Salop, *Information and Market Structure: Information and Monopolistic Competition*, 66 Am. Econ. A. Rev. 240, 240 (1976) (emphasis in original); see Satterthwaite, *Consumer Information, Equilibrium Industry Price, and the Number of Sellers*, 10 Bell J. Econ. 483 (1979); Stuart, *Consumer Protection in Markets with Informationally Weak Buyers*, 12 Bell J. Econ. 562 (1981).

be expected to shop vigorously and compare deals.⁹⁷ Yet as early as the 1950's, social scientists found it "surprising how lethargic and casual" most consumers were in "the hunt" for a home.⁹⁸ In his study of two high-income Connecticut communities, Professor Hempel found that about one-third of the homebuyers spent less than a month actively searching for a home and visited or sought information about fewer than six homes; almost one-half of the homebuyers did not shop for a loan.⁹⁹ Peat Marwick's 1980 report to HUD on closing costs (the Peat Marwick Study) concluded that two-thirds of the homebuyers sampled did no shopping for a

⁹⁷ Stigler, *supra* note 96, at 219; see Schwartz & Wilde, *Imperfect Information*, *supra* note 95, at 1433. Yet empirical studies have shown that consumers often engage in very little overt search for very expensive products. See, e.g., Katona & Mueller, *A Study of Purchase Decisions*, in 1 *Consumer Behavior: The Dynamics of Consumer Reaction* 30, 56 (L. Clark ed. 1954) (durable goods); Newman & Staelin, *Prepurchase Information Seeking for New Cars and Major Household Appliances*, 9 *J. Marketing Research* 249 (1972). Economists have been working to refine the classical model in light of these studies. See, e.g., Beales, Mazis, Salop & Staelin, *Consumer Search and Public Policy*, 8 *J. Consumer Research* 11 (1981).

⁹⁸ See Norris, *Processes and Objectives of House Purchasing in the New London Area*, in 1 *Consumer Behavior: The Dynamics of Consumer Reaction*, *supra* note 97, at 25; Ray & Dunn, *Local Consumer Information Systems for Services: The Market for Information and Its Effect on the Market*, in *The Effect of Information on Consumer and Market Behavior* 92, 94 (A. Mitchell ed. 1978) (median number of houses that a homebuyer sees is around two or three, and many consumers apparently buy first house shown).

⁹⁹ Table 1 in Hempel, *Search Behavior and Information Utilization in the Home Buying Process*, in *Marketing Involvement in Society and the Economy* 241, 243 (P. McDonald ed. 1969) (1969 Fall Conf. Procs. Am. Marketing Ass'n), reveals that 28% of the surveyed homebuyers spent a month actively searching for a home before signing a purchase agreement, 32% visited only two homes with the intent of considering for purchase, and 46% contacted, at most, one institutional lender concerning a mortgage loan. Thirty-nine percent of the sample actively shopped for two to six months before signing purchase agreement, 34% visited three to seven homes with intent of considering for purchase, and 34% contacted two to three lenders. About one-third of the sample shopped quite vigorously. In another publication based on the same data, Professor Hempel reported that factors reducing consumer search included not wanting to miss out on a "good value" (48%), expiration of a lease or sale of home (22%), husband or wife were "busy" and wanted to minimize search (12%), desire to get settled before baby was born or school started (11%), desire to stop paying rent and avoid double payments (4%), and others (15%). D. Hempel, *The Role of the Real Estate Broker in the Home Buying Process* 35, table 8 (1969). Factors extending search were inability to find what the family wanted (45%), lack of urgency (11%), need to find mortgage financing (11%), delay pending change in family situation (10%), inability to shop intensively for any solid period of time (9%), need to find a buyer for the previous home (5%), one family member hesitant to buy a home (5%), and others (18%). *Id.* These reasons for extending searches suggest that some of the "vigorous" shoppers actually did not do a thorough job of searching.

lender and over 80% did no shopping for title insurers or other providers of closing services.¹⁰⁰

Professor Arndt persuasively argues that homebuyers usually do not engage in wealth-maximizing behavior but, instead, act like "satisficers."¹⁰¹ They search for alternatives until they find one that is "good enough," rather than "best," because it satisfies their threshold needs.¹⁰² A satisficing strategy involves a more superficial search for information and less cognitive work than a wealth-maximization strategy: fewer requirements must be met, fewer alternatives will be canvassed (and will be tested rather haphazardly), and the testing criteria will be a minimum range of qualities (i.e., a cutoff point rather than a weighted addition of desired qualities).

Although satisficing uses sensible short-cuts that generally yield good results for low-cost decisions,¹⁰³ it may be a poor strategy for high-cost decisions such as buying and financing a home. A bad decision made on insufficient information costs the homebuyer thousands of dollars. Given the high stakes, why do so many consumers fail to shop? Professors Janis and Mann suggest a conflict model to explain why people act as satisficers instead of maximizers even when the consequences may be costly.¹⁰⁴ The conflict model asserts that choices create stress within the decisionmaker and that the greater the perceived potential losses the greater the

¹⁰⁰ 2 Peat, Marwick, Mitchell & Co., *Real Estate Closing Costs: RESPA § 14a*, at XIV.7 (1980) [hereinafter cited as Peat Marwick Study]. This study is the published report of Peat Marwick's comprehensive investigation of the effectiveness of RESPA, which HUD commissioned.

¹⁰¹ See J. Arndt, *Consumer Search Behavior: An Exploratory Study of Decision Processes Among Newly-Married Home-Buyers* 27-28 (1972).

¹⁰² *Id.* Professor Arndt's study of first-time homebuyers in Bergen, Norway found that about half of the consumers searched for a month or less, relied on word of mouth, and only inspected one home. *Id.* at 24-25. The distinction between maximizing and satisficing in decisionmaking is also discussed in J. March & H. Simon, *Organizations* (1958); H. Simon, *Models of Man: Social and Rational* (1957); Wright, *Consumer Choice Strategies: Simplifying vs. Optimizing*, 12 *J. Marketing Research* 60 (1975).

¹⁰³ Although conceding that decisionmakers are "not always motivated to seek an optimal choice," Professor Klein argues that satisficing strategies very often produce good decisions. Klein, *Utility and Decision Strategies: A Second Look at the Rational Decision Maker*, 31 *Organizational Behav. & Hum. Performance* 1 (1983).

¹⁰⁴ I. Janis & L. Mann, *Decision Making: A Psychological Analysis of Conflict, Choice and Commitment* (1977). For other studies that incorporate conflict theory, see F. Hansen, *Consumer Choice Behavior: A Cognitive Theory* 145-63 (1972); Bettman, *Consumer Information and Search Strategies*, in *The Effect of Information on Consumer and Market Behavior*, *supra* note 98, at 35.

stress.¹⁰⁵ Some perception of risk (thus, stress) is necessary for effective decisions because this perception creates a condition of "vigilance."¹⁰⁶ Low risk, on the other hand, suggests to the decisionmaker that he need not spend much thought or effort on the decision, according to the conflict model. A very high degree of risk (stress), however, can actually disrupt the rational decisionmaking process.

First, such risk may lead to "defensive avoidance," in which the decisionmaker becomes frustrated by the stress of what apparently are a series of costly alternatives that are hard to compare. A defensive avoidance reaction may take one of three forms: "procrastination," if the decisionmaker thinks the disadvantages of postponement are not great; "shifting responsibility" for the decision to someone else, if he believes that someone else is more knowledgeable and can be trusted; or "bolstering," simply choosing the most readily available alternative, if he thinks the disadvantages of postponement are great and has little confidence that further information will help him make a better decision.¹⁰⁷ Second, a high level of risk may lead to "hypervigilance," in which further information may be useful, but the decisionmaker thinks that there is insufficient time to search for that information and deliberate.¹⁰⁸ This perception causes panic, paralyzing the decisionmaker's search abilities.¹⁰⁹ Again, he chooses the most readily available alternative.¹¹⁰

This explanation of decisionmaking provided by the conflict model suggests intuitively appealing reasons why consumers' degree of search activity in looking for homes differs so markedly. The above-noted studies suggest that the amount of shopping is

¹⁰⁵ See I. Janis & L. Mann, *supra* note 104, at 45-80.

¹⁰⁶ The conflict model specifies four conditions for "vigilant" decisionmaking: (1) awareness of a serious threat, disadvantage, or lost advantage if no action is taken; (2) awareness of risks if the most obvious action is taken (low confidence that path of least resistance is the best one); (3) hope that a search for information and advice will lead to a better, or less risky, escape route (confidence that a satisfactory solution exists and can be discovered); and (4) belief that there is sufficient time to search and deliberate before any serious threat, disadvantage, or loss of advantage will materialize (high confidence that a good solution can be found within the time available). See *id.* at 62.

¹⁰⁷ *Id.* at 87.

¹⁰⁸ *Id.* at 51.

¹⁰⁹ *Id.*

¹¹⁰ *Id.*

usually more a function of people's emotional response than a rational assessment of the costs and benefits of further search.¹¹¹ That is, the high stakes and the overwhelming complexity of the transaction will paralyze many homebuyers' desire to shop for the best deal. For instance, first-time homebuyers tend to shop for homes less effectively than more experienced homebuyers because of excessive stress.¹¹²

The conflict model also explains that homebuyers are generally less inclined to shop for mortgage loans and related expenses because these decisions are less likely to be made under the ideal amount of stress.¹¹³ Although costly, settlement services are minor compared to the price of the house. Thus, the consumer will have a low level of stress and, as a result, less incentive to shop for the best deal. Even when the buyer has more stress, such as in the loan decision, bolstering or shifting of responsibility may occur because the complex factors involved discourage all but the most confident and knowledgeable shopper from a thorough search. Moreover, there is a substantial likelihood of some hypervigilance for both the loan and settlement decisions. Once the homebuyer has signed the sales contract, there is pressure on him to obtain a loan and retain settlement providers quickly. In addition, upon making the big decision of which home to buy, the consumer may want to "get it over with," by completing the deal; the choice of the home may have consumed whatever cognitive energy the consumer had.

The conflict model suggests that homebuyers do not always make the best choices concerning the home, the loan, and the set-

¹¹¹ See D. Hempel, *supra* note 99, at 37 (homebuyer comments that the search process was often terminated "to reduce the frustration and anxiety resulting from attempts to reconcile a bewildering array of factors which affect the purchase decision"; the general attitude, "I'm glad it's over.>").

¹¹² This fact may explain the difference in shopping found in the Hempel and Arndt studies. Professor Arndt's sample (half looked at only one home) was young, first-time homebuyers in Norway, whereas Professor Hempel's sample (two-thirds of the homebuyers looked at several homes) consisted of persons from an affluent area in Connecticut, who were more knowledgeable and experienced consumers.

¹¹³ For sources empirically supporting this conclusion, see 2 Peat Marwick Study, *supra* note 100 (little shopping for closing costs); U.S. Dep't of Housing and Urb. Dev. & Veterans Admin., *Mortgage Settlement Costs* (1972), reprinted in *Real Estate Settlement Costs*, FHA Mortgage Foreclosures, Housing Abandonment, and Site Selection Policies: Hearings on H.R. 13337 Before the Subcomm. on Housing of the House Comm. on Banking and Currency, 92d Cong., 2d Sess. 735 (1972) [hereinafter cited as HUD/VA Settlement Costs Study]; Hempel, *supra* note 99, at 243, 247 (little shopping for loans).

tlement services because they may not shop for alternatives. Even when they do shop, consumers often make poor choices because of cognitive error in the weighing and evaluation of information.¹¹⁴

One type of cognitive error is that decisionmakers often give too much weight to "vivid" information (information that is either presented dramatically or that sparks an emotional response) because it is more memorable. Because of this "availability heuristic," useful but straightforward and bland information may be slighted in favor of flashy, emotive information.¹¹⁵ This tendency may skew homebuying and financing decisions because the information conveyed in the most dramatic form (advertisements and sales talk) is usually biased.

Another type of cognitive error is the "representativeness heuristic," in which decisionmakers categorize something based on its similarity to a scheme or stereotype, thus ignoring the possibility of random similarity or differences in a particular case.¹¹⁶ Thus, the homebuyer whose friend likes the house that a certain homebuilder built or who received a low-interest loan from a certain bank may overgeneralize what could be a random experience and want to do business with these same firms without a careful survey of other experiences.

A third cognitive problem is "anchoring," in which the decisionmaker makes an initial judgment based on a single characteristic and then fails to adjust the initial decision to account for other characteristics.¹¹⁷ In the home sale and loan transaction, the buyer

¹¹⁴ For the best sources of this genre of psychological decisionmaking literature, see R. Nisbett & L. Ross, *Human Inferences: Strategies and Shortcomings of Social Judgment* (1980); Tversky & Kahneman, *Judgment Under Uncertainty: Heuristics and Biases*, 185 *Sci.* 1124 (1974), reprinted in *Judgment Under Uncertainty: Heuristics and Biases* 3 (D. Kahneman, P. Slovic & A. Tversky eds. 1982) [hereinafter cited with page references to the reprinted article].

¹¹⁵ For an excellent discussion of the biases that vivid, or "salient," information creates, see R. Nisbett & L. Ross, *supra* note 114, at 45-62.

¹¹⁶ See R. Nisbett & L. Ross, *supra* note 114, at 17-28, 36-42; Tversky & Kahneman, *supra* note 114, at 4-11. Experimental results show that most people do, indeed, believe in the erroneous "law of small numbers"—that a small sample set of the population will yield representative results. This erroneous belief causes decisionmakers to have unrealistic expectations about the stability of observed patterns and the replicability of prior beneficial experiences. See Tversky & Kahneman, *Belief in the Law of Small Numbers*, 2 *Psychological Bull.* 105 (1971), reprinted in *Judgment under Uncertainty: Heuristics and Biases*, *supra* note 114, at 23.

¹¹⁷ See R. Nisbett & L. Ross, *supra* note 114, at 41-42; Tversky & Kahneman, *supra* note 114, at 14-18.

may focus on a vivid feature or a generalization and fail to adjust the deal's value when he later learns more of its details, such as the loan terms or settlement costs.

2. *The Importance of Intermediaries—The Sales Pitch*

An agent or broker is the person who actually sells the house. If the seller is a large homebuilder, it typically has its own staff to show potential homebuyers model homes or sample apartments. If the seller is not a homebuilder, he usually retains a real estate broker or firm. The broker helps the seller price the house, "lists" the house (i.e., places a description of it on his own list of homes for sale and usually on a "multiple listing service" that a pool of brokers use), and shows the house to potential buyers; he also helps the buyer arrange closing services and financing. When a home is listed in a multiple listing service, "cooperating brokers" may show the house to buyers whom they have contacted.¹¹⁸

Whatever the species, agents have an incentive to shorten homebuyers' shopping and steer them to particular deals. Agents are eager to make sales because they typically earn all or most of their income on a commission basis.¹¹⁹ The "sales pitch" is the tool agents use to make sales. Honed to a pseudo-science by builders and brokerage firms to make their agents more effective, the sales pitch seeks to maximize the prospect that the marginal homebuyer (the buyer who is likely to buy a competing home or not buy at all) will promptly purchase one of the houses for which the agent is responsible.

¹¹⁸ Eighty-one percent of the existing homes sold each year are sold through real estate brokers operating under exclusive listing contracts, 92% of sales through brokers are listed on a multiple listing service, and 66% of the broker sales involve cooperating brokers. See 1 FTC Los Angeles Regional Office, *The Residential Real Estate Brokerage Industry* 8 (Dec. 1983) [hereinafter cited as *FTC Brokers Study*].

¹¹⁹ Discussion of the means of compensating sales agents, especially real estate brokers, can be found in *id.* at 79-110; 2 Peat Marwick Study, *supra* note 100, at II.6-.14; Garfinkel, *Your Sales Staff Can Be Your Best Asset If You . . .* 1. Train Salespeople to Hang in There and Work a Little Harder; 2. Motivate and Compensate Salespeople so They Don't Cop Out Mentally, *Housing*, June 1982, at 56-59.

In 1966, three out of four builders used their own staff to sell houses, and 61% of the builders paid the staff on a pure commission basis. Bureau of Building Marketing Research, *Builder Practices in Selling Single-Family Homes* 2 (1966). Today, it appears that fewer builders pay a straight commission, and many builders pay a salary augmented by a sum based on sales performance.

A common and widely publicized technique of home marketing is "action selling"—continuous controlled interaction between the agent and the buyer, where the agent is always the initiator, pushing the buyer toward a particular sale.¹²⁰ Once the agent encounters a prospective customer,¹²¹ he determines the buyer's preferences and suggests homes that seem to fit them.¹²² If the buyer seems interested in one of the suggested homes, the agent "involves" the prospect by demonstrating how various features of the home solve the buyer's problems or advance his goals. During this time, the prospect is treated as the future owner of the home.¹²³ Once the prospect becomes involved with the recommended home, the action seller pushes him toward a decision by feeding him justifications to buy now rather than later. The most common justifier is that "this home is a real bargain that might go away,"¹²⁴ but other justifiers appeal to tax advantages of owning a home, possi-

¹²⁰ "Action selling" is explicated at great length in J. Mills, *Action Selling: NAHB's New Handbook for Salesmen* (1975). Other recent expositions along similar lines include Gers, *How to Sell Today's Wary Homebuyer*, *Housing*, Feb. 1981, at 37-45; Jordan, *Concrete Ideas to Sell Houses*, *Builder*, May 1982, at 82, 84; Thagard, *How to Sell a House*, *Builder*, Aug. 1983, at 38-40; *Nine Techniques for Winning Sales Game*, Prof. Builder, *Apartment Bus.*, Mar. 1981, at 72.

It is unclear how prevalent action selling is in the day-to-day activities of salespeople and brokers. It is clear, however, that many (and probably most) of the unusually successful sales personnel and firms use some variation of the technique. These "successful sellers" proselytize the technique in trade journal articles, in speeches at professional conventions, and in lectures at seminars run by firms and trade associations (such as the national and state associations of Realtors and homebuilders). Finally, homebuilding and brokerage firms train their personnel in these techniques; indeed, action selling is the subject of a set of video tapes (starring Jim Mills) that have in the last decade been widely used to train sales agents.

¹²¹ See J. Mills, *supra* note 120, ch. 3, at 47-72 ("Prospecting—or How to Dig Up Your Own Raw Material"). Mills suggests aggression at every point. For example, in phone and advertisement prospecting, he urges the use of "power words," words that pack a "wallop." *Id.* at 64-67. "Real impact comes when you involve emotions with your words and phrases." *Id.* at 65.

¹²² See Thagard, *supra* note 120, at 38; see also J. Mills, *supra* note 120, at 83-84 (the most persuasive approach to selling homes is to solve the buyer's problems for him); *id.* at 97-113 ("digging out the buying situation" by a friendly interview to determine most important considerations for the particular buyer).

¹²³ Even if the prospects "decide against the lot, by drawing them in as participants instead of treating them as audience you've set them up so their next lot will be seen through the eyes of potential owners" J. Mills, *supra* note 120, at 140.

¹²⁴ According to Jim Mills, *"A Bargain Justifies Almost Anything: Any purchase seems justifiable, if it's a wild bargain."* *Id.* at 174 (emphasis in original).

ble investment value, or the importance of a settled home for the family.¹²⁵

The buyer often has reservations about purchasing a home that the sales agent recommends. Rather than avoiding discussion of these objections, the action seller seeks them out so that he can negate them.¹²⁶ For example, buyers can usually afford higher monthly payments than their current rental payments because of the tax deductions for mortgage interest. The agent may answer other reservations, which point to real trade-offs, more indirectly—by minimizing the importance of the objection, refocusing the objection to make it answerable, deflecting attention from the objection with countervailing advantages, or (if all else fails) resorting to generalities about the importance of owning a home.¹²⁷

Despite the agent's justifications, the buyer may hold back. The action seller then seeks to "pivot" the prospect from involving and analyzing to buying.¹²⁸ Sometimes the pivot will be a small preliminary decision (for example, the color scheme of the kitchen) that can make the buyer feel committed to the ultimate purchase.¹²⁹ The pivot may also be a summary of the justifications mentioned earlier, especially the idea that the purchase must be made immediately or the buyer will suffer. Such "urgency pivots" include the following: "The available interest rate looks like it may go up next week. Better buy now." Or: "Another buyer is interested in this

¹²⁵ For these and other justifiers, see *id.* at 173-89. Among the justifiers used by T. Richey & Co. of Texas are the following: "Play on the prospective buyer's fear of loss by demonstrating the expected amount of money that may be lost by waiting until later to buy a house"; "[e]xplain and clarify tax benefits"; and "show the reluctant buyer how withholding taxes can be reduced to increase monthly cash flow." *Nine Techniques for Winning Sales Game*, *supra* note 120, at 72.

¹²⁶ See Thagard, *supra* note 120, at 40 ("Eliminate the objections, and help the shoppers make a decision. People avoid decisions just by nature."); see also J. Mills, *supra* note 120, ch. 11, at 210-29 ("Defensive Actions"); Ryness, *Twelve Marketing Points to Help Sell Homes*, *Pac. Coast Builder*, Dec. 1980, at 15 (most buyers seek reasons not to go ahead with a purchase; salesperson's job is to blunt these reasons by systematically eliminating perceived problems).

¹²⁷ See J. Mills, *supra* note 120, at 219-27. Jim Mills' basic advice is "to consider NEGATIVES AS POISON IVY—the sooner you can return to a positive environment the better Defend, and then get the hell out of there." *Id.* at 227.

¹²⁸ See *id.* ch. 10, at 200-08 for a comprehensive analysis of the types of "pivots" and their role in selling homes.

¹²⁹ See Thagard, *supra* note 120, at 40 (once salesperson has interested the buyer in a house, he should try to obtain a money deposit to hold the home open and commit the buyer to the decision).

one-of-a-kind home. If she makes a deal, all our effort will be wasted. Better move fast."¹³⁰

The sales pitch often helps orient the homebuyer to the many factors involved in the purchase of a home and conveys useful information. On the other hand, it is also calculated to short circuit the process of rational decisionmaking by engaging the buyer's emotions (to stimulate faulty cognitive evaluations) and by de-emphasizing the need to shop and compare.¹³¹ For example, a primary purpose of action selling is to convey vivid information that makes the home appear to be an attractive deal. The most vivid characteristics of the house may be the kitchen, the low-rate financing, and the energy-saving insulation package. Less vivid trade-offs and disadvantages will then be less important in the buyer's evaluation of the home. The buyer might even anchor his decision to the features the sales agent emphasizes, without sufficiently adjusting for other important considerations, such as the high-risk mortgage needed to finance the house. If the consumer is concerned about the terms of the mortgage packaged with the home, the agent can reassure him through the representativeness heuristic: other homebuyers have found that the risky mortgage works fine.

The sales pitch also seeks to minimize or eliminate homebuyer shopping that would reveal comparable or better deals. It creates conditions for bolstering by giving the homebuyer the impression that further shopping would not be useful. It creates conditions for hypervigilance by stressing urgency items and conditions for shifting responsibility by giving the buyer the impression that the agent is an expert on the complex process of home buying.

This phenomenon of the agent's befriending and counseling the homebuyer is the most significant.¹³² The agent may seriously mislead the buyer, who may not be aware of the agent's duties and motives (a "hidden agenda"). When a cooperating broker shows the buyer a home advertised on a multiple listing service, for ex-

¹³⁰ The pivots in text are adopted from *Seven Urgency Items to Weave Into Every Sales Presentation*, Housing, June 1982, at 60; see Gers, *supra* note 120, at 40-41 ("create urgency" for the homebuyer by offering bargains, fostering fears of loss due to inflation in sales prices or interest rates, and building a "buy now" psychology).

¹³¹ See, e.g., B. Napier, *How to Show and Tell to Up the Sell: A Guide for Home Builders, Real Estate People and Bankers* 21 (1979) ("Tip 7. People Buy Emotionally, Then Justify Purchases Rationally").

¹³² See Home Builder, *A Good Friend In Today's Mortgage Market*, Home Builder News, Oct. 1983, at 8.

ample, the buyer becomes aware that there is another broker—the “listing broker”—who represents the seller and splits his commission with the cooperating agent. Because the cooperating broker has been so helpful, the buyer naturally believes that the broker is his agent and is thus representing his interests.¹³³ This conclusion is not necessarily correct. Many multiple listing services contemplate that the cooperating broker will be the subagent (for the seller) of the listing broker.¹³⁴ The law in many states is quite ambiguous about when, if ever, the cooperating broker represents the buyer.¹³⁵ Functionally, the cooperating broker sees his job as putting together a deal, *not* necessarily representing the buyer's interests.¹³⁶

The homebuyer is even more likely to shift responsibility for the loan decision to the agent. The homebuyer is usually under pres-

¹³³ See Levine, *Does the Home Buyer Need His Own Broker?*, Real Est. Rev., Spring 1983, at 98, 99. But see Adler, *Disclosure and the Buyer-Broker Relationship*, Real Est. Rev., Winter 1982, at 94, 99 (buyers realize that brokers are self-interested and so discount the sales pitch). The FTC Brokers Study reports that 72% of the surveyed buyers believed that the cooperating broker “represented” them (31% believed this even when the listing broker sold the home), 1 FTC Brokers Study, *supra* note 118, at 69, and therefore told the broker the highest price they would pay (assuming that the information would remain confidential). *Id.* at 78. Four-fifths of the buyers said that the cooperating broker played a major role in negotiating the price on their behalf. *Id.* at 183. Sellers are also confused by the broker's ambiguous role. See *id.* at 78-79 (62% of buyers were told by brokers how low the seller was willing to go). The FTC Brokers Study concluded, however, that buyers are more seriously underrepresented in the process. *Id.* at 186-88.

¹³⁴ According to 1 H. Miller & M. Starr, *Current Law of California Real Estate* § 4.8, at 18-19 (1975),

[t]he standard form multiple listing agreement expressly authorizes the listing broker to seek the aid of cooperating brokers . . . [and] expressly authorizes the service or its members to act as sub-agents in procuring a purchaser in accordance with the terms of the listing. The result of this express authorization is that a cooperating broker becomes the agent of the listing seller for the purpose of imposing on the cooperating broker the fiduciary duties generally owed by an agent to his principal.

Accord *Kruse v. Miller*, 143 Cal. App. 2d 656, 300 P.2d 855 (Dist. Ct. App. 1956); *Frisell v. Newman*, 71 Wash. 2d 520, 429 P.2d 864 (1967); Comment, *Real Estate Brokers' Duties to Prospective Purchasers*, 1976 B.Y.U. L. Rev. 513 (1976); Comment, *A Reexamination of the Real Estate Broker-Buyer-Seller Relationship*, 18 Wayne L. Rev. 1343, 1353 (1972).

¹³⁵ See *infra* note 356. The FTC Brokers Study notes the modern industry view that cooperating brokers are agents of the seller, but points out that most buyers believe cooperating brokers represent them and that many brokers see themselves representing both buyer and seller in transactions. 1 FTC Brokers Study, *supra* note 118, at 182-84.

¹³⁶ See 1 FTC Brokers Study, *supra* note 118, at 193-94 (because they are paid on a contingency basis, some brokers view negotiation more in terms of closing the transaction, rather than representing a client).

sure to obtain financing immediately, is inexperienced in dealing with mortgage lenders, and is bewildered by the array of loan choices. Because the agent has already revealed his expertise in financing options (an integral part of the sales pitch), the buyer will often welcome or seek the agent's advice on which lender to use.¹³⁷

Similarly, the homebuyer will be inclined to shift responsibility to the agent or the lender for decisions relating to settlement services because of their complexity, their comparatively small cost, and the pressure induced by the lender's limited time commitment to make the loan.¹³⁸ Sometimes the lender will all but dictate the settlement services by requiring them to meet its standards of quality.¹³⁹ If the lender requires mortgage insurance on a conventional mortgage loan, it typically retains a mortgage insurer when the loan application is submitted, without even consulting the borrower.

In shifting responsibility for loan and closing cost decisions to the sales agent or the lender, the homebuyer is giving the decisions to people who may not care about price or future risks. Indeed, the referring intermediaries often have a hidden agenda of incentives to refer the homebuyer to second-best providers—either because the providers pay them, provide them with services, or have ongoing business connections with the intermediaries.¹⁴⁰

¹³⁷ The Hempel Study found that 46% of the buyers relied on real estate brokers or builders in deciding where to apply for a mortgage loan; 31% of the buyers also relied on brokers and builders for advice about the terms and conditions of the loan. Hempel, *supra* note 99, at 247, table 3.

The Peat Marwick Study suggests that one-third of all homebuyers today do no shopping and simply use the lender that the agent recommends. Peat Marwick found that in the eight metropolitan areas surveyed (Boston, Denver, D.C., Jacksonville, Los Angeles, San Antonio, St. Louis, and Seattle), 65% of the surveyed homebuyers did not shop at all for a lender; of this group of nonshoppers, 40% selected the lender a real estate broker recommended, and 11.5% used a lender the seller or homebuilder specified. 2 Peat Marwick Study, *supra* note 100, at X.14, .31.

¹³⁸ See 2 Peat Marwick Study, *supra* note 100, at VIII.2 (complexity and time constraints lead consumers to depend on others to arrange for settlement services).

¹³⁹ Peat Marwick found that 24.3% of the surveyed borrowers were required to use one or more service providers—especially title insurers (in 72.4% of the cases), escrow agents (53.5%), attorneys (44.5%), and surveyors (43.2%). *Id.* at X.48, exhibit X-16. Lenders affirmatively recommended providers to 24.4% of the surveyed borrowers—mainly title insurers (73.0% of the cases), escrow agents (58.2%), mortgage insurers (54.2%), surveyors (33.8%), and attorneys (33.1%). *Id.* at X.49, exhibit X-17.

¹⁴⁰ See Real Estate Settlement Procedures Act—Controlled Business: Hearings Before the Subcomm. on Housing and Community Development of the House Comm. on Banking, Fi-

3. *The Formally Integrated Transaction*

The "functionally integrated" transaction, where the builder or broker selling the home refers the homebuyer to sources of financing and settlement services, makes it easier for consumers to buy homes but also has the effect of discouraging shopping. Large homebuilders and a few brokerage firms have carried this process one step further by creating a "formally integrated" transaction for the buyer. In the formally integrated transaction, the firm controls the loan and settlement decisions and may use this control as an important part of the sales pitch. Chart 1 sets forth the integrated transaction as structured by many of the large builders.¹⁴¹

Once the buyer contracts to purchase one of the homes the builder offers, the agent will direct the buyer to the offices of an allied lender, often a wholly-owned subsidiary of the builder.¹⁴² The lender will offer a range of standard and alternative mortgage instruments, some of which are specially designed to qualify

nance and Urban Affairs, 97th Cong., 1st Sess. (1981) (lender or broker referrals to their "controlled" title companies may contribute to higher prices) [hereinafter cited as 1981 RESPA Hearings]; Breckenfeld, *supra* note 12 (builder-controlled mortgage companies accounted for almost all of builders' profits in 1981).

¹⁴¹ For glimpses of the formally integrated transaction, see Breckenfeld, *supra* note 12 (role of builder-owned mortgage subsidiaries); Hale, *Buying Down Interest Rates: New Form of Typical Financing?*, Real Est. Appraiser & Analyst, Summer 1983, at 21-23. Nothing in the extensive real estate/builder literature, however, has investigated this important marketing innovation. My research assistant, Kurt Giesler, and I therefore conducted a telephone survey of the organization and marketing practices of the 10 largest homebuilders and an in-depth study of one of the builders. W. Eskridge & K. Giesler, *Survey of Homebuilders* (1984) (unpublished survey) (copy on file with the Virginia Law Review Association). The study found that all of the nation's largest homebuilders maintain mortgage subsidiaries and an overwhelming majority of new homebuyers obtain financing from these affiliated lenders. At least one firm simply refuses so-called "outside financing." The others, on a local or regional basis, may refer prospective buyers to two or three selected alternative lenders. In either case, financing alternatives remain closely tied to sales efforts: affiliated and allied lenders provide virtually all mortgage financing in sales by large builders. Settlement services are integrated in turn by the lenders. The homebuyer who enters a sales office and finds ready financing next enters the mortgage company office to find title and mortgage insurance, legal services, taxes, and escrows conveniently prearranged. Comparison shopping for some services is permitted in theory, but most new home buyers are, in practice, led through a standardized closing with a set cast of characters. First-time buyers are especially likely to assume essentially passive roles in the settlement process.

¹⁴² See Breckenfeld, *supra* note 12, at 122 (at least 26 large homebuilders have their own mortgage subsidiaries); see also H. Hoagland & L. Stone, *supra* note 11, at 437-38 (in many instances, the financial institution making the loans for construction also does the final mortgage financing).

CHART 1

The Formally Integrated Homebuying Process

"borderline" buyers to purchase homes. Employees of the allied lender, or a firm with which it has an established relationship, will conduct settlement. The allied lender receives the mortgage note bearing the below-market interest rate that the builder advertised. Soon after settlement, the allied lender will sell the note at a discount pursuant to a prearranged commitment with a buyer on the secondary mortgage market. The builder, which has received the proceeds of the home sale, will pay the allied lender a specified number of points to reimburse it for making the below-market loan and will reimburse the allied lender for settlement costs.

This strategy has become popular because builders realize that buyers are more concerned about high interest rates and their ability to qualify for loans. A formally integrated transaction can allay these concerns by offering a package deal offering a below-market interest rate and easy qualification criteria, made possible through GPMs or ARMs with low initial rates. To the extent that buyers are also concerned about being able to afford both a downpayment and closing costs, the builder might arrange for settlement and even pay most of the expenses.¹⁴³

This package deal often becomes a critical part of the builder's marketing campaign. Advertisements stress low-rate financing terms and reduced closing costs. The sales pitch further stresses that the integrated transaction is effortless because all the decisions have been made for the buyer and that the great financing deal enables the buyer to qualify for a better home. Indeed, the agent may be able to anchor the buyer's attention onto the financing and settlement terms, using them to bolster the buyer's original attraction to the deal and to answer objections.

Like the sales pitch and functional integration, the formally integrated transaction is a market response to consumer desires to make homebuying easier. The trade-off is that shopping is curtailed and rational decisionmaking made more difficult. Builders dispute this conclusion by arguing that shopping is now concentrated up front: the decision to buy a home explicitly includes clos-

¹⁴³ Thus, in 1982, when demand was depressed, one survey found that 60% of the homebuilders bought down interest rates, 55% paid buyer's points, and 44% paid buyer's closing costs (except for taxes and prepaid escrow items). *Marketing Strategies to Sell Homes*, *supra* note 76, at 2; see "What's Working?" *Builder Success Stories*, *The NAHB News*, May 17, 1982, at 7.

ing cost and financing considerations.¹⁴⁴ This argument, however, suggests a further problem. Homebuyers often cannot understand low-rate financing and closing cost deals because the builder has factored the points and closing costs it pays back into the price of the house.

Pricing a house, like the sales pitch, has been systematized by many homebuilders, especially the larger ones. Each model the builder offers is priced by adding up its costs—the lot, the structure, area preparation costs, profit, and anticipated closing costs and points—and then adjusting the cost-plus price to fit the market (increasing the price if the market is booming, lowering it in periods of low demand).¹⁴⁵ Customers typically do not understand whether or how much the cost of closing costs and points bleeds back into the home price.

The functionally or formally integrated home sale and loan transaction encompasses all homebuying decisions, from house shopping through closing. Marketed through a powerful sales pitch as a convenient, no-hassle package, the integrated transaction can cause consumers to truncate their shopping and distort their infor-

¹⁴⁴ Cf. Leichey, *Here's How Home Manufacturers Can Establish Own Finance Companies*, *Automation in Housing and Manufactured Home Dealer*, Oct. 1983, at 22. Most builders consider their involvement in the financing and settlement aspects of home sales incidental to their primary objective of moving inventory. See W. Eskridge & K. Giesler, *supra* note 141. Integration of the overall transaction is described as an efficient means of expediting home sales for the following reasons: (1) like builders, buyers consider financing and settlement incidental to purchase, and they seek out vendors offering no-fuss packages; (2) builders can comparison shop for these incidentals more effectively than most homebuyers and can therefore offer a package worth more than the sum of its parts; and (3) integration permits builders to qualify marginal borrowers for loans and to react flexibly in various markets to changes in interest rates.

Some builders' marketing strategies specifically emphasize the integrated character of the transaction. Most claim, however, to concentrate their efforts on matching buyers to homes and to developing and employing expertise in finance and settlement matters only to the extent necessary to consummate sales.

¹⁴⁵ In the 1950's, development companies priced lots they sold based upon the costs of land, overhead, and advertising. See H. Hoagland & L. Stone, *supra* note 11, at 439-40. Builders in the 1970's have become even more rigidly tied to cost-plus pricing. See L. Grebler & F. Mittelbach, *The Inflation of House Prices: Its Extent, Causes and Consequences* 61 (1979). If as a matter of marketing strategy, the builder decides to pay points or closing costs, they become a cost of doing business and part of overhead (or a separate line for marketing costs). If, on the other hand, the builder pays points to rid itself of excess inventory on an ad hoc basis, the points may then just be one-time expenses not considered in pricing. See Hale, *supra* note 141, at 26. Under either approach, the home price will remain subject to competitive pressures.

mation processing. Ironically, it is these very activities that federal disclosure laws are designed to encourage.

B. The Inadequacy of Federal Disclosure Rules to Correct Information Imperfections

The tendency of the marketing process to discourage or distort homebuyers' shopping is cause for concern because it creates information imperfections and, therefore, opportunities for sophisticated intermediaries to take advantage of homebuyers. The purpose of federal disclosures is to reduce these opportunities and to stimulate shopping and efficient decisionmaking. Usually, however, the disclosures fail to accomplish these purposes because the homebuyers receive them after they have reached a decision, and because these disclosures are sometimes inaccurate, misleading, or hard to use and understand.¹⁴⁶

1. Disclosure: Too Late

A central flaw is that the rules generally do not require disclosure until the homebuyer applies for a mortgage loan.¹⁴⁷ Yet the effective decisionmaking period is usually before the application is

¹⁴⁶ Several early empirical studies concluded that the Truth-in-Lending Act disclosures did make consumers somewhat more aware of the cost of credit, but that "the improved knowledge of credit rates and charges that could reasonably be attributed to TIL had relatively little effect on credit search and usage behavior." Day & Brandt, *Consumer Research and the Evaluation of Information Disclosure Requirements: The Case of Truth in Lending*, 1 J. Consumer Research 21, 31 (1974); see Brandt, Day & Deutscher, *Information Disclosure and Consumer Credit Knowledge: A Longitudinal Analysis*, 9 J. Consumer Aff. 15 (1975); Mandell, *Consumer Perception of Incurred Interest Rates: An Empirical Test of the Efficacy of the Truth-in-Lending Law*, 26 J. Fin. 1143, 1148 (1971).

¹⁴⁷ The Truth-in-Lending Act originally required that disclosure be made "before the credit is extended," Pub. L. No. 90-321, § 128(b), 82 Stat. 146, 155 (1968), which permitted lenders to provide the disclosures to homebuyers at settlement—the very point when the homebuyer is likely not to read the disclosures carefully—supposedly because there is simply no time to do so earlier. The Simplification Act coordinated the Truth-in-Lending Act requirements with the timing of RESPA disclosures. 15 U.S.C. § 1638(b)(2) (1982); see 24 C.F.R. §§ 3500.6-.7 (1984). For residential mortgage loans also subject to RESPA, "good faith estimates" of Truth-in-Lending Act disclosures must be made to the mortgagor within three days of his application. 15 U.S.C. § 1638(b)(2) (1982); 12 C.F.R. § 226.19(a) (1984).

Federal agency regulations concerning alternative mortgage instruments require that the requisite disclosures be made no "later than three business days following receipt of an application," id. § 545.33(f) (FHLBB), or on the earlier of the date on which the bank first provides written information concerning alternative mortgage loans or provides a loan application to the prospective borrower. Id. § 29.7(a) (Comptroller General).

made. The sales pitch is designed to focus the buyer's attention on the special deal that the agent offers and to discourage the buyer from comparing different lenders. Once a decision is made, even if tentative, the theory of "cognitive dissonance" posits that the buyer views subsequent data as supportive of the decision: he will seek out and emphasize positive data, while ignoring or denigrating negative data.¹⁴⁸ Thus, a homeowner will tend to consider himself committed to his decision by the time he submits a loan application, and subsequent disclosures will have a minimal impact.¹⁴⁹

Another reason disclosures do not necessarily encourage shopping is that they do not yield comparative data. The homebuyer will generally submit an application to just one lender because the application process is troublesome and because most lenders charge a nonrefundable application fee of several hundred dollars.¹⁵⁰ With only one application submitted, there is only one set of Truth-in-Lending, RESPA, or alternative mortgage disclosures, and thus little basis for comparison shopping. In the formally integrated transaction, there may be official barriers to comparison shopping. The broker or builder may simply inform the homebuyer

¹⁴⁸ The original theory of "cognitive dissonance" posited that decisionmakers confronted with conflicting data will weigh alternatives and gather information before making a decision, but that once the decision is made the decisionmaker will attempt to reduce "dissonance" by justifying the decision and ignoring or denigrating contrary data and alternative choices. See L. Festinger, *Conflict, Decision and Dissonance* (1964).

Later studies reject Festinger's distinction between predecisional and postdecisional cognitive processes and argue that it is the pattern of coping rather than the stage of decision process that is the crucial factor determining receptiveness to information and lack of bias in evaluating that information. See I. Janis & L. Mann, *supra* note 104, at 171-72, 212-14. Professors Janis and Mann, for example, divide the decisional process into five stages: (1) appraising the challenge, (2) surveying alternatives, (3) weighing alternatives, (4) deliberating about commitment, and (5) adhering to the initial choice despite negative feedback. They point out that suboptimal operation will occur long before commitment if the conditions for defensive avoidance or hypervigilance are present. They do concede, however, that the decisionmaker's pattern of coping will often change from vigilance to defensive avoidance as he moves from stage three to stage four because the decisionmaker has formed the tentative opinion that he will not find a better solution, and in stage four there will often be a temporary period of selective exposure to information that bolsters the favored alternative. *Id.* at 213-14.

¹⁴⁹ See White & Munger, *Consumer Sensitivity to Interest Rates: An Empirical Study of New-Car Buyers and Auto Loans*, 69 *Mich. L. Rev.* 1207, 1210, 1239 (1971).

¹⁵⁰ See 2 Peat Marwick Study, *supra* note 100, at III.12 (more than 60% of the lenders surveyed required nonrefundable prepayment for credit report and appraisal at the time loan application is submitted).

which lender and title company should be used,¹⁵¹ and the homebuyer is likely to defer to that fiat.

2. *Disclosure: Misleading*

The most common disclosure made during the sales process is the APR. Yet the applicable federal regulations permit sellers and their agents to use APR or effective interest rate figures that severely understate or deflect attention from the true costs of credit.

The Truth-in-Lending Act "finance charge" (the basis for determining the APR) does not include many expenses the homebuyer incurs to induce the lender to make the mortgage loan. Thus, although premiums for lender-required mortgage payment protection, mortgagor life/accident/health insurance, and property damage/liability insurance are included in the finance charge, premiums for title insurance, which lenders also require, are not.¹⁵² Attorneys' fees, notary charges, appraisal fees, and charges for credit reports are also excluded, even though the lender would not make the mortgage loan if the buyer did not agree to pay these expenses.¹⁵³ There is no functional difference among these charges to justify excluding some of them from the finance charge; the reason for the exclusions is largely historical and political. These exclusions created the need for RESPA—a separate and somewhat duplicative disclosure regime. As a result of these exclusions, the APR is not only unrealistic but may be misleading, because sellers and lenders have perverse incentives to keep the advertised APR low, while charging higher prices for homes or settlement services.

The exclusion of seller's points from the finance charge is sub-

¹⁵¹ Although RESPA § 9, 12 U.S.C. § 2608(a) (1982), forbids sellers from requiring the buyer to use any particular title insurer, the seller's allied lender can achieve the same result. See Ford & Allison, *The Impact of Title Insurance and Controlled Business on the S&L Industry*, Fed. Home Loan Bank Board J., June 1981, at 2, 5 (lenders sometimes charge review fee if the homebuyer does not use the title company it suggested). Some lenders charge a review fee of several hundred dollars if the borrower does not use the attorney it suggests, which also effectively forecloses buyer shopping.

¹⁵² Compare 12 C.F.R. § 226.4(b)(7)-(8), (d) (1984) (finance charge includes premiums for credit life, accident, health, loss-of-income, property damage, or liability insurance, unless certain consumer protections are assured) with id. § 226.4(c)(7)(i) (in residential mortgage transactions, however, finance charge does not include title insurance).

¹⁵³ Compare id. § 226.4(b)(4) (finance charge generally includes appraisal, investigation, and credit report fees) with id. §§ 226.4(c)(7)(ii)-(iii) (in residential mortgage transactions, finance charge does not include document preparation, notary, appraisal, credit report fees).

ject to the greatest manipulation.¹⁵⁴ These points are excluded even though buyer's points are included and the buyer is usually indirectly paying most or all of the seller's points through a higher home price. The original position of Regulation Z was that discount or seller's points were to be included in the finance charge to the extent that they were passed on to the buyer in the form of a higher home price.¹⁵⁵ The Federal Reserve Board revised the Regulation in 1981 to exclude seller's points from the finance charge,¹⁵⁶ on the ground that it is hard (if not impossible) for lenders to determine whether the seller actually increased the sales price.¹⁵⁷ Similar arguments were successfully made by lenders and trade associations when the Board's staff recommended changing the rule in 1982.¹⁵⁸

Nevertheless, the difficulty of administration argument is unpersuasive. If the earlier "soft" rule was difficult to administer, the Board should have created a "hard" rule that seller's points are part of the finance charge, regardless of whether they are passed on to the buyer. Such a rule better fits the marketplace reality that some or all of the points are passed on, and comports with the

¹⁵⁴ Compare id. § 226.4(b)(3) (finance charge generally includes "points") with id. § 226.4(c)(5) (finance charge excludes "seller's points").

¹⁵⁵ 35 Fed. Reg. 17,029 (1970) (formerly codified at 12 C.F.R. § 226.406(b) (1980)).

¹⁵⁶ 12 C.F.R. § 226.4(c)(5) (1982) ("Charges excluded from the finance charge" include "Seller's points"); see id. pt. 226, Supp. I-Official Staff Interpretations, Comment 17(c)(1)-3 (examples of third party buydowns). New Part 226 was promulgated after enactment of the Simplification Act, 46 Fed. Reg. 20,848, 20,892 (1981), but compliance with the new regulations was optional until April 1, 1982 (later extended to Oct. 1, 1982).

¹⁵⁷ See 47 Fed. Reg. 32,433, 32,433-34 (1982); FTC, Memorandum and Consumer Fact Sheet (Mar. 17, 1983), reprinted in 5 Consumer Cred. Guide (CCH) ¶ 96,752 (Mar. 31, 1983); Schlar, *From the Administrative Agencies: Disclosures to Home Buyers in "Creative Financing" Situations—The FRB Backs Down*, 11 Real Est. L.J. 349, 353 (1983).

¹⁵⁸ In response to criticisms of the new rule, the Board proposed two different types of amendments in 1982. See 47 Fed. Reg. 32,433, 32,433-36 (1982). The first alternative would have removed the exclusion and stipulated that seller's points are finance charges if (and only to the extent that) they are passed on only to buyers taking advantage of a financing arrangement. If the lender were unsure whether seller's points were being passed on (or the amount), it could include all or any part of them in the APR. Id. at 32,437-39 (proposing deletion of 12 C.F.R. § 226.4(c)(5)). The second alternative would have required disclosure in statements and advertisements of these facts: (1) that the seller has paid money to obtain the financing, (2) the amount paid by the seller, and (3) that the APR understates the cost of credit to the extent that the seller's payment is passed on in the form of a higher sales price. Id. at 32,439-41 (to be codified at 12 C.F.R. §§ 226.17(a)(1) n.38, .18(s), .24(b)-(c)). Although the Board rejected both alternatives after adverse industry comment, 47 Fed. Reg. 44,742 (1982), either would be preferable to the existing regulation.

language of the Truth-in-Lending Act, which says that discounts and points are to be added to the finance charge.¹⁵⁹

Finally, current disclosure regulations enable sellers and their agents to advertise initial interest rates, called "teaser rates," that are substantially less than the rates that will prevail for most of the loans' lives. Teaser rates are sometimes used with fixed-rate mortgages (usually as the result of partial seller buydowns), but they are particularly troublesome with mortgage instruments whose future interest rate is indeterminate (ARMs). For these mortgages, Regulation Z permits advertisement of an initially low "effective rate" that enables buyers to qualify for loans, if the APR is also disclosed and the advertisement shows the limited term to which the rate applies.¹⁶⁰ The APR for an ARM is a composite of the initial rate and the future rate under the applicable adjustable index. Because no one knows what the level of the index will be in the future, the present index level is used.¹⁶¹ It is hard to see how this procedure will educate homebuyers, for neither of the rates that may be advertised is the "real" rate. The effective rate is an artificially low hook used to attract the buyer's attention or to enable marginal buyers to qualify for loans, and the APR is a hypothetical blend of the present rate and what the future rate would be if the future resembled the present.

¹⁵⁹ 15 U.S.C. § 1605(a)(1) (1982) (finance charge includes "any amount payable under a point, discount, or other system of additional charges"); see *infra* note 167 (most or all sellers' points are passed on to buyers in the form of higher home prices). There is also substantial case law involving health spa and other tied financing plans suggesting that disclosure is compelled when notes are sold at a "discount" to the ultimate lender pursuant to prearranged commitments—similar to the arrangement in the wholly integrated home transaction. See *Yazzie v. Reynolds*, 623 F.2d 638 (10th Cir.), cert. denied, 449 U.S. 982 (1980); *Joseph v. Norman's Health Club, Inc.*, 532 F.2d 86, 93-94 (8th Cir. 1976); *Kruger v. European Health Spa, Inc.*, 363 F. Supp. 334 (E.D. Wis. 1973); *Glaire v. La Lanne-Paris Health Spa, Inc.*, 12 Cal. 3d 915, 926-27, 528 P.2d 357, 364-65, 117 Cal. Rptr. 541, 548-49 (1974). Other courts have declined to apply the *Joseph-Kruger* line of cases when a large number of customers of the seller bought with cash. In these circumstances, the discount fees were generally absorbed in the seller's overhead and not specifically built into the price. See *Jennings v. Edwards*, 454 F. Supp. 770, 777 (M.D.N.C. 1978), *aff'd mem.*, 598 F.2d 614 (4th Cir. 1979); *Manzina v. Publishers Guild, Inc.*, 386 F. Supp. 241, 244 (S.D.N.Y. 1974).

¹⁶⁰ See 12 C.F.R. § 226.24(b) (1984); 49 Fed. Reg. 13,482, 13,484, 13,1486 (Apr. 5, 1984) (to be codified at 12 C.F.R. pt. 226, Supp. I—Official Staff Interpretations, Comment 24(b)-5).

¹⁶¹ See 12 C.F.R. pt. 226, Supp. I—Official Staff Interpretations, Comment 22(a)(1)-4 (1984); 49 Fed. Reg. 13,482, 13,485 (Apr. 5, 1984) (to be codified at 12 C.F.R. pt. 226, Supp. I—Official Staff Interpretations, Comment 18(f)-8); Anderson & Bowman, *Does Your Advertising Pass Truth-in-Lending Test?*, *Real Est. Rev.*, Spring 1983, at 92-95.

3. *Disclosure: Too Much*

Critics have complained that Truth-in-Lending Act disclosures overwhelm consumers with complicated forms and too much information, thus discouraging them from shopping.¹⁶² Consumers have a limited ability to absorb and process information during any given period. If they receive too much, they either will be unable to make accurate comparisons or will be discouraged from even trying to evaluate the data.¹⁶³ Some psychological studies suggest that the processing capacity of short term memory is five to seven "chunks" of information—beyond that, processing problems occur.¹⁶⁴ These "information overload" studies may not represent the final word on the subject, but there is substantial agreement that decisionmakers cannot effectively process numerous chunks of information. Even after the Simplification Act, which was meant to reduce information overload, the proliferation of disclosure rules threatens the goals of federal regulation by overwhelming the homebuyer with information.

The Truth-in-Lending Act form may be simpler, but it still discloses more than ten items of information, and these disclosures are in addition to those required by RESPA. There are even more disclosures for a homebuyer applying to a savings and loan for an ARM. Apart from the APR and RESPA disclosures, the homebuyer will receive more than ten facts and several complicated explanations that must be disclosed pursuant to FHLBB regulations.¹⁶⁵ The size and complexity of these disclosures will in-

¹⁶² See, e.g., Davis, *Protecting Consumers from Overdisclosure and Gobbledygook: An Empirical Look at the Simplification of Consumer-Credit Contracts*, 63 Va. L. Rev. 841, 843-44 (1977) (consumers intimidated by excessive Truth-in-Lending Act disclosures); Landers & Rohner, *A Functional Analysis of Truth in Lending*, 26 UCLA L. Rev. 711, 721-34 (1979) (Truth-in-Lending disclosures all but impenetrable for typical consumer).

¹⁶³ See J. Bettinan, *An Information Processing Theory of Consumer Choice* (1979); Malhotra, *Information Load and Consumer Decision Making*, 8 J. Consumer Research 419 (1982).

¹⁶⁴ Compare Simon, *How Big is a Chunk?*, 183 Sci. 482 (1974) (chunk capacity of short term memory is five to seven), with Broadbent, *The Magic Number Seven After Fifteen Years*, in *Studies in Long Term Memory* 1-18 (A. Kennedy & A. Wilkes eds. 1975) (magic number may be as low as three or four); Malhotra, *supra* note 163, at 427-28 (dysfunctional effects of information overload if respondents provided with 10 or more alternatives in the choice set or with information on 15 or more attributes).

¹⁶⁵ FHLBB regulations require that the following facts be disclosed:

- the term of the contract;
- the initial interest rate (if known);

timidate the average homebuyer, who will either not read the disclosures carefully or will read them only with guidance from an intermediary.

In a sense, this confusion is not the fault of disclosure rules, for they simply mirror the complexity of the choices. If a homebuyer really does want to compare various ARMs, for example, he must know the initial (qualifying) rate and how long that rate will remain; the index used to adjust the rate and the margin above the index at which the new rate is set; how often the lender can adjust the rate or monthly payment in response to index changes; the loan-to-value ratio and mortgage insurance costs; the number of points and any caps on how much rates or payments can go up each year or over the life of the loan; prepayment penalties; delinquency and default charges; and property, life, or health insurance requirements.

The desire for disclosure rules that foster rational decisionmaking thus creates a seemingly insurmountable dilemma: complete disclosure will be hard to use, if not utterly paralyzing, but fragmentary disclosure (as in the case of seller's points) creates opportunities for sellers or lenders to present misleading "bargains." A second problem is that little if any of the disclosed information is psychologically meaningful to the homebuyer. For example, the

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- the amount of the initial payment (if known);
 - an explanation of how the lender establishes the amortization schedule for the loan;
 - a full explanation of how the interest rate, the payment, the loan balance, or the term to maturity may be adjusted, including identification of the index to be used and the effect the adjustment of one item may have on the others;
 - information to be contained in each notice of an adjustment and how far in advance that notice will be provided;
 - a description of all contractual contingencies under which the loan may become due or that may result in a forced sale of the home;
 - if the loan is a partially or a nonamortized loan, a statement that a large payment will be due at maturity and that the lender is under no obligation to refinance the loan;
 - a description of any prepayment penalty and escrow payments the contract requires; and
 - an example of the interaction of all variable features of the loan over a period of time.

12 C.F.R. § 545.33(f) (1984). The Comptroller General requires banks to make similarly detailed disclosures. *Id.* § 29.7. Note that the FHLBB and Comptroller General disclosure rules are deemed to be substitutes for the special Truth-in-Lending Act requirements for VRMs. *Id.* § 226.18(f) & n.43.

FHLBB requires the presentation of a hypothetical situation showing how the variable features of the loan might interact, but lenders usually present "safe" scenarios in which interest rates fluctuate without major consequence. Thus, nothing concretely reveals the main risks; nothing counteracts the vivid portrait of the advantages of buying that is painted during the sales process.

C. Market Forces Do Not Solve Specific Mortgage Loan Problems

Many homebuyers make purchase and financing decisions based on imperfect information. Current disclosures do little to rectify this problem and may even exacerbate it by providing misleading information that brokers can use during the sales process to anchor consumer decisionmaking to an unrealistically low APR or effective interest rate. Thus, homebuyers are sometimes misled, pay excessive prices for the loan or settlement services, or take on too much risk. Market incentives to offer consumers good deals are weak because the market for loans and closing services is linked to the home sale market. Moreover, the market is not perfectly responsive to competitive pressures because of the cooperative behavior of intermediaries and the failure of consumers to shop carefully.

1. Misleading Apparent Bargains: "Free" Closing Costs and Rate Buydowns

The homebuyer family reads the following ad: "TRUE VALUE HOMES—FINANCING THREE PERCENT BELOW MARKET (APR 11.25%). WE PAY CLOSING COSTS!!!!" The homebuyers go to see a True Value model home and encounter a salesperson, who emphasizes the low-rate loan available through True Value Financing Co. and the minimal up front cash the homebuyers will need to buy. The "easy terms" package impresses the homebuyers, who say that they will think over this bargain. "Great," says the agent, "but you'd better not dawdle because the builder won't be offering the closing costs bargain much longer. And because federal deficits might force interest rates up again, 11.25% financing may be discontinued." The homebuyers sign a sales contract the next week.

This strategy, where the homebuilder uses the finance and set-

tlement terms as an integral part of its sales effort, is common.¹⁶⁶ Sellers engage the potential homebuyer's attention through offering an apparent bargain interest rate and "free" closing costs, use that bargain as leverage to push the buyer toward the product, and clinch the deal by subtle warnings that this bargain may be short-lived.

In many instances, the "bargain" is not what it appears to be. The builder usually recoups closing costs and points paid to the lender by charging more for the home.¹⁶⁷ The homebuyers' net payments over time will be about the same—they trade lower up front charges for slightly higher monthly payments.¹⁶⁸ This trade-

¹⁶⁶ See supra note 143 and accompanying text. A survey of builder advertisements in the real estate section of the *Saturday Washington Post* from June 1976 to June 1978 (a period of interest rate stability) and from December 1979 to December 1981 (a period of substantial rate volatility), inspired this hypothetical. In the former period, typical advertisements by the large homebuilders emphasized: "No closing costs (except prepaid items). VA \$99 Moves You In. Excellent Conventional Financing Available." (Pulte Homes) "Low Downpayment! Low Interest Rates! Ryland will pay \$1500 toward Closing Costs (Except pre-paid items)." (Ryland Homes) "VA—No Money Down. Closing Costs Paid by Builder." (Hylten Enterprises) In the latter period, when interest rates were at very high levels, advertisements by large builders de-emphasized the closing cost gimmick and stressed low-rate financing.

This hypothetical was also inspired by the "Gregory Builders" scenario developed in the "Jim Mills Tapes" used by some homebuilders to train sales staff (Tape # 3). See supra note 120. To defuse homebuyer reservations about high costs and interest rates, the hypothetical salesperson counters with the builder's bargain closing costs and mortgage rate.

¹⁶⁷ See supra note 145 and accompanying text. Many writers have made the flat assertion that "the usual result of the existence of a point system is that the seller increases the price of his house so that he can absorb the discount." Benfield, Money, Mortgages and Migraine: The Usury Headache, 19 Case W. Res. L. Rev. 819, 860 (1968); see, e.g., Alberts, Business Cycles, Residential Construction Cycles and the Mortgage Market, 70 J. Pol. Econ. 263, 268-69 n.15 (1962). One econometric study suggests that the pass-through may be significantly less than 100% for FHA and VA loans, which purport to have strict appraisal checks on home prices. See Zerbst & Brueggeman, FHA and VA Mortgage Discount Points and Housing Prices, 32 J. Fin. 1766, 1770-72 (1977) (only 43% of FHA points and 56% of VA points are passed on to buyers, because sellers failed to predict accurately the number of points needed to meet FHA/VA yield requirements). A response to that study, however, questions its methodology and suggests that the pass-through is between 77% and 100% even for these more strictly monitored loans. See Colwell, Guntermann & Sirmans, Discount Points and Housing Prices, 34 J. Fin. 1049, 1054 (1979).

¹⁶⁸ Assume that the homebuyer purchases a \$55,000 home with a \$5000 downpayment. The builder pays \$1000 in closing costs plus \$4000 in points so that the lender will offer the \$50,000 loan at 13% interest, rather than the market yield of 14.4%. See FNMA, Mortgage Yield Conversion Tables and Supplemental Amortization Tables 450 (4th ed. 1979). The monthly payment on the 13% loan would be \$553.10 for a 30-year mortgage, id. at 721, compared with \$608.30 on the 14.4% loan. Id. at 745. Reasonably assuming, however, that the builder raised its price by \$5000 to enable it to pay points and closing costs, see supra

off might be advantageous to the homebuyers if they are short of cash after paying the downpayment. It is just as likely, however, that the homebuyers are fooled. They think they are getting a genuine bargain (a gift of closing costs and low-rate financing), an impression the wording of the advertisement reinforces: "True Value pays your closing costs and gives you low-rate financing," rather than "Closing costs included in the price of the house, and bought-down financing available."¹⁶⁹ The agent's sales pitch will also try to anchor the homebuyers' decision to the free closing costs and points, directing attention away from the higher price or other disadvantages. As a result, the buyers may rush their decision and truncate their shopping so as not to miss the apparent bargain; if they understood the true value of this particular deal, they would not be so eager to close the deal.¹⁷⁰

The homebuyers might actually be worse off with the True Value deal. For example, had the homebuyers taken out a 14% loan to finance the house at a lower price, they would have the option of refinancing the loan at a lower interest rate in the event that rates declined after the sale. They would not have that free-

note 167, the home price would have been \$50,000 and the 14.4% mortgage would have had a principal of only \$45,000 (with a \$5000 downpayment). The monthly payment for such a 30-year loan would be \$547.47, FNMA, *supra*, at 745, or almost \$6 less per month than the "bargain loan."

¹⁶⁹ At one point in the 1970's, the FTC in its informal compliance efforts took the position that "no closing costs" and "builder pays closing costs" were misleading and that the representation should be "closing costs included in price." The Federal Reserve Board, however, found that builders did not violate the Truth-in-Lending Act if they advertised "no closing costs" and "no charges for the seller's arranging financing for the buyer." See Federal Reserve Board Advisory Letter No. 848 (Oct. 11, 1974), reported in Consumer Cred. Guide (CCH) ¶ 31,170 (1974).

¹⁷⁰ About half of the respondents in the Hempel Study who rushed their homebuying decision did so to take advantage of a "bargain." See *supra* note 99. Professor Benfield has cogently argued that points mislead the buyer because he will often not know the seller is paying a discount to the lender. "If the buyer knew the amount of discount and the effect on the rate, he might prefer to arrange a loan from a different lender, or use other assets of his own in the purchase, or, perhaps, forgo the purchase until credit is available on better terms." Benfield, *supra* note 167, at 861; see also Regulation Q Hearings, *supra* note 84, at 215-16 (colloquy between Rep. D'Amours and S. Klamon, Nat'l Ass'n Mut. Sav. Banks) (few borrowers know exactly how points work); *id.* at 729 (testimony of R. Gnaizda, Public Advocates, Inc.) (points are deceptive if homebuyers are not aware of the actual hidden costs they impose). In the hypothetical developed *supra* note 168, if the buyers did not realize that seller-paid points and closing costs were factored back into the home price, they could be convinced that their monthly payment was actually \$55 less, instead of \$6 more, than the going rate.

dom under the True Value deal because the note bears interest at only 11.25%.¹⁷¹

Even if interest rates did not decline enough to make refinancing attractive, the homebuyers might have good reasons to prefer a lower price to a lower interest rate. For example, a larger percentage of their monthly payments over time would be tax-deductible interest payments, rather than nondeductible principal.¹⁷² Also, if the homebuyers only intend to keep the house for a short time, they clearly would prefer a lower price to a lower interest rate, because they expect to forgo most of the advantages of the low rate. It appears that if the loan is paid off before year seven, homebuyers who have effectively paid the buydown points have lost money.¹⁷³ Even if the homebuyers desired an 11% loan because they wanted to stay in the house for a long period, it is in their best interest to buy down the rate themselves (and get a lower home price) rather than to permit True Value to buy down the rate for them. When the homebuyers pay the buydown points, they may take an additional tax deduction; they probably receive no deduction when True Value pays the points.¹⁷⁴

¹⁷¹ See Regulation Q Hearings, *supra* note 84, at 215 (statement of Rep. D'Amours).

¹⁷² A recent Rand Corporation Study noted:

The advantages to the buyer of such an arrangement are . . . usually illusory. Although it may seem a bargain to get a loan at 4% below the market rate, the buyer's interest expense is deductible from his taxable income, so an after-tax cost of the interest payment is less than the after-tax cost of the same amount paid as principal. Of course, the interest rate could be reduced by enough, relative to the above-market price, to compensate for the tax disadvantage. However, most buyers are probably more adept at comparing interest rates than property values, so they are likely to agree to a less beneficial arrangement because they do not understand by how much the purchase prices exceeds the property's cash value.

I. Lowry, C. Hillestad & S. Sarma, *California's Housing: Adequacy, Availability, and Affordability* 194-95 (1983); see 47 Fed. Reg. 32,433, 32,436-37 n.5 (1982).

¹⁷³ Lenders calculate buydown points by reference to tables assuming that the loan will be paid off in 12 years. See, e.g., FNMA, *supra* note 168. Actually, most mortgage loans are repaid before year 12, and lenders receive their money back—to lend again at market rates—and part of the buydown payment has been “wasted” by the homebuyer. See Kamath & Gesing, *Should a Home Buyer Pay a Point to Reduce His Mortgage Rate?*, *Real Est. Rev.*, Summer 1980, at 84 (arguing that taking into account the tax advantages of paying interest on the mortgage loan, as well as the disadvantages noted above, buyers lose money if they pay buydown points and then sell their home after less than seven years).

¹⁷⁴ Section 163(a) of the Internal Revenue Code permits taxpayers who itemize deductions to include “all interest paid or accrued within the taxable year on indebtedness.” I.R.C. § 163(a) (1982); see *id.* § 461(g) (up front “point” charges are deductible but must be prorated); Treas. Reg. § 1.163-1(b) (1984). Section 163(a), however, does not permit deduc-

Federal disclosures can be tools of deception because they enable sellers to advertise interest rates that look like bargains. As the drafters of the Truth-in-Lending Act intended, it is easy for consumers to compare advertised APRs, much easier than it is for them to compare home prices.¹⁷⁵ The APR is a convenient "screening device" that homebuyers use to separate good deals from bad. The problem with screening devices is that when they are not precisely defined, sellers can adapt them to their marketing strategies, offering apparent bargains without really improving the deal.¹⁷⁶

This strategy is successful not only with naive homebuyers (who believe in the proverbial free lunch) but also with homebuyers who are more skeptical about "bargains." In response to questions about how True Value Homes can offer such a deal, the salesperson can emphasize that True Value Financing can obtain mortgage money at lower rates because the company buys large blocks of this money at "wholesale prices." This explanation makes sense to average homebuyers (who receive discounts of 20% or more when they buy goods at wholesale outlet stores), but it is misleading. True Value Financing may be able to get a \$10 million loan package at a 13% rate when the market rate is 14%, but it will not be able to do much better.¹⁷⁷ Moreover, the "bargain" may evaporate when the 1% commitment fee paid for the option is included. The agent may further state that the closing costs are less because True Value Financing handles most of the matters itself and achieves

tion of "payments made on obligations of others," *Sheppard v. Commissioner*, 37 B.T.A. 279, 281-82 (1938), and it seems probable that seller's buydown points cannot be deducted by the purchaser. Note that most closing costs are not deductible, even if paid by the purchaser. *Cagle v. Commissioner*, 539 F.2d 409, 416 (5th Cir. 1976); Rev. Rul. 297, 1967-2 C.B. 87 (1967). These costs may be treated, however, as part of the price paid for the property, thus reducing gain on any subsequent sale. *Warner Mountains Lumber Co. v. Commissioner*, 9 T.C. 1171, 1174 (1947); I.R.C. § 1012 (1984).

¹⁷⁵ Even naive homebuyers realize that a home advertised at \$60,000 might not be nearly as good as a similar sized home at \$70,000, if the latter has a more aesthetic location or extra features. Where one builder advertises 11.25% APR financing, however, and others are advertising higher APRs, the homebuyers can easily see that 11.25% APR is a better deal and often will anchor their decisions to the clear factor.

¹⁷⁶ See Salop, *Parables of Information Transmission in Markets, in The Effect of Information on Consumer and Market Behavior*, supra note 98, at 3, 6 ("[i]f sellers are aware of buyers' use of these rules-of-thumb, they have an incentive to exploit the screening device to misrepresent the value of their product").

¹⁷⁷ See Breckenfeld, supra note 12, at 124 (a national homebuilder can borrow large chunks of money for as much as 100 basis points (1%) less than a small builder could borrow from a local bank or savings and loan).

great economies of scale. Although believable, this statement is also misleading. There are economies of scale achieved when the builder can make a large package deal with a title insurance company, but the total cost of closing is not much less than that which could be achieved independently.

Although some salespersons will concede that the home price increases, the impression of a bargain will remain. Falling prey to the representativeness heuristic, the homebuyers are persuaded that they are receiving a true bargain — and to a substantial degree so is the salesperson. Moreover, the whole deal is presented as a vivid drama in which the homebuyers *and* True Value come out ahead. As Professor Leff has argued, this type of presentation is the most effective sales technique because it paints a credible “unique mutual bargain.”¹⁷⁸

The same I-win-you-win drama is even more effectively played out when the seller of an existing home (advised by a real estate broker)¹⁷⁹ or a builder buys down the interest rate for only a few years. Here the seller can reduce the advertised rate substantially below market for a lower cost. The advertisements trumpet: “Qualifying Interest Rates at 10%*,” and a note at the bottom says that the rate goes up to 13% by year four. Sales based on such rates are

¹⁷⁸ A. Leff, *Swindling and Selling* 117 (1975). Leff generally argues that there are structural similarities between sales techniques and con deals. Both rely on a convincing script in which the mark is convinced that his gain is not the con man's loss because marks are skeptical of getting something for nothing. The deal described in the text, where an average homebuyer is involved, is a classic example of what Professor Leff calls “The Squaresville Pitch,” in which the seller convinces the buyer that he can sell the good more cheaply than anyone else. Thus, it is in the buyer's “interest to buy, for what he wants is not available any more inexpensively anywhere else.” *Id.* at 119. The pitch is deceptive insofar as the seller really is not more efficient and productive than his competitors—a deception that is easy to establish in the home selling business because of the meticulously differentiated product.

Professor Leff's description of “The Sale” is similar to the deal described earlier in the text for the naive homebuyers. Whether based upon a fire, going out-of-business, or George Washington's birthday, the loudly trumpeted sale tells the buyer that there is a one-sided bargain (favorable to the buyer, not to the seller) that outside circumstances have forced upon the seller. *Id.* at 130-31. Thus, even if the homebuyer were more curious about the closing costs/financing bargain, the salesperson would have such ready answers as the following: “Business is bad”; “We are trying to clear out our old line of homes.”

¹⁷⁹ Brokers may also advise sellers to offer full-term below-market rates (through buydowns or self-financing), though the partial buydowns described in text are now far more common. The full-term buydown is a good deal for the seller, who receives a higher price (which might not be immediately taxable), and for the broker, who receives a higher commission. It is no bargain for the homebuyer, however, if he trades away tax deductible interest payments for nondeductible principal payments.

troubling because the homebuyers' advantages are smaller than they appear. They are actually paying for the buydown fees through a higher home price; and, although the buydown does help them qualify for a higher loan, their monthly payments will increase over three years, perhaps to an amount more than they can afford.¹⁸⁰ It is quite likely that only the seller comes out much ahead—by making a sale to buyers who would otherwise shop for a better deal or defer purchase until interest rates came down.

Generally, the practice of delivering whatever combination of buydowns and other loan features is necessary to qualify a buyer for a more expensive home than he could otherwise afford poses potential dangers for lenders and borrowers. The problems with this technique are exacerbated because they are increasingly used in combination with adjustable rate features. This combination has spawned a generation of "meretricious mortgages" (to use Professor Guttentag's term) that are deceptively attractive.¹⁸¹

Some sophisticated homebuyers are perfectly aware of the mechanics of builder-paid points and closing costs. These buyers will avoid the True Value deal or insist on a price break in return for their arranging their own financing or paying closing costs. The late Senator Paul Douglas (sponsor of the Truth-in-Lending Act) and others have argued that in many markets the existence of a substantial number of sophisticated homebuyers will discourage the True Value business practices.¹⁸² These sophisticated

¹⁸⁰ The 3-2-1 buydown is one used by many sellers. For a conventional \$80,000 loan at 13% (plus two points), the monthly payments would be as follows (parentheses for the seller subsidy):

Year 1 (10%)	\$702.40 (\$183.20)
Year 2 (11%)	\$762.40 (\$123.20)
Year 3 (12%)	\$823.20 (\$ 62.40)
Years 4-30 (13%)	\$885.60

Thus, monthly payments increase by over \$180 in three years.

¹⁸¹ J. Guttentag, *supra* note 76, at 8-14 (builder buydowns); *id.* at 14-16 (seller buydowns); *id.* at 25-28 (meretricious ARMs); see 1984 Secondary Mortgage Market Hearing, *supra* note 41, at 215, 216-17 (statement of L. Kendall, President, Mortgage Ins. Cos. of Am.). Offering low initial qualifying rates that jump up to several points above the index after a year or two, these teaser rate ARMs resemble bait-and-switch swindling schemes. The dramatic low-rate financing for the first year or two of the loan is the hook to attract the homebuyer's interest in the home and then becomes the centerpiece of a drama that induces homebuyers to anchor their decision onto only one of several important factors.

¹⁸² See Nat'l Comm'n on Consumer Fin., *Consumer Credit in the United States* 176-77 (1972) (summarizing the views of Sen. Paul Douglas). For a recent exposition of the Douglas approach, see Schwartz & Wilde, *Intervening in Markets*, *supra* note 95, at 637-38, 649-50.

homebuyers are interested in low home prices without the frilly points and closing cost gimmicks. True Value's builder competitors theoretically will have an incentive to lower their prices to attract all the sharp homebuyers. As its market share shrinks, True Value will abandon its misleading marketing strategy and return to price competition.

In the home sale market, however, precisely the opposite phenomenon has occurred repeatedly in recent years. Once one builder offers or one brokerage firm suggests bought-down financing or closing costs, others offer similar deals instead of cutting prices—marketing gimmicks replace price competition.¹⁸³ The main reason for this phenomenon is that the housing market is not perfectly price competitive. Although there are many buyers and sellers of homes, the product is not homogeneous. Thus, buyers do not shop extensively enough or compare the many tangible and intangible features carefully enough to recognize the best price deals. Sales techniques can also short circuit buyer shopping plans and corner a sufficient segment of the market. For example, an effective salesperson can blunt the shopping effect of price differences by arguing that the slightly higher price of his home indicates superior craftsmanship.¹⁸⁴ Thus, the real estate market tends to be one characterized by “monopolistic competition,” in which each of the many sellers can exercise some degree of monopoly power over

¹⁸³ See *supra* note 143; see also Homebuilding's New Look, *Bus. Wk.*, Nov. 7, 1983, at 95 (“Builders contend that a good financing package is still the most important selling tool.”).

Although substantial price cuts (making the home a demonstrable bargain) may still be very effective sales devices, see, e.g., Price Cuts Do What Buy-Downs Didn't, *Builder*, Jan. 1983, at 61, the standard wisdom is that recently set forth in the following broker-homebuilder marketing authority:

I don't believe your primary concern should be cutting someone else's prices by a few bucks. Worry about being different, about being non-comparable, and you'll have those buyers coming to you and meeting your sale price because [a little deviation within the same] range makes no difference!

....

I've sold more houses by raising the price than I have by cutting the price and that's a fact. Sometimes we added a feature or a benefit when we raised the price, true, but we found it to be far more effective than cutting the price to make a sale. B. Napier, *supra* note 131, at 15-16; see Cooley & Steckman, Five Projects Blast Out of the Recession, *Builder*, May, 1983, at 54, 61.

¹⁸⁴ For complex differentiated goods such as homes, consumers' initial reactions usually are that a slightly higher price means slightly better quality. See McConnell, The Price-Quality Relationship in an Experimental Setting, 5 *J. Marketing Research* 300 (1968) (discussing beer).

the segment of the market drawn to its form of the deal, resulting in some price dispersion.¹⁸⁵ Builders and brokers can do perfectly well catering to naive homebuyers, and any competitors who cut prices may have a hard time demonstrating their "bargain."

The prospect of repeat business or the desire to maintain a good commercial reputation does not necessarily give builders and brokers an incentive to cut prices rather than engage in misleading sales gimmicks. The recent analysis of Professors Klein and Leffler suggests that, even assuming perfect consumer information, the promise of repeat business may not prevent higher producer prices over time.¹⁸⁶ Because the home purchase decision is infrequently made, the competitive pressure of repeat buyers may be less important in the home sale industry. Also, many homebuilders and brokers do not remain in the market very long, due to its notorious fluctuations. These participants will be even less influenced by long term reputation considerations.

A final irony is that because of the financing system, homebuilders and other real estate professionals may have a collective self-interest in keeping nominal home prices high during low-demand (high-interest) periods, by pushing nonprice bargains. Before a loan is made, the house to be sold is appraised. Although the appraiser uses three methods to "value" the house (comparative, cost, and income methods), the bottom-line valuation is usually based upon the comparative analysis.¹⁸⁷ The appraiser determines a fair price by comparing prices for similar homes recently sold and adjusting the value for differences between the homes. Thus, the appraiser has a fair amount of discretion, which is usually exercised in favor of the seller's price. For example, the appraiser of a home in a developer's subdivision will typically com-

¹⁸⁵ See E. Mansfield, *Microeconomics: Theory and Applications* 325-32 (3d ed. 1972) (providing model for the theory of monopolistic competition); Salop & Stiglitz, *Bargains and Ripoffs: A Model of Monopolistically Competitive Price Dispersion*, 138 *Rev. Econ. Stud.* 493 (1977) (same); see also J. Guttentag, *supra* note 76, at 13 (buydowns are profitable for builders because of buyer myopia and enable the builder to practice price discrimination—buyers who do not want the buydown can pay full price).

¹⁸⁶ See Klein & Leffler, *The Role of Market Forces in Assuring Contractual Performance*, 89 *J. Pol. Econ.* 615 (1981) (repeat business will not assure high quality in the market unless there is a price premium and substantial sunk capital in the enterprise, such as advertising and brand identification).

¹⁸⁷ See *Am. Instit. of Real Est. Appraisers, The Appraisal of Real Estate* 506-09 (7th ed. 1978).

pare other houses the same developer recently sold.

As a result of this system, if sellers cut prices in periods of depressed demand, they cannot immediately raise prices when demand improves because appraisers cannot justify mortgages in light of prior sales. On the other hand, if sellers maintain prices in periods of depressed demand and instead offer bargains on interest rates, prices will be at a good level when demand picks up.¹⁸⁸ Thus, builders may be able to position themselves for price increases when the hoped for recovery comes by refusing to cut nominal prices during depressed conditions. Interestingly, sellers of existing homes do the same thing, perhaps because of the brokers' influence. The National Association of Realtors estimates that "real" home prices were 16.5% lower than nominal ones in 1982 because sellers were willing to take back low-interest loans in return for the high prices they were demanding.¹⁸⁹

2. *Inflated Prices—Title and Mortgage Insurance, Title Search, Conveyancing Services, and Loans*

Recent empirical studies suggest that the price homebuyers pay for mortgage loans or (especially) settlement services is often higher than the competitive market price.¹⁹⁰ Two competing theo-

¹⁸⁸ "Flexible" (i.e., seller-oriented) appraisals have long allowed sellers to increase the prices of their homes to incorporate seller's points in VA and FHA transactions. As Professor Guttentag notes:

[I]f discounts tend to be generally higher in one area than in another, other things being the same, appraisals also will be higher in the first area. In the existing home market, appraisals are based largely on price comparisons with "comparable properties." If the sale price of one property is marked up to reflect discounts, other properties using that one as a standard of comparison will be marked up similarly.

Guttentag, *Changes in the Structure of the Residential Mortgage Market: Analysis and Proposals*, in *Study of the Savings and Loan Industry 1480, 1500* (I. Friend ed. 1969); Zerbst & Brueggeman, *supra* note 167, at 1772. Based upon more recent studies, Professor Guttentag concludes that "buydowns significantly inflate appraisals and thereby increase property risk to lender." J. Guttentag, *supra* note 76, at 11.

¹⁸⁹ Home Prices Overstated Due to Below-Market Financing, *Housing Fin.*, Nov. 1982, at 2; see Salkin & Durning, *What Is a House Really Worth?*, *Mortgage Banking*, Oct. 1982, at 10 (proliferation of owner financing reduces real price appreciation). This strategy of below-market seller loans may be discouraged by Pub. L. No. 98-369, § 41, 98 Stat. 494, 553-54 (1984) (to be codified at 26 U.S.C. § 483), which establishes a minimum interest rate for seller-financed loans and imputes a rate for loans that are above the minimum rate.

¹⁹⁰ See 1 Peat Marwick Study, *supra* note 100, at III.6-12 (brokerage, lending, title assurance, conveyancing and mortgage insurance industries); 1 FTC Brokers Study, *supra* note 118, at 40, 74-77, 153-55 (real estate brokers).

ries have emerged to explain this phenomenon. First, loan-related costs may be high because homebuyers do not shop and rely instead on referrals. Loan and settlement providers engage in "reverse competition," that is, competing for referrals instead of engaging in price competition. Because the intermediaries referring providers are price-insensitive, prices may be high.¹⁹¹ A problem with this explanation is that it is not clear why, short of outright collusion, intermediaries do not shop for the best price and use that to attract more customers.

Advocates of the second theory argue that reverse competition is not anticompetitive per se because real estate intermediaries are better able to determine good deals than are consumers. Professor Wallace, for example, suggests that settlement costs are high because builders, brokers, and bankers discourage consumers from taking account of closing costs to increase the total demand for homes. They then segment homebuyer demand into components of different elasticities so that the highest prices can be charged for the items with the most inelastic demand, mainly settlement services, after the consumer commits to buy a particular house.¹⁹² One problem with this argument is that builders and brokers often emphasize the closing and loan costs in the sales process, using them to present an apparent bargain.¹⁹³

The economic and psychological structure of the home sale and loan transaction may better explain the phenomenon. Because of the tendency (reinforced by the sales process) of consumers to shift responsibility for decisions to intermediaries, buyers often choose the loan or closing cost providers that intermediaries recommend or require. The referral does not necessarily assure high prices, but tends to do so when (1) the intermediary has a strong incentive not

¹⁹¹ See 1 Peat Marwick Study, *supra* note 100, at III.5; see also HUD/VA Settlement Costs Study, *supra* note 113.

¹⁹² See Wallace, *supra* note 54, at 205-20; see also Owen, Kickbacks, Specialization, Price Fixing, and Efficiency in Residential Real Estate Markets, 29 *Stan. L. Rev.* 931 (1977) (high prices for conveyancing services are largely a result of price fixing and other anticompetitive practices).

¹⁹³ See *supra* notes 166-89 and accompanying text. For example, even though RESPA does not require the distribution of settlement cost estimates and booklets until the loan application, many brokers and builders routinely provide homebuyers with such estimates. Fully aware of the integrated nature of the transaction, these intermediaries realize that if the homebuyer does not have enough cash for settlement expenses, the deal will fall through, and much effort will be wasted. See *infra* notes 292-93 and accompanying text.

to recommend the best price deal (the hidden agenda) and the marketplace does not punish the intermediary for failing to recommend the best deal (the failure of market discipline), or (2) the provider can exercise market power and exact a high price (imperfect provider market).

Generally, the hidden agenda arises out of the increasingly integrated home sale and loan transaction and the interdependence of the various intermediaries. For example, if the intermediary or his firm has a business connection with a provider, referrals will be automatic even if the price is excessive. The failure of market discipline results from the intermediaries' incentives to cooperate rather than compete in providing services. An imperfect provider market may exist if a few firms dominate a particular market, creating barriers to the entry of new competing firms. Whoever chooses the provider will then find supernormal prices.

a. Loan Price

The mortgage market in the last two decades seems to have been competitive, as evidenced by the constant rate fluctuation in response to market demands.¹⁹⁴ Thus it is somewhat surprising that the Peat Marwick Study found rate variations of 1.44% to 2.13% and monthly payment variations of \$85-\$126 (for a standard \$75,000 loan) within the same metropolitan areas at the same time.¹⁹⁵ Differences in nonprice mortgage terms probably explain much of this dispersion, but the data suggest possible market problems that may be exacerbated in the future.

The leading empirical surveys suggest that between 50% and 65% of homebuyers do not shop for mortgage loans.¹⁹⁶ About half

¹⁹⁴ See Whitman Letter, *supra* note 5, at 3-4. Except to the extent that mortgages are not perfectly homogeneous, the classical requisites of pure competition exist with respect to mortgage lending: a large number of independently acting lenders (variety of financial institutions), ease of market entry (because of easy access to the secondary mortgage market), and the availability of information to consumers. See 2 Peat Marwick Study, *supra* note 100, at X.3-21.

¹⁹⁵ 2 Peat Marwick Study, *supra* note 100, at X.24-30; accord Stoppello, *supra* note 54, at 403-09 (arguing that mortgage lending is not competitive and is characterized by substantial rate variations). Peat Marwick termed this variation "moderate" and did not consider it sufficient to conclude that mortgage lending is not characterized by "workable competition" because the survey did not correct for differences in the terms of the mortgages for which interest rates were quoted. 2 Peat Marwick Study, *supra* note 100, at X.30.

¹⁹⁶ See 2 Peat Marwick Study, *supra* note 100, at X.14, .31 (64% of the homebuyer re-

of the buyers who do not shop for loans (or, about one-third of all homebuyers) opt for the lender suggested by the builder, broker, or attorney.¹⁹⁷ Because most buyers fail to shop and because intermediaries shop for them, mortgage lenders compete with one another for referral business, not for direct customers.

Although real estate agents often shop effectively for the best loan values, they sometimes have incentives to refer homebuyers to a lender that does not charge the best rates. Traditionally these perverse incentives were rebates or commissions.¹⁹⁸ Today, formal business links may be more important: the sales agent may send customers to a lender because the brokerage or building firm owns or controls it (the formally integrated transaction) or because the agent or his firm has an ongoing personal or cooperative relationship with the allied lender (the functionally integrated transac-

spondents did not shop for a lender); Hempel, *supra* note 99, at 243, table 1 (50% of the homebuyers looked at only one lender); see also Albaum & Kaufman, *Variable Rate Residential Mortgage: Implications for Borrowers*, in 1 *Alternative Mortgage Instruments Research Study*, *supra* note 78, at VI-1, VI-16 to -17 (60% of the homebuyers did not shop for a mortgage); Colton, Lessard, Modest & Solomon, *The National Survey of Borrower's Housing Characteristics, Attitudes and Preferences*, in 1 *Alternative Mortgage Instruments Research Study*, *supra* note 78, at III-85 (46% of the surveyed homebuyers looked at only one lender; 54% contacted two or more lenders). In a later study of households in Connecticut, Professors Hempel and Jain found a greater incidence of shopping for a lender; the average homebuyer sampled contacted three lenders concerning the terms of financing. Hempel & Jain, *House Buying Behavior: An Empirical Study in Cross Cultural Buyer Behavior*, 6 *Am. Real Est. & Urb. Econ. A. J.* 1, 11 (1978). It may be that the sample consisted of fairly sophisticated buyers. Otherwise, there is no apparent reason why its measure of shopping for a mortgage loan should be at variance with his earlier findings and those of other recent studies.

¹⁹⁷ See 2 Peat Marwick Study, *supra* note 100, at X.14 (10.5% of the borrowers who did not shop for a lender selected a lender with whom they had prior dealings; 15% relied on referral by someone unconnected with the homebuying process; 10% assumed existing loans; 40% relied on referral by brokers; and 11.5% relied on referral by sellers (mainly builders)); Colton, Lessard, Modest & Solomon, *supra* note 196, at III-85 n.68 (41% of the borrowers who contacted only one lender did so because it was "convenient"; 34% relied on the realtor's advice; 12% had no choice (builder-required); 13% had other reasons); *Loan Marketing: It's Not What It Used to Be*, Savings & Loan News, June 1977, at 90, 91-92 (some lenders receive 75% to 90% of their applications from brokers and builders).

¹⁹⁸ Although RESPA prohibits fees to agents for referral of "business incident to or a part of a real estate settlement service," RESPA § 8(a), 12 U.S.C. § 2607(a) (1982), the prohibition does *not* apply to fees a lender pays to "its duly appointed agent for services actually performed in the making of a loan" and to "any person of a bona fide salary or compensation or other payment . . . for services actually performed." *Id.* § 8(c)(1)(C), (2), 12 U.S.C. § 2607(c)(1)(C), (2) (1982).

tion).¹⁹⁹ Perceiving the importance of personal and business connections, lenders can (and apparently do) engage in less price competition.²⁰⁰ A final perverse incentive may be most important today. The agent wants the homebuyer to qualify for a loan and thus may recommend a teaser rate loan that has a low initial rate, but an aggregate rate (or APR) greater than that of other loans. Because these loans are hard to compare, especially when the teaser loan is an ARM, lenders may compete for low initial rates, rather than low overall rates.

Under principles of market discipline, real estate agents who recommend high-interest loans should lose customers either to agents who recommend low-interest loans or to agents who pass on their profits by reducing their prices or commissions. The former rationale, used by some nationally integrated broker and builder firms, has met with some success and may exert considerable pressure on agents to obtain low-interest loans—but the malleable nature of the APR enables builders and brokers to offer low-interest loans while raising the home price.

The latter reason seems even less likely to reduce real loan rates. Builders recommending high-interest loans have little incentive to pass on their extra profits through home prices, which are harder to shop and compare. Nor do real estate brokers seem willing to reduce their commissions in response to competitive pressures. Since the 1920's the industry has operated under a creed of cooperation and accommodation rather than competition.²⁰¹ Sale of property included in a multiple listing service itself entails mutually advantageous coordination among brokers, and has contributed to uniformly high commissions and (apparently) some discrimination

¹⁹⁹ See 2 Peat Marwick Study, *supra* note 100, at X.50 (brokers and builders are frequently represented on the boards of directors of local lenders); Stoppello, *supra* note 54, at 409 (brokers and builders will refer mortgage borrowers to specific lenders in hope of ready availability of mortgages for their customers in periods of tight money).

²⁰⁰ Responding to the query how they develop new business, 76% of the lenders that Peat Marwick surveyed said they develop more contacts with brokers who could recommend their institution, 61% made more contacts with builders, and only 24% considered the possibility of lowering the interest rate. *Id.* at XII.11; accord Stoppello, *supra* note 154, at 408-09.

²⁰¹ See 1 FTC Brokers Study, *supra* note 118, at 141-63; Nightingale, *Calif. Real Est.*, Apr. 1924, at 12, quoted in *id.* at 110 (multiple listing services "have replaced the old spirit of competition with one of cooperation"); see generally Nat'l Ass'n of Realtors, Code of Ethics arts. 14, 21-23, in *Realtors Institute Reference and Practice Book* (1977) (ethical duties of Realtors not to encroach upon or disparage the business dealings of competing Realtors; disputes to be resolved by arbitration).

against discount brokers.²⁰² Brokers will steer their buyers away from property listed for a discount commission, either because cutting rates is considered “unprofessional” or because the cooperating broker will get a lower commission himself.²⁰³ Furthermore, real estate brokerage considers itself a service industry, providing subjective, intangible benefits to buyers, even if not at the lowest price. The broker views his success as dependent on his ability to reduce the homebuyer’s stress—to make the purchase and loan processes easier, not necessarily cheaper.²⁰⁴

In short, neither builders nor brokers (the primary sources of loan referrals) see their commercial reputation as resting upon their finding the best loan deal. Instead, it rests on their finding an acceptable home for the buyer and making the purchase minimally troublesome. Sometimes the deal that profits them most has a higher than market rate or has terms that impose future costs on the consumer. The rise of ARMs and teaser rate loans, when combined with these incentives and failures of market discipline, may undermine, in the short term at least, the workable competition under which the mortgage market has largely operated for the last twenty years.

b. Title Assurance and Conveyancing Prices

The charge to the homebuyer for title assurance and conveyancing typically consists of three items: the cost of the title search and opinion; the insurance premium; charges for escrow and document preparation and other settlement services. The price to the buyer for this cluster of services varies significantly from one location to another because of different local practices.²⁰⁵ More significantly,

²⁰² See 1 FTC Brokers Study, *supra* note 118, at 73-78, 268-301.

²⁰³ See *id.* A 50% share of the standard 6% commission is obviously higher than a 50% share of a 4% discount commission.

²⁰⁴ The FTC Brokers Study reports that price competition is often displaced by promotional efforts intended to obtain listings, provision of extra services, and intensive advertising to create an image of friendliness and supportiveness *Id.* at 44.

²⁰⁵ The title insurance industry is localized based on past custom and state regulation. Three systems of providing title protection are common. See 2 Peat Marwick Study, *supra* note 100, at V.19-.22; B. Owen & J. Grundfest, A Report to the State of California: Licensing of Real Estate Brokers as Title Insurance Agents (1976) (Stanford University Studies in Indus. Econ. No. 64); Payne, Ancillary Costs in the Purchase of Homes, 35 Mo. L. Rev. 455 (1970). An attorney’s opinion that title is valid (based either upon the attorney’s own search or the search of title abstracters), backed up by the attorney’s assurance that the opinion is

the price varies substantially within locales. The Peat Marwick Study found variations of \$500 or more for the same title and conveyancing services within the Los Angeles market (standard deviation over \$200), and smaller but significant variations in the other seven markets surveyed (standard deviations ranging from \$59.21 in St. Louis to \$173.95 in Seattle).²⁰⁶

There appear to be two levels at which workable competition breaks down. With respect to the insurance premium, there are about fifteen national title insurance-underwriting firms, and a combination of four of them dominates most of the local markets.²⁰⁷ These companies behave like a classic oligopoly by informally following a common schedule of uncompetitive title insurance premiums that do not fluctuate with market conditions.²⁰⁸ Because insurance premiums are uniform (albeit high), the substantial variation in charges that consumers actually pay occurs at the retail level. The providers (attorneys, title companies, or branch offices of title insurers) charge significantly different prices for title searches and conveyancing services.²⁰⁹

correct, was the earliest form of title protection and is still the primary protection in New England and scattered Southern and Midwestern states. In over 15 states (especially in the Southeast), protection is provided by an attorney's opinion, guaranteed absolutely by a title insurance underwriter (for which the attorney is usually an agent). In the Western and several Midwestern states, a title company performs the search and insures the result. Even within these three broad groups, practices vary enormously. Thus, the local agent (attorney, underwriter, title company, or branch office of the underwriter) often performs services as escrow agent and preparer of settlement documents, again with substantial variation among the different areas.

²⁰⁶ See 2 Peat Marwick Study, *supra* note 100, at XII.11-15. The Peat Marwick Study observed 99 providers in the Los Angeles area, of which 11 charged \$300-349, eight charged \$350-399, 11 charged \$400-449, 13 charged \$450-499, seven charged \$500-549, eight charged \$550-599, five charged \$650-699, four charged \$700-749, eight charged \$750-799, and the remainder charged scattered prices. *Id.* at XII.30.

²⁰⁷ The ten state markets that Peat Marwick surveyed show four-firm market concentrations ranging from 50.21% (Florida) to 93.71% (Washington), with most of the surveyed states having a four-firm concentration of more than 70% of the local market. *Id.* at XII.5.

²⁰⁸ See *id.* at XII.3-4; Owen, *supra* note 192, at 939-44. Apart from the concentration of business with several insurers for each locality, title insurance is also structured like an oligopoly because it is hard for new firms to break into the industry due to the high start-up costs (developing a title plant) and because no one has an incentive to cut prices. Price information is usually on file with state insurance commissions so that other firms will know of any price cuts promptly and immediately follow, thus depriving a price-cutter of any competitive advantage. See 2 Peat Marwick Study, *supra* note 100, at XII.7-8.

²⁰⁹ See generally 2 Peat Marwick Study, *supra* note 100, at XII.10-40 (price that a consumer pays for title assurance and conveyancing varies among locations and providers).

The breakdown in competition for title search and conveyancing (settlement) charges is not due to market concentration, for there are often numerous providers at that level. Indeed, the problem is that these providers charge widely divergent prices. This price variation is due to consumers' failure to shop for title search and conveyancing services and their reliance on self-interested referrals by intermediaries. The Peat Marwick Study found that only 11% of the interviewed homebuyers spoke to more than one title company, and of the buyers who hired an attorney, only 18% spoke to more than one.²¹⁰ Consumers are very likely to shift responsibility for the decision to the broker (49% of all homebuyers interviewed), the lender (16%), or an attorney (17%).²¹¹

These intermediaries often have perverse incentives for recommending certain high-cost providers. The Peat Marwick Study reports that some brokers and lenders still receive kickbacks and other financial rewards for referring business to attorneys and title companies.²¹² Attorneys and title companies, in turn, sometimes receive extra "commissions" in return for referring customers to particular underwriters.²¹³ The most effective way for brokers, attorneys, and lenders to profit from these services, however, is to establish their own title agencies and then refer all their business to them. Such "controlled companies" are then in a good position

²¹⁰ See *id.* at XII.8. This result is not surprising because the decision is considered to be minor by the consumer, must be made under time pressure, and involves providers about which the consumer has very little information. *Id.* at XII.9 (homebuyers believe that title assurance/conveyancing prices and services are all uniform).

²¹¹ *Id.* at V.24.

²¹² Although referral fees, kickbacks, and commission splitting by brokers and lenders in connection with real estate settlement services are prohibited, RESPA § 8(a)-(b), 12 U.S.C. § 2607(a)-(b) (1982), Peat Marwick's survey of industry participants indicated that kickbacks and referral fees to bankers, brokers, and builders continue, albeit at a diminished pace. 2 Peat Marwick Study, *supra* note 100, at XII.47.

²¹³ In states where the attorney renders the initial opinion on the title and an underwriter insures the result (Eastern states), the attorney is paid by the homebuyer for the title search and may receive 50% to 65% of the risk premium as well. In states where there is an all-inclusive charge for search and insurance, the agent may receive 80% to 90% of the charge as his commission. See Ford & Allison, *supra* note 151, at 4-5. This practice is on its face legal under RESPA § 8(c)(1)(A)-(B), 12 U.S.C. § 2607(c)(1)(A)-(B) (1982) (authorizing fees to attorneys for "services actually rendered" and fees by a title company to its duly appointed agent for services "actually performed in the issuance of a policy of title insurance"). Although the attorney-agent does most of the "work" (searching title, attracting the customer), it may be questioned whether the commissions reflect the true level of services performed. See 2 Peat Marwick Study, *supra* note 100, at XII.49-51.

to charge high prices, which yield high profits for the hidden owners.²¹⁴

Rebates and controlled title companies may theoretically be pro-competitive forces.²¹⁵ Controlled title companies might be able to extract higher commissions from the national underwriters and pass these savings (and others due to lower transaction costs) on to homebuyers through lower charges. Likewise, rebates might be a way of distributing the industry's excess profits to brokers, who will then lower their commissions to attract new customers. The problem with this theory is that little if any of the extra commissions or rebates are actually passed on to consumers because of the familiar cycle of industry cooperation and consumer failure to shop. Brokers have therefore maintained their commissions at abnormally high levels through patterns of professionalism and cooperation embodied in their multiple listing services.²¹⁶

There is also evidence that controlled title companies are equally unlikely to pass on any cost advantages to nonshopping consumers. Instead, such companies may charge higher-than-market prices for title searches or for service as escrow or settlement agent at closing.²¹⁷ Administrative proceedings in California, for example, found that the title company owned and controlled by Coldwell Banker charged rates 50% higher than those of competitors.²¹⁸ Moreover, recent testimony before Congress suggests that con-

²¹⁴ According to the Peat Marwick Study, in one-third of the cases where the lender required the use of a specified title or conveyancing provider, there was a formal business connection, 2 Peat Marwick Study, *supra* note 100, at X.50-51, and congressional hearings in 1981 suggest that in some areas the incidence of formal connection (controlled companies) is even higher—and growing. See 1981 RESPA Hearings, *supra* note 140 (addressing problem of widespread lender and Realtor ownership of title insurance companies).

²¹⁵ See Owen, *supra* note 192, at 943-44, 949-50.

²¹⁶ See *id.* at 944-49; *supra* notes 201-04 and accompanying text.

²¹⁷ See Am. Land Title Ass'n, *The Controlled Business Problem in the Title Insurance Industry* (1979); 2 Peat Marwick Study, *supra* note 100, at XII.56 (controlled firms help perpetuate high prices); I. Plotkin, *The Economic Consequences of Controlled Business in the Real Estate Industry* 4-5 (Sept. 16, 1981), reprinted in 1981 RESPA Hearings, *supra* note 140, at 510, 514-15 (prices are "much higher" as a result of the controlled title companies); Ford & Allison, *supra* note 151, at 5 & n.17 (controlled business relationships maintain high prices; increased escrow and settlement fees can produce extra profits where title insurance charges are regulated).

²¹⁸ State of Cal., Dep't of Ins., *Findings of Fact, Conclusions of Law & Recommendation, In re Guardian Title Co.*, File No. L-67, UTC LA-70 (Oct. 27, 1976), *rev'd*, 2 Civ. No. 55067 (Super. Ct.), *rev'd* and recommendation reinstated, 102 Cal. App. 3d 381, 162 Cal. Rptr. 487 (1980).

trolled companies may be more lax in examining the validity of title than are independent title companies.²¹⁹

c. Mortgage Insurance Price

Perhaps most troubling of all mortgage-related practices is the way that private mortgage insurance is "sold" to homebuyers. Most buyers are not given details of mortgage insurance plans—or informed that they can avoid purchasing that insurance by making a 20% downpayment.²²⁰ Often the insured has little or nothing to say about the choice of the insurer.²²¹ In addition, the homebuyer is probably paying too much for mortgage insurance. Here the concentrated market structure is important.²²² The first mortgage insurance company, Mortgage Guaranty Insurance Co. (MGIC), has dominated the market since the 1950's, and in 1980 it did 40% of the nation's mortgage insurance business; the top seven firms account for over 90% of the business. There have been few new entrants into this field in the last decade because of the forbidding capital requirements and the importance of being a recognized name in the industry.²²³ As a result of this oligopolistic market

²¹⁹ For example, the President of Valley Title Co. in San Jose, California testified that her firm lost most of its business to a broker-owned title firm that charged higher prices and did shoddy work. 1981 RESPA Hearings, *supra* note 140, at 150-51 (statement of Clyda Guggenberger); see *id.* at 152-211 (other testimony to the same effect).

²²⁰ Only about 55.2% of the homebuyers Peat Marwick surveyed discussed the mortgage insurance with the lender or agent. Of the group that did discuss the policies, 89.6% discussed price, 52.4% discussed policy differences, and 39.2% discussed policy cancellations. Lenders failed to discuss the issue of alternative mortgage payment plans 65% of the time. Of the respondents who purchased mortgage insurance, 36.5% were unaware that an increase in downpayment would reduce the mortgage rate or insurance premium (though of the group that was aware that a larger downpayment could result in lower mortgage insurance premiums or in a lower mortgage rate, only one in five indicated that such knowledge influenced the amount of their downpayment). 2 Peat Marwick Study, *supra* note 100, at XI.19.

²²¹ See *id.* at XI.18 (25.2% of buyers thought that agent required or recommended an insurer; 23.1% thought that lender required or recommended an insurer); *id.* at XI.32-33 (only 50% of buyers believed they had a choice in the selection of an insurer).

²²² See generally The Arthur D. Little Study of the Private Mortgage Insurance Industry 25-26 (Nov. 1975) (discussing industry concentration and market shares in 1973); 2 Peat Marwick Study, *supra* note 100, ch. IV.

²²³ FNMA and FHLMC require \$5 million in initial capital and surplus before they will accept insurance from a company. Many states have similar capitalization requirements and also require a contingency reserve, in which 50% of all premiums are set aside for 10 years or more unless losses exceed 35% of premiums earned. Thus, a successful new entrant would need substantial long term capital just to get started—and with no assurance that it

structure, these firms offer virtually the same plans for the same prices. Their prices have neither shifted in response to demand nor in response to differing loss experience in different geographical areas. Some observers think that profits in the industry have been abnormally high.²²⁴

Despite these problems, there has been increased competition among the established companies, though not necessarily as to price.²²⁵ There is little incentive to engage in price competition because the insurers see the lender—which is relatively price-insensitive—as the only party that they have to please. Lenders choosing one or more mortgage insurers care less about price, which is ultimately paid by someone else, than they do about benefits they receive from the choice. Thus, the dominant mortgage insurance companies compete by offering different levels of risk coverage; by providing ancillary services to the lender (e.g., prompt analysis of the soundness of the loan); by building a good reputation for prompt and fair handling of claims; and by dispensing favors, entertainment, and free services to bank officers.²²⁶ These “extra services” are of little or no benefit to the homebuyers who actually pay for them.

3. *Dangers of Excessive Risk*

Assume that a family with a monthly income of \$2800 wanted to buy a home in 1977. Their income would have qualified them for an \$85,000 mortgage loan at a market interest rate of 9%, because the loan's monthly principal-and-interest payments (less than \$700) would have put them within most lenders' qualification

would be able to break the lockhold of the top firms (unless it were tied to a parent that could refer it business) because conservative lenders look to established contacts and demonstrated performance in choosing the insurers. See 2 Peat Marwick Study, *supra* note 100, at XI.22.-24.

²²⁴ See *id.* at XI.37-45 (discussing pros and cons of argument that mortgage insurers have excessive profits).

²²⁵ For example, Pamico, a lender-owned mortgage insurance company, sought to break into the top seven in the 1970's by offering rates 12% below those the dominant firms offered. The firm met with only limited success in attempting to sell a lower priced product outside of Pennsylvania because many lenders viewed Pamico as an insurer that was “small, of low capitalization, highly concentrated, and unable to offer the full range of services offered by the larger competitors.” As a result, the price reduction policies of the firm have not been truly tested for market acceptance. *Id.* at XI.26.

²²⁶ See *id.* at XI.36.

guidelines. Assume further that the homebuyers had \$10,000 to invest in a downpayment, so they could afford a \$95,000 home. The only home they liked, however, cost \$100,000. To buy this home, they needed a \$90,000 mortgage, but the monthly payments (almost \$725) disqualified them under most lender guidelines then in place.

Wanting to make the sale, the broker told the homebuyers that a graduated payment, adjustable mortgage loan (GPAML) would enable them to buy the home they wanted. The initial rate would be 8%, with a corresponding monthly payment well under \$700. In the third year, the interest rate would be increased or decreased to match the average rate on mortgages FNMA had purchased in the preceding quarter, with similar adjustments every six months. At the end of five years, the loan would fall due.²²⁷ Because of the graduated payment feature, the broker cautioned the family that monthly payments in the first three years would not even cover accrued interest, and the principal would increase by over \$2000. The adjustable rate feature would allow for an increase in the applicable interest rate; thus, the amount of monthly payments might also increase.

These points concerned one spouse, but the other still wanted the loan, in part because he was confident that the home would appreciate rapidly.²²⁸ His optimism, augmented by the broker's,

²²⁷ The inspiration for this hypothetical is one of the ARM Plans (Plan # 2) that FNMA offered in the period 1977-1982. Compare the same \$50,000 mortgage with an initial rate of 8.78% under a fixed-rate plan; ARM Plan # 2, which adjusted rates every six months based on Treasury bills; Plan # 3, which adjusted rates every year and had a payment cap; and Plan # 7, which adjusted rates annually based upon the FHLBB contract rate:

		<u>Fixed Rates</u>	<u>Plan # 2</u>	<u>Plan # 3</u>	<u>Plan # 7</u>
Monthly					
Payment:	Yr. 1	\$394	\$394	\$394	\$394
	Yr. 2	\$394	\$394	\$424	\$408
	Yr. 3	\$394	\$394	\$456	\$450
	Yr. 4	\$394	\$590	\$490	\$575
	Yr. 5	\$394	\$590	\$527	\$592
	Yr. 6	\$394	\$590	\$560	\$644
Remaining					
Principal		\$47,856	\$57,020	\$54,794	\$48,588

See *The Facts of ARMs*, Housing Fin., Aug. 1982, at 2, 5.

²²⁸ A 1982 poll that FNMA commissioned indicated that notwithstanding recent price stagnation, 22% of the respondents expected home prices in their area to go up "a lot" in the next two or three years, and homeowners in general gave "investment" as their principal

closed the deal—but it was not well founded. The interest rate jumped to over 11% in year three, with a corresponding monthly payment of over \$860, and increased to almost 15% by year five, with a monthly payment of over \$1130. This disrupted the couple's budget and forced them to borrow heavily. When the principal, then over \$92,000, fell due in year five, the house could not be sold due to slow demand and the couple's inability to offer creative financing. They defaulted, and the lender took over the house.

This scene has been enacted repeatedly in the last few years. Like the last players in a Ponzi scheme, optimistic homebuyers taking novel mortgages in 1977 to 1983 found themselves stranded among high interest rates and a dead resale market. As a result, many lost their homes or savings.²²⁹ Current federal regulations provide little protection against the risks posed by these mortgages when a financial institution makes the loan—and virtually no protection when a seller of an existing house makes it.²³⁰

Whenever the monthly payment might increase during the loan term, the mortgagor-homebuyer faces mortgage payment uncertainty, which poses three sorts of risks: default on the loan, payment shock at sudden big adjustments, and disruption of budget planning when payments drift upward slowly or unpredictably. These risks can be minimized by regulating the length of time between rate adjustments, by requiring the interest rate to be tied to

reason for buying. Buyers Would Accept ARMs—If They Understood Them, Builder, Oct. 1982, at 22, 23.

²²⁹ Econometric studies had originally predicted that ARMs would not yield default rates in excess of those for standard fixed-rate mortgages. See, e.g., Vandell, Default Risk Under Alternative Mortgage Instruments, 33 J. Fin. 1279, 1294 (1978). The experience of private mortgage insurers as of 1984, however, has been that default on ARMs has been alarming. The California Association of Realtors reports that the value of claims paid by private mortgage insurers increased from \$29 billion in 1981 to \$112 billion in 1983—largely as the result of ARMs and other alternative mortgages. H. Snyder, *supra* note 70, at 15-16. A 1981 study by MGIC predicted very high default rates by ARMs combined with GPMs, and industry experience seems to be bearing this out. *Id.* at 16.

Balloon mortgages and other creative financing devices have also led to many defaults and foreclosures. See Andrew, Houses of Cards—"Creative" Financing Ends in Foreclosure For More Home Buyers, Wall St. J., Feb. 26, 1982, at 1, col. 6; Califoreclosure—Creative Financing's Dark Side, Time, June 14, 1982, at 65. For a sensitive analysis of the human consequences of foreclosures, see Brooks, Foreclosing on a Dream, N.Y. Times, Sept. 12, 1982, at 68 (Magazine).

²³⁰ The Truth-in-Lending Act, for example, only applies to a creditor who "regularly extends . . . consumer credit which is payable by agreement in more than four installments or for which the payment of a finance charge is or may be required." 15 U.S.C. § 1602(f) (1982).

a stable index, and by capping the amount of the rate increase in any single period or over the life of the loan.²³¹ Current federal regulation, however, permits adjustment of interest rates and monthly payments, based on any index verifiable by the borrower and not subject to the lender's control; there is no ceiling on the amount of rate adjustment.²³² Thus, within a year after entering into an ARM a family may be faced with monthly payments several hundred dollars greater than they originally planned.

Some risks of payment uncertainty can be decreased by taking an ARM in which interest rate increases are not immediately reflected in the monthly payment, or by taking a GPM that offers a stable, relatively low monthly payment for the first several years. This strategy, however, raises the problem of negative amortization: the monthly payments do not cover the accrued interest, which therefore becomes capitalized as part of the principal. At the end of the period in which monthly payments are shielded from increases attributable to the real interest rate, the homebuyer owes more money than he originally borrowed. Negative amortization restricts the homeowner's ability to sell the property, especially in periods of sluggish demand, because the sale price may not cover the increased principal plus the 6% to 7% broker's commission.²³³ Negative amortization also increases the risk of default on the home mortgage loan.²³⁴ Despite these problems, federal regulation generally permits negative amortization.²³⁵

²³¹ See Guttentag, *Solving the Mortgage Menu Problem*, 2 *Housing Fin. Rev.* 227, 234-36 (1983); Kaplan, *Recommendations on Alternative Mortgage Instruments*, in 1 *Alternative Mortgage Instruments Research Study*, supra note 78, at I-1; Weinrobe, *Analysis of Consumer Safeguards for AMIs*, in 3 *Alternative Mortgage Instruments Research Study*, supra note 78, at XXI-1.

²³² 12 C.F.R. §§ 29.3-.4 (1984) (Comptroller General regulations applicable to banks and mortgage companies); id. § 545.33(e) (FHLBB regulations applicable primarily to savings and loans).

²³³ S. Rehde, *Unrestricted Adjustable Rate Mortgages: A Review of the Early Experience and An Analysis of the Implications of Negative Amortization* (July 27, 1981), reprinted in *Adjustable Rate Mortgages: Hearings Before the Subcomm. on Financial Institutions Supervision, Regulation and Insurance of the House Comm. on Banking, Finance and Urban Affairs*, 97th Cong., 1st Sess. 94-157 (1981) [hereinafter cited as 1981 ARM Hearings]; see H. Snyder, supra note 70, at 8-10; Guttentag, supra note 231, at 237; Weinrobe, supra note 231, at XXI-33 to -35.

²³⁴ See Crawford & Harper, *Further Evidence on the Default Risk of AMLs*, 1 *Housing Fin. Rev.* 377 (1982); Webb, *Borrower Risk Under Alternative Mortgage Instruments*, 37 *J. Fin.* 169 (1982).

²³⁵ 12 C.F.R. pt. 29 (1984) (Comptroller General); id. § 545.33 (FHLBB)

Negative amortization becomes even more serious when combined with another problem source—balloon payments (unpaid principal or interest due at the end of a loan term). Short term (three-to-ten year) balloons represent a high-stakes gamble by the home purchaser that he can refinance the principal with a new loan, or that he can sell the house for a price close to or higher than the balloon.²³⁶ In 1977, there may have been some justification for optimistic homebuyers to think (incorrectly, in retrospect) that interest rates would not be higher in the future and that home prices would continue their steep upward spiral. There is less basis for optimism today.²³⁷ Balloons thus represent a significant risk that the homebuyer will either default or lose a significant amount of money in redeeming his investment. Balloons by financial institutions are substantially deregulated under the Garn Act,²³⁸ and balloons taken back by individual sellers of existing homes are not regulated at all.

Because of the publicized problems with alternative mortgage instruments, some consumer resistance to the riskiest instruments has emerged. Moreover, lenders, secondary market buyers, and mortgage insurers have a market incentive to discourage loans that will end up in foreclosure and, as a result, have encouraged instruments more protective of the consumer interest in not defaulting.²³⁹ For example, in late 1983 FNMA and FHLMC adopted three new ARM plans using Treasury rate indices, payment caps of 7.5% (no rate caps), and a negative amortization cap of 125%.²⁴⁰

²³⁶ See Weinrobe, *supra* note 231, at XXI-79 to -87.

²³⁷ See L. Grebler & F. Mittelbach, *supra* note 145, at 157-69 (arguing that the stampede of housing prices in 1975-1977 was similar to other periods of cyclical home price inflation, certain to be followed by a period of price stability or even deflations); see also S. Rohde, *supra* note 233, reprinted in 1981 ARM Hearings, *supra* note 233, at 125-57 (recent regulatory actions allowing significant amounts of negative amortization may permit loan balances to increase as much as 10%, too high to be offset by increased property values, thus eroding homeowner equity).

²³⁸ See *supra* note 68.

²³⁹ Lenders and secondary market buyers generally do not want to foreclose on mortgages because of the administrative inconvenience involved, and some have recently called for greater federal regulation of alternative instruments. See U.S. League to Tell Bank Board that ARM Guidelines Should Be Adopted, 12 Housing & Dev. Rep. (BNA) 113 (July 2, 1984). FNMA and FHLMC, both public oriented buyers of mortgages on the secondary market, have directed consumer and lender surveys in their efforts to develop guidelines for alternative instruments they will purchase.

²⁴⁰ See Mylod, *ARMs: Cream-of-One-Crop, Mortgage Banking*, Aug. 1983, at 13.

These new instruments significantly reduce the risk of default, but do not address other risks. They still have an undesirable potential for payment shocks: if interest rates go up sharply, deferred interest will accumulate rapidly because the yearly payment cap will prevent immediate pass-on of the full rate increase. Once the negative amortization limit of 125% is reached, however, the payments may go up significantly.²⁴¹ The disruption of budget planning may be even greater because some of the plans permit partial seller buydowns.

More troubling is that many institutional lenders are still offering much riskier alternative mortgage instruments, including short term balloons and teaser rate ARMs without rate or payment caps.²⁴² This year, Congress heard testimony that lenders are offering loans advertised at 9% to 10% rates, which jump to 13% to 15% at the end of six months to one year and carry as much as \$400 per month in negative amortization.²⁴³ It is not apparent that the marketplace will purge itself of these loans. Lenders and their managers are under strong pressure to initiate a large volume of loans. Like sellers that buy down the interest rate and then recover the cost through a higher home price that is not as easily shopped, lenders too believe they can attract more business by offering low initial rate loans whose future risks are hard to evaluate and compare.²⁴⁴ Also, brokers and builders (the source of most loan referrals) encourage lenders to originate such loans and, through the

²⁴¹ See J. Guttentag, *supra* note 76, at 26-28.

²⁴² It appears, for example, that short term balloons with a below-market rate for the first two years and a higher rate thereafter ("multiple rate balloons") are still being offered. See Levary, *Complex Calculations for Balloon Mortgages*, *Mortgage Banking*, Oct. 1983, at 100. A recent FHLMC Survey reports that only 55.1% of ARM loans have either a rate or payment cap (23.6% have a rate cap, 19.4% a payment cap, 12.2% both) and 11% of the ARM loans adjust interest rates twice a year. See Lea, *Freddie Mac ARM Lender Survey: The State of the Market, in What Makes an ARM Successful?* 16-17 (1983) (FHLMC, Publisher). But see ARM Survey Finds Widespread Use of Rate, Payment Caps to Protect Borrowers, 12 *Housing & Dev. Rep. (BNA)* 307 (Sept. 10, 1984). Moreover, a large number of ARM loans and ARM programs bear an initial "hook" rate substantially below that for fixed rate mortgages—some programs average 4% below market (with most being 2% to 3%).

²⁴³ See J. Paulson, *Testimony Before the Housing Subcomm. of the House Comm. on Banking, Finance and Urban Affairs* 1 (July 25, 1984), reprinted in 1984 ARM Hearings, *supra* note 70.

²⁴⁴ See J. Guttentag, *supra* note 76, at 21-23, 43.

sales pitch, often persuade homebuyers to enter into them despite their riskiness.

For example, assume that a homebuyer family in 1984 is in a situation similar to that of the 1977 family: they cannot afford a three-bedroom home in the area where they want to live—until they see a Fancy Homes ad: “9.75% QUALIFYING INTEREST RATE. BUY A \$104,000 HOME FOR LESS!” [Bottom of ad: “*9.75% effective rate for six months, APR 12.5%”].²⁴⁵ The loan has adjustable rates, graduated payments, and a five-year balloon—all features of concern to the homebuyers. These reservations can be overcome, however, through vivid, easily available promotional materials that Fancy Homes developed or has received from the National Association of Homebuilders. One chart shows the appreciation of homes between 1970 and 1981. Even after accounting for the negative amortization, the chart indicates that the home will be worth much more than the outstanding balance after a few years if the appreciation rate continues.²⁴⁶ A second chart shows that a 1970 buyer having a similar adjustable mortgage would not have faced alarming payment increases through 1984; this could rebut homebuyer worries about rate and payment adjustments.²⁴⁷ Another chart shows the homebuyers that if they consider the tax deductions for mortgage interest and property taxes plus the probable appreciation on their home, their investment will be even more profitable.²⁴⁸ Having overcome the homebuyers’ initial reservations by generalizing from these specific

²⁴⁵ This example is based on the real life one presented by Realtor Jack Paulson. See J. Paulson, *supra* note 243, at 4-5.

²⁴⁶ Part of the action selling technique is to be very optimistic about the investment value of the house. See, e.g., *A New House Is The Best Investment You Can Make And NOW Is The Time To Buy*, Prof. Builder, Ap’t Bus., Nov. 1980, at 90; *Goodkin, Tools For Selling In Credit Crunch*, Prof. Builder, Ap’t Bus., June 1980, at 75 (“[m]ake people comprehend that real estate is the best option against inflation.”). The National Association of Home Builders touts the healthy appreciation of homes in the 1970’s. See *Marketing Strategies to Sell Homes*, *supra* note 76.

²⁴⁷ See Kamath & Raimier, *Do VRMs Really Transfer Interest Rate Risks?*, *Real Est. Rev.*, Spring 1981, at 105-08 (1970 VRM starting at a lower initial rate than a fixed-rate mortgage would yield only a few hundred dollars’ difference in total cost over 10 years, though a VRM originated in 1975-1978 would create more financial pressure on buyers).

²⁴⁸ The salesperson could use “The Real Cost of Ownership After Tax Benefits” and “Tax Savings Under the 1982 Tax Law” developed by the NAHB, see *Marketing Strategies to Sell Homes*, *supra* note 76, at 3 (these were used by 34% and 15% of builders in 1982), or some other promotional materials that dramatically limit the costs of owning. See Goodkin, *supra* note 246, at 75 (use simple charts to show how tax deductions subsidize the mortgage payment).

examples (using the representativeness heuristic), the salesperson sees a chance to clinch the deal. "You are losing tons of money as renters! If you wait even a year to buy a house, this eleven-year average suggests that the house will cost \$110,000. Even with bargain financing you could not qualify for a loan at that point."²⁴⁹

The homebuyers buy the house and agree to the GPAML with a balloon payment at the end of five years. Apart from the false attractiveness of the "bargain" interest rate used to hook the homebuyers, the homebuyers do not really understand how big a risk they are taking. By anchoring their decision to the investment projections of the sales agent, the homebuyers may underappreciate the prospect of a rate jump to 13% after six months, and a steep rise in monthly payments or negative amortization thereafter. The worksheets and graphics frequently used by builders and brokers to ease buyer objections to high prices and chancy mortgage rates often tell only part of the truth. For example, the second chart correctly notes that home prices went up a good deal in the 1970's, but does not disclose forecasters' predictions that any rise in the 1980's will be far more modest.²⁵⁰ A home costing \$100,000 in 1984 probably will not cost \$110,000 in 1985. No one can predict the course of mortgage rates, moreover, in the next five years. Thus, a chart that accurately describes the history of an ARM entered in 1970 is no more representative than a chart showing the terrible consequences of a 1977 ARM. Only the first chart, however, is developed for the prospective homebuyers.

Real estate brokers often use these same optimistic techniques to persuade buyers and nonbuilder-sellers to engage in risky crea-

²⁴⁹ The salesperson might use "The Cost of Waiting for Lower Interest Rates" developed by the National Association of Home Builders, and used by 33% of its builders in 1982, see *Marketing Strategies to Sell Homes*, *supra* note 76, at 3, to show the qualification problems if prices were to increase and interest rates not diminish (a very questionable assumption). See also *Yes, You Can Afford To Buy A New Home*, Prof. Builder, Sept. 1981, at 103 (chart showing that owning will save \$32,935; critical assumption is that home will appreciate each year).

²⁵⁰ See generally L. Grebler & F. Mittelbach, *supra* note 145, at 157-69; 1981 ARM Hearings, *supra* note 233, at 85-87 (statement of A. Fishbein, Director, Neighborhood Revitalization Project, Center for Community Change) (relatively high national average rate of increase in sales prices has, at least for present, dramatically changed). For the first six months of 1981, real home prices *declined* 2.8%; appreciation between August 1980 and March 1981 was virtually nil. See S. Rohde, *supra* note 233, at 126-27. Even in periods of housing inflation, certain neighborhoods may not "keep up" with the overall increases, pinching homeowners in those areas. *Id.* at 127-28.

tive financing. The buyer cannot obtain a mortgage at prevailing rates, and the seller does not want to give a price concession. The broker therefore persuades both parties to enter into a short term balloon note, with an inflated selling price and below-market interest rate. The broker may be able to minimize the apparent riskiness of the loan through charts showing enormous home appreciation and rosy forecasts about interest rates.

The unsophisticated seller, advised mainly by the optimistic broker, is even more prone to finance a risky mortgage instrument than is the institutional lender—and even more vulnerable to the ramifications of the buyer's default. A 1983 Rand Corporation study of the California mortgage market reports that as a result of below-market financing (and sellers' factoring the cost of financing back into home prices), over 75% of all California homes sold in 1981 had nominal prices greater than their cash values, and over 25% of the buyers could not have resold the homes for enough to pay off the loans.²⁵¹ Defaults are rising as these loans fall due because property values have not increased much and because the original loans were so unsound that institutional lenders will not refinance them. The study projects that home purchasers will continue to depend on creative (seller) financing through 1986, typically at below-market rates with short term balloons. This surge of unregulated, unsound creative financing creates the danger of a default crisis in the future.²⁵²

III. INTEGRATED FEDERAL REGULATION OF THE RESIDENTIAL FIRST MORTGAGE TRANSACTION: REDUCING CONSUMER ERRORS

After more than a century of regulatory effort on their behalf, homebuyers are still subject to unfair dealing in connection with home mortgages and related charges. Given one hundred years of ineptitude²⁵³ in state (usury) and then federal (disclosure) regulation of home mortgages, one may wonder whether any regulation is worthwhile.²⁵⁴ This question cannot be definitively answered here,

²⁵¹ I. Lowry, C. Hillestad & S. Sarma, *supra* note 172, at 195-97.

²⁵² A buyer default crisis, according to the Rand study, might trigger a chain reaction of seller defaults as well. *Id.* at 212-19.

²⁵³ Apologies to G. Garcia-Marquez, *One Hundred Years of Solitude* (1970).

²⁵⁴ Professor O'Connell cogently argues that many of the defects in the insurance industry are "cultural" (beyond the ability of conventional forms of regulation to affect), and some may even have been encouraged by ineffective regulation. See O'Connell, *The Frustrations of Insurance*, 43 U. Cin. L. Rev. 847 (1974).

but two reasons suggest continued regulatory concern. One justification for regulation is its norm-setting role: rules signal the marketplace participants that our society will not tolerate intermediaries' taking advantage of consumers' vulnerability when they seek home mortgages. Also, regulation has produced some tangible benefits. Empirical studies suggest that, overall, the Truth-in-Lending Act has made consumers more aware of credit costs, and RESPA has made them more aware of closing costs.²⁵⁵ This increased awareness has in turn generated some increase in shopping, which improves the competitiveness of the loan and settlement industries.²⁵⁶ Furthermore, federal regulations have probably caused many lenders to be more cautious about recommending settlement providers and alternative mortgage instruments, and to make a greater effort to inform consumers about costs and risks.²⁵⁷

Although the evidence is far from conclusive, disclosure seems to be one useful mode of regulation. The effectiveness of disclosure regulation could be significantly increased, and the unintended negative effects reduced, however, by a more sophisticated regulatory regime. Disclosures best inform the consumer and encourage shopping if they contain accurate information, are useful and comprehensible, and are provided before tentative decisions are made.²⁵⁸ The accuracy of disclosures would be improved by including *all* charges in the APR. Disclosures would be further improved

²⁵⁵ 1 Peat Marwick Study, *supra* note 100, at III.2 (RESPA); T. Durkin & G. Elliehauser, 1977 Consumer Credit Survey 7, table 2-1 (1978) (level of APR awareness increased from 14.5% in 1969 to 54.5% in 1977).

²⁵⁶ See 1 Peat Marwick Study, *supra* note 100, at III.2 (RESPA disclosures induced 10% of shoppers to engage in comparative shopping; shopping is one reason why inflation in title charges was modest in the 1970's); T. Durkin & G. Elliehauser, *supra* note 255, at 23-24 (few consumers shop more because of heightened APR awareness, but their shopping makes the market more competitive for all consumers).

²⁵⁷ 3 Peat Marwick Study, *supra* note 100, at II.2; E. Gray, *supra* note 70, at 8, 11-17 (FHLBB concern for prudent alternative mortgage practices has encouraged the industry to develop in a responsible manner).

²⁵⁸ A leading study, Day, *Assessing the Effects of Information Disclosure Requirements*, J. Marketing, Apr. 1976, at 42, 47, concluded that disclosures are most effective

when the buyer (a) has easy access to the information at the point of sale, (b) can readily comprehend and process the information, and (c) can use it to make direct comparisons of the choice alternatives along relevant attributes—in short, when the information is easy to use and relevant to the choice process.

if they provided comparative data for all mortgages and concrete "worst case" rate and payment scenarios for adjustable mortgages.

Greater standardization of mortgage instruments should complement this disclosure strategy, especially for new alternative mortgages. By removing minor matters from the shopping process and cutting away the huge diversity of alternative mortgages, standardization could mitigate the existing tension between providing complete disclosures and avoiding information overload. Because of the risks involved in ARMs and other alternative mortgage instruments, federal standardization should include specific consumer protections for these mortgages.

Disclosure plus standardization may be an incomplete solution, however, because many consumer mortgage problems can be traced to the structure of the real estate industry and the sales process. To the extent that some mortgage-related problems are structural, systemic changes may be justified to protect consumers. One such problem arises from homebuyers' reliance on self-interested intermediaries for advice about mortgages and settlement services. Ideally, these consumers should have "buyers' agents" to advise them. Some homebuyers retain agents now, but it is unclear whether this practice will become widespread in the near future. Until it does, there should be more specific common-law or federal fiduciary standards for intermediaries to explain misleading sales gimmicks, to be honest about the range of prices and any business connection between the intermediary and a referred provider, and to set forth the risks of alternative mortgages.

A second structural problem is the rise of controlled loan and settlement providers. Some evidence suggests that controlled providers charge higher prices and deliver inferior service. Until more decisive conclusions can be made, no structural reforms should be adopted. At a minimum, though, consumers should be warned about the potential dangers of a formally integrated transaction and given the opportunity to opt out of it. A final systemic problem arises from the patterns of cooperation found within the real estate sale, financing, and settlement industry. Prophylactic rules and the application of antitrust precepts should be used to disrupt systematic anticompetitive behavior.

A. *More Effective Disclosures to Homebuyers*

It is time to refine the philosophy of federal disclosure rules.²⁵⁹ Reform lies neither in requiring fewer disclosures (the approach of the Simplification Act) nor in requiring more (the FHLBB's approach to alternative mortgages). Instead, federal regulations should provide disclosures that more accurately reflect the total costs and risks of the loan and that consumers can realistically use during the shopping process.

1. *More Accurate Disclosure of the Cost and Risk of Mortgages*

The keystone of existing disclosure rules is the APR, a standardized measure of the cost of credit that can be advertised, quoted to buyers, and compared across lenders. The APR must be re-evaluated because it understates the true cost of credit for standard fixed-rate mortgages, can be manipulated by sellers paying buydown fees or lenders advertising low initial rates, and is virtually meaningless for many alternative mortgage instruments. To address these accuracy problems, there must be new rules for APR calculation, advertisement, and (in connection with ARMs) supplementation.

a. *Expanded Definition of Finance Charges Used to Calculate the APR*

Many charges are not currently considered part of the finance charge even though they accrue to the lender's benefit—seller's points, title insurance, attorney's fees, appraisal charges, and credit checks. These charges are analytically indistinguishable, however, from charges that are included—buyer's points, mortgage insurance, and origination fees.²⁶⁰ This phenomenon is problematic be-

²⁵⁹ There may also be a bureaucratic problem as a result of the plethora of disclosure regimes—the Truth-in-Lending Act administered by the Federal Reserve Board and FTC, RESPA administered by HUD, and the alternative mortgage rules for specific lenders administered by the FHLBB, Comptroller General, and the National Credit Union. Although the agencies have done a commendable job of coordinating their rules, a unified disclosure regime administered by the Federal Reserve Board could reduce some of the regulatory overlap that now occurs. For example, the Housing Subcommittee of the House Banking Committee called upon the Federal Reserve Board this summer to take the lead in developing more helpful disclosure rules for alternative mortgage instruments (specifically, to require "worst case" disclosures).

²⁶⁰ See *supra* notes 152-54 and accompanying text; see also *supra* text accompanying

cause in the integrated transaction, the builder, broker, or banker has an incentive to "bleed" expenses from the APR items to those not included in the finance charge. That is, because the APR is so easily shopped and compared, lowering it may create a false bargain when the bleeding results in a higher home price, title charge, or insurance burden, all of which are harder to compare.

A payment by the homebuyer should be part of the finance charge if it is "imposed directly or indirectly by the creditor as an incident to the extension of credit."²⁶¹ The Act's original philosophy assumes a functional definition of finance charge that, carried to its logical conclusion, should include not only interest charges but also premiums for insurance that lenders require; estimated fees for credit reports, surveys, or appraisals that lenders require; estimated attorney or other fees necessary to prepare the mortgage documents, unless the buyer retains his own attorney; loan or service charges and buyer's points; and seller's commitment and buydown points.

The APR should also be calculated on the basis of the loan's expected life rather than its nominal term. It would be the rate that would yield the finance charge "when it is applied to the unpaid balances of the amount financed, calculated according to the actuarial method of allocating payments made on a debt between the amount financed and the amount of the finance charge"²⁶² (assuming that the loan were paid off after its expected life). For example, if the loan's expected life were twelve years,²⁶³ the finance charge would include the net expected interest payments plus anticipated lender-required insurance premiums plus up front charges (e.g., points and title insurance). The APR would be the rate needed to generate this total over the twelve-year loan term.²⁶⁴

notes 15-30 (state usury law approach to what is included as interest).

²⁶¹ 15 U.S.C. § 1605(a) (1982).

²⁶² *Id.* § 1606(a)(1)(A).

²⁶³ Twelve years is the figure used by a standard lender yield table to calculate the number of points needed to buy down interest rates. FNMA, *supra* note 168, at 4, 7 ff.

²⁶⁴ This differs from the present method of computing the APR in at least one significant respect. Under the current system, the lender simply adds any up front charges to the total interest charges projected over the 30-year life of the mortgage and computes the APR from that total "finance charge." This method results in the understating of the lender's return from the up front charges (such as points) because mortgage loans are generally paid off before their term—meaning that the lender receives the principal within 12 years or less and can then lend it out again, charging more up front points.

Oral statements and advertisements including credit terms would have to use this APR. The Truth-in-Lending Act disclosure statement would reveal the total principal and the total finance charge plus a breakdown into interest charge (interest plus points) and ancillary charge components, in addition to this APR.

The proposed finance charge definition (embracing many currently excluded charges) and the proposed calculation of the APR (based upon the expected life of the loan rather than its term) would make the APR a more realistic indication of the real cost of credit for the home mortgagor. It could also make shopping easier and give lenders an incentive to minimize closing costs. The proposal incorporates the advantages of the "lender pay" concept, but without its main drawbacks.

In the early 1970's, Professor, now Dean, Whitman formulated the lender pay concept. He suggested that the law compel lenders to pay all closing and financing expenses except for prepaid items and taxes. The lender would be expected to cover the expenses either by charging a higher interest rate or (according to a later version of the proposal) by charging one lump sum.²⁶⁵ The advantage of lender pay is that it requires a knowledgeable party to shop and pay for closing services. Because the cost would be included in the easy-to-compare interest charge or lump sum, the lender would have a substantial incentive to eliminate marginal services and to shop for the lowest price.²⁶⁶ The present proposal gives lenders an even more powerful incentive: the estimated closing charges are reflected both in a lump sum on the disclosure statement and in the disclosed and advertised APR.

²⁶⁵ Whitman, *Home Transfer Costs: An Economic and Legal Analysis*, 62 *Geo. L.J.* 1311, 1346 (1974), proposed that (1) mortgage lenders be required by federal law to pay all closing costs; (2) mortgage lenders be required to provide homebuyers with title and settlement services equivalent in quality to those services obtained by lenders for their own benefit; and (3) mortgage lenders would not be permitted to charge homebuyers or sellers any fees, discounts, or other charges except simple interest.

²⁶⁶ *Id.* at 1346-47. Professor Stoppello has argued that lender pay will not necessarily put pressure on lenders to shop carefully (and thereby keep their stated interest rate as low as possible) because loan rates themselves are not competitive. Stoppello, *supra* note 54, at 400-11 (1979). Although Professor Wallace contends that "[t]here is no significant evidence that loan rates are not competitive," Wallace, *supra* note 54, at 247 n.232, the Peat Marwick Study found interest rate dispersion that may indicate imperfect mortgage loan competition in some markets under certain circumstances. See *supra* note 195 and accompanying text. On the other hand, the Peat Marwick Study found the market for loans to be one of workable competition, and it seems quite clear that the mortgage loan industry is much more competitive than that for most loan-related closing expenses.

Despite lender pay's conceptual strength and enduring political support in the last decade, it encountered serious opposition within the mortgage industry and in Congress.²⁶⁷ Lenders objected that they did not want the added administrative burden of retaining settlement service providers. Consumer advocates objected that lender pay deprived consumers of any role in choosing settlement providers. Members of Congress were concerned that lender pay would encourage the proliferation of settlement providers controlled by big lenders.²⁶⁸

By redefining the Truth-in-Lending Act finance charge to include lender-dictated settlement expenses, this article's proposal avoids these concerns. It does not impose substantial burdens on the lender, but instead provides an incentive for lenders to reevaluate loan-related services and to seek out the least expensive provider. More important, this present proposal preserves the buyer's freedom to shop for settlement providers charging prices that are lower than those estimated by the lender. As Professor Wallace has observed in his critique of lender pay, a disclosure-oriented approach may have the advantages of lender pay while permitting greater consumer flexibility.²⁶⁹

b. Including Seller's Points in the Finance Charge

An advantage of this expanded finance charge definition is that it would reduce consumer confusion often caused by the use of seller's points to buy down the interest rate while raising the price.

²⁶⁷ Senator Proxmire introduced legislation embodying Professor Whitman's proposal. See S. 3232, 93d Cong., 2d Sess. (1974); 120 Cong. Rec. 8091 (1974) (remarks of Senator Proxmire). Representatives of the Reagan administration proposed "lender packaging," in which the lender would provide all settlement services and charge a lump sum for the package. 1981 RESPA Hearings, *supra* note 140, at 7-9 (statement of Dr. E. Savas, Ass't Sec. Policy Dev. & Research, HUD); *id.* at 74 n.2 (statement of T. Stanten & J. Brown, FTC); see 3 Peat Marwick Study, *supra* note 100, ch. IV (evaluating and generally approving lender pay concept). The Senate rejected Senator Proxmire's proposal in favor of the disclosure and anti-kickback rules of RESPA. See Real Estate Settlement Costs: Hearings Before the Subcomm. on Housing of the House Comm. on Banking and Currency, 93d Cong., 1st & 2d Sess. (1973-1974). The Reagan administration proposals were also not acted upon by Congress.

²⁶⁸ See, e.g., 1981 RESPA Hearings, *supra* note 140, at 30-31, 39-40 (remarks of Rep. Patterson); *id.* at 41-43 (remarks of Rep. Carman); *id.* at 44, 140-42 (remarks of Rep. Gonzalez).

²⁶⁹ Wallace, *supra* note 54, at 256; see 1979 Simplification Act Hearing, *supra* note 58, at 32-33 (statement of R. Hobbs, Nat'l Consumer Law Center).

Allowing sellers to buy down the advertised interest rate can be deceptive because homebuyers often assume that the points are not built into the home's price. The proposal adopts the bright-line rule that seller's points should be added to the finance charge, and rejects the pre-1981 rule that seller's points should be included only to the extent that sellers pass them on as part of the home price. Although the pre-1981 rule has a distinguished history in state usury regulation,²⁷⁰ lenders cannot realistically determine how much of the seller's payment has been passed on to consumers. In addition, lender competition for homebuilder and broker referrals creates an incentive for lenders to be conservative in estimating the amount of seller's points passed on to consumers.²⁷¹ A pass-on rule is simply an invitation for lenders to ignore seller's points, as they did in the 1970's.

An alternative to the proposed bright-line rule would be to require the disclosure of the information recommended by the Federal Reserve Board staff in 1982. The staff recommended that seller's points not be included in the finance charge (APR), but that advertisements would have to alert consumers that "[t]o obtain financing for you at the annual percentage rate shown, the seller may have incurred some costs, and these costs may be included in the purchase price you pay."²⁷² This approach apprises

²⁷⁰ See *Johnson v. Federal Nat'l Mortgage Ass'n*, 271 Ark. 588, 609 S.W.2d 60 (1980); *Schleimer v. McPherson*, 60 A.D.2d 837, 400 N.Y.S.2d 566, appeal dismissed, 44 N.Y.2d 730, 405 N.Y.S.2d 460 (1978); *Maynard v. England*, 13 Wash. App. 961, 967-68, 538 P.2d 551, 555 (1975).

²⁷¹ If one bank consistently includes seller's points in the finance charge and another bank does not, builders and brokers—who want to be able to advertise low-rate bargain rates—will tend to take their business to the second. Thus, a "competition of laxness" in computing seller's points in the finance charge (and APR) characterized lenders and sellers in the 1970's, when the Federal Reserve Board's "pass-on" test was in effect. In the 1980's, when many builders and brokers own their own mortgage subsidiaries, the controlled lender is even less likely to include the seller's points in the finance charge.

²⁷² Fed. Reserve Bd. Div. of Consumer & Community Affairs, *Seller's Points Under Regulation Z (Truth-in-Lending)* 10 (Sept. 27, 1982) [hereinafter cited as *FRB Seller's Points Memo.*] (copy on file with the Virginia Law Review Association). The staff memorandum evaluated various alternatives for dealing with seller's points. It rejected a "pass-on" rule because it would have involved complicated and expensive calculations by lenders and probably would have resulted in inconsistent practices (some lenders would routinely include seller's points, others rarely, if ever). *Id.* at 7. Two other proposals, requiring disclosure that seller's points had been paid and that the home price might be affected, were rejected because they would have required revamping Truth-in-Lending Act disclosure statements and would have imposed unjustifiable burdens on lenders. *Id.* at 9-10. The staff rejected the

the consumer of the general problem, relieves the lender of the sticky determination of the amount of points passed on to the consumer, and permits the seller to market the home through a low APR rather than a low home price.

The staff's 1982 proposal, however, would confuse or mislead many homebuyers. The proposed language is so contingent and general (seller "may" have incurred costs, which "may" be included in the price) that the consumer is likely to pay little attention to it; if he does ask the builder or broker about the relation between the home price and the loan rate, the sales pitch can minimize the relationship.²⁷³ Soft approaches have simply not worked to regulate seller's points. The only approach that will work is a hard rule that seller's points must be included in the finance charge.

The only real objection to the proposed rule would be that it is unclear whether "most" or merely "some" seller's points are passed on as part of the home price.²⁷⁴ Common sense suggests, however, that a seller offering a lower interest rate will generally charge a higher home price. The evidence is overwhelming that most, and often all, of the seller's points are reflected in the home price.²⁷⁵ Even in 1981-1982, when many sellers offered low-rate financing without raising prices, housing demand was so depressed that sellers would have been forced to cut prices otherwise—so the failure to reduce prices was itself a way of having home prices re-

1981 rule that seller's points are not part of the finance charge and not otherwise disclosed because it found that

seller's points are in some instances passed along to the consumer in part or in full When the seller's points passed on are substantial, the APR that is calculated excluding seller's points is significantly different from the APR that would result if the points were treated as a finance charge. This could lead to misleading cost disclosures concerning the credit transaction.

Id. at 6. The Board of Governors, however, voted in favor of this last proposal.

²⁷³ See *supra* text accompanying note 178.

²⁷⁴ See Fed. Reserve Bd. Seller's Points Memo., *supra* note 272, at 7 (although seller's points are "often" passed on "to some extent," staff believed that degree of problem in 1982 or in the future was very unclear); Fed. Reserve Bd. Div. of Consumer and Community Affairs, Summary of Comments on the Treatment of Seller's Points (Regulation Z) 2-6 (Sept. 28, 1982) (copy on file with the Virginia Law Review Association).

²⁷⁵ See *supra* note 167 (summarizing empirical studies); J. Guttentag, *supra* note 76, at 11 & n.1 (citing unpublished studies that "find that some significant portion of the true value of concessionary financing terms is capitalized in house prices"); Benfield, *The Effect of Credit Regulation on Real Estate Transactions*, 25 *Bus. Law.* 501, 501-02 & n.2 (1970).

flect seller's points. Because seller's points are passed on to consumers to some extent, they should be included in the finance charge.

c. Limiting Teaser Rates

Under the rule proposed thus far, the seller could buy down the interest rate for the first several years of the loan and advertise a bargain, or teaser, rate if the term of the low rate and the APR (including the buydown points) were both revealed. Because the buydown is only for a year or two, the points would not increase the APR significantly, and many homebuyers would still be lured by the apparent bargain or the ability to qualify for a larger loan. Similarly, lenders advertising very low initial rates for ARMs may attract homebuyers to very risky investments. These meretricious mortgages require additional regulatory attention. Recent FNMA and FHLMC mortgage plans limit initial teaser rates by stipulating that the monthly payment on loans they purchase may not increase by more than 7.5% in any given year.²⁷⁶ This approach is sound and should be incorporated into federal regulations of alternative mortgages.

2. "Worst Case" or "Bad Case" Disclosures for Adjustable Mortgage Instruments

The APR can be a useful shopping tool for standard mortgages and GPMs where the schedule of payments is known at the loan initiation. It is less useful, however, for mortgages whose rates fluctuate with a market index (ARMs). The APR for such loans is an average of the projected interest rate for each year of the loan, using the current index rate.²⁷⁷ This projection may mislead consumers: the firm numerical value suggests much greater certainty

²⁷⁶ See Mylod, *supra* note 240, at 13. At the 1984 ARM Hearings, Professor Guttentag proposed that mortgage payments not increase more than 10% per year, as one way of discouraging teaser rates. J. Guttentag, *supra* note 76. The lower FNMA/FHLMC figure may be preferable because it is closer to the expected rate of income inflation for the 1980's. Gordon Steinbach of MGIC (the main mortgage insurer) believes that a 7.5% yearly payment increase is "about the maximum that's prudent." Quoted in H. Snyder, *supra* note 70, at 8.

²⁷⁷ See 12 C.F.R. § 226.22 (1984); *id.* pt. 226, Supp. I—Official Staff Interpretations, Comment 22(a)(1)-4; 49 Fed. Reg. 13,482, 13,485 (Apr. 5, 1984) (to be codified at 12 C.F.R. pt. 226, Supp. I—Official Staff Interpretations, Comment 18(f)-8).

about the future than is reasonable.²⁷⁸ The APR also does not reveal significant risks inherent in some of the adjustable mortgages.

These problems do not necessarily support the elimination of APR disclosure for ARMs, but instead suggest that their Truth-in-Lending Act disclosures and advertisements must at least reveal the APR's contingent nature.²⁷⁹ In any event, a more meaningful disclosure for these mortgages would give a concrete indication of how the interest rate and the monthly payment might fluctuate. The FHLBB requires disclosure of a scenario of the interaction of all the loan's variable features over any period of time.²⁸⁰ This form of disclosure is useful because it illustrates how the loan works in dollars-and-cents terms—it is information vividly presented to the consumer. Unfortunately, the FHLBB scenario typically paints a rather safe picture, if anything reinforcing the message of the sales pitch.

A worst case scenario is needed so that the consumer can see the possible downside risks.²⁸¹ The scenario for an ARM might assume that interest rates will rise substantially (to the extent allowed by caps) and demonstrate the effect this rise would have on the rates and monthly payments for each year of the loan, together with the

²⁷⁸ Another possible problem is that sellers and lenders may have a long term incentive to push ARMs in periods when they expect the index to increase, thus creating a bias in the APR that causes it to understate risk. For example, if the ARM index were currently 12% and expected to increase, lenders would want buyers to enter into ARMs and would be willing to offer the loans at an initial rate significantly below that which they charge for fixed-rate mortgages. Encouraged by brokers, homebuyers would then gravitate toward what appears to them to be a much better deal than it really is. On the other hand, if interest rates were 17% and expected to fall, lenders would not offer a low initial rate for ARMs and would not push them with consumers.

²⁷⁹ Suggested language for forms and advertisements stating APR:

Because the future interest rate on this loan will fluctuate with a market index, the APR is a projection that assumes that the current index rate applies for the life of the loan. This is an assumption of convenience. THE APR FOR THIS LOAN OVER TIME WILL DEVIATE FROM THE QUOTED APR.

²⁸⁰ 12 C.F.R. § 545.33(f)(11) (1984). The Comptroller General requires a 10-year historical series tracing the index chosen for the ARM, but does not require that the lender show what effect increases in the index will have on the mortgage rate, monthly payments, or the principal. *Id.* § 29.7(a)(3).

²⁸¹ The FHLBB's VRM Regulations issued in 1978, and amended in 1979, required lenders to set forth a worst case schedule for the VRM, showing every maximum increase at the time it could first occur, the highest possible payment during the loan term, and the total cost over the term of the loan, including a statement that extension of the maturity would increase the total cost of credit. 12 C.F.R. § 545.6-2(c)(5)(ii) (1980). This requirement has been superseded by the Board's AML Regulations, described in the text.

principal outstanding at the end of each year (loans with a graduated payment element would show increasing principal amounts in the early part of the loan).²⁸² The advantage of worst case disclosure is that it gives homebuyers concrete facts (rate, monthly payment, and loan balance) that also indicate the risk of fluctuation. The disadvantage of worst case disclosure is that it is not a realistic indication of what might happen. For that reason, a bad case scenario (reflecting pessimistic assumptions) might be required instead.

Even a two-scenario disclosure would not necessarily enable consumers to make accurate comparisons. For example, assume two adjustable mortgages. Mortgage A is tied to one-year Treasury notes, bears an initial rate of 9.875%, has no yearly rate cap but has a 5% life-of-loan cap and a 4.875% floor rate. Mortgage B is tied to three-year Treasury notes, bears an initial rate of 12%, and has a cap of 2% for each three-year change, a 4.5% life-of-loan cap, and a 12% floor. Also, assume two scenarios, one providing an example of rising and volatile interest rates and another a period of relative stability.²⁸³ The ten-year average for Mortgage A is 13.15% under the bad case scenario and 11.74% under the stable

²⁸² Professor Guttentag has proposed that disclosures for ARMs include three schedules for two scenarios—(1) an “interest cost” schedule setting forth the average interest rate for each year of the loan, (2) a mortgage payment schedule showing the projected monthly principal-and-interest payment for each year, and (3) a loan balance schedule for each year. See J. Guttentag, *supra* note 76.

²⁸³ This hypothetical is taken from a chart developed in Berry, *Choosing Mortgage May Be Harder Than Choosing House: Analysis Shows Different Performance of Adjustable Loans*, Wash. Post, Apr. 28, 1984, at E1; *id.* at col. 4, E62 (reproduced in full as Appendix 1 to this article). I have scrambled the order of the scenarios. The stable scenario noted in text is scenario 2 below; the first volatile scenario in text is scenario 1 below. The second two volatile scenarios (invoked in the following paragraph in text) are scenarios 3 and 4 below:

<u>Year</u>	<u>Scen. 1</u>	<u>Scen. 2</u>	<u>Scen. 3</u>	<u>Scen. 4</u>
1984	11	11	11	11
1985	14	12	12	14
1986	15	9	15	9
1987	10	9	8	10
1988	9	10	9	11
1989	11	12	11	14
1990	12	8	12	10
1991	14	9	9	12
1992	9	8	12	15
1993	11	8	14	8

scenario, while the averages for Mortgage *B* are 13.75% and 11.95%. The homebuyer would probably assume that Mortgage *A* is "better" than Mortgage *B*, but he would not necessarily be right.

If the highest interest rates in the bad case scenario occur in different years, Mortgage *B* would have the edge. Its ten-year averages of 12.25% and 12.85% would be demonstrably better than the Mortgage *A* averages of 13.01% and 12.95%. By chance, Mortgage *B*'s years of adjustment were low-rate years under the previous two scenarios. For this reason, disclosure of several scenarios would be useful for homebuyers.²⁸⁴

3. *Comparative Data Presented During the Shopping Process*

The APR for a loan and its specific closing cost components are of diminished value to the consumer if he does not receive them during the decisionmaking process or if it is hard to compare them with the deals that other lenders and settlement service providers offer. Mortgage disclosure regulations should be amended to require intermediaries to provide some type of comparative disclosures before a loan application is made if they make representations about financing or recommend a specific loan. Alternatively, HUD or another appropriate agency should periodically publicize comparative loan and settlement service data.

a. *Comparative Disclosures*

Current disclosures only provide loan and settlement cost information about the mortgage for which the homebuyer applies. Yet sometimes the homebuyer fails to shop because he assumes incorrectly that all lenders and providers charge about the same price.²⁸⁵ Psychological studies suggest that if consumers are

²⁸⁴ The broader lesson to be drawn from this hypothetical is that no disclosure can tell homebuyers exactly what their likely rate on an ARM will be because there is no crystal ball for the course of interest rates. See W. Eskridge, *Call to ARMs: Protecting Consumers Who Enter into Adjustable Rate Mortgages* 18-19, 23-25, 26-28 (June 21, 1984), reprinted in 1984 ARM Hearings, *supra* note 70.

²⁸⁵ The Peat Marwick Study surveyed both borrowers and lenders to determine why 64% of all homebuyers do not shop for a loan. 2 Peat Marwick Study, *supra* note 100. Nearly two-thirds of the lenders surveyed believed that homebuyers assume that all lender institutions are the same (though homebuyers themselves gave this as the main reason for not shopping in only 12% of the responses). *Id.* at X.14. Of the 34% of the homebuyers who did engage in shopping activity, 78% (in the first survey) and 84% (in a second survey) believed

presented with a display of unitized price data in systematic tabular arrays, they are more likely to comparison shop because such arrays negate conditions for bolstering and shifting responsibility.²⁸⁶ Comparative price information should therefore be made available to homebuyers as part of the standard Truth-in-Lending Act disclosures.

Consumers interested in a fixed-rate mortgage should have available a list of mortgage lenders *plus* their current APR rates *plus* lump sums of estimated closing costs. Similarly, the consumer should have referral lists of mortgage insurers, title companies or agents, and other settlement providers.²⁸⁷ Consumers interested in alternative mortgage instruments should be given an array of selected alternative instruments, with columns comparing the main variable features and a tabular comparison of interest rates for those selected loans under four scenarios.²⁸⁸

Homebuyers should have these comparative disclosures; the question is how they should be provided. Such tabular comparisons are now developed and distributed in many metropolitan real estate markets to help brokers and builders shop for mortgage rates.²⁸⁹ Regulators should select a few areas and require intermediaries to subscribe to approved comparison services on a trial basis and to distribute the weekly-updated sheets to consumers. If the experiment works, it could be expanded to other real estate markets.

that their shopping efforts were worthwhile. *Id.* at X.17.

²⁸⁶ Russo, Krieser & Miyashita, *An Effective Display of Unit Price Information*, J. Marketing, Apr. 1975, at 11, found that "unit pricing" in grocery stores (giving total price plus price per unit for a product) did not generate increased shopping behavior on the part of consumers. The explanation was that although useful information was available to consumers, they found it too difficult to process because of the diffuse way it was displayed. The authors tested the effectiveness of using a single, organized list of all raw prices and corresponding unit prices and found that for relatively homogeneous products (e.g., dishwashing liquid and facial tissue) the organized list significantly increased consumer sensitivity to price differentials and stimulated shopping behavior. *Id.*

²⁸⁷ Cf. 3 Peat Marwick Study, *supra* note 100, at III.26-28 (recommending referral lists of mortgage insurers); *id.* at III.49-50 (recommending referral lists of title insurers and attorneys).

²⁸⁸ See *infra* Appendix 1.

²⁸⁹ See 3 Peat Marwick Study, *supra* note 100, at III.16-17 (publishing services in selected areas of the country collect and publish comparative mortgage financing terms updated frequently, often weekly).

b. Disclosures During the Shopping Process

Although homebuyers typically make a tentative commitment to specific loans while shopping, most disclosures are not made until they actually apply for a loan. The psychological dynamics of the home sale and loan transaction suggest that more information needs to be given to homebuyers during the shopping process. Lenders or credit arrangers should make some or all of these disclosures available to homebuyers upon oral inquiry or when they receive application forms. Thus, the lender or sales agent must under current law give the APR whenever the lender or agent provides any interest rate quotation (orally or in writing) to a borrower.²⁹⁰

If the transaction is integrated, the basic disclosures (APR, good faith estimate of closing costs, settlement booklet) should be made by the sales agent if he makes representations about financing or recommends a specific loan.²⁹¹ For example, homebuilders offering pre-arranged financing should have standard mortgage disclosure forms on hand at their model homes, so that sales representatives can give them to homebuyers. Similarly, if a broker recommends a particular loan during the sales pitch, he should give the disclosures to the buyer before he applies. On the other hand, the builder salesperson or the broker need not provide disclosures if he does not make representations about credit and does not steer the buyer toward a particular loan.

This proposal roughly reflects the current practice of many brokers and builders. Before the sales contract is signed, national homebuilders generally encourage their sales representatives to demonstrate on a printed form what closing costs will likely be paid at settlement and what APR the allied lender is charging.²⁹²

²⁹⁰ 15 U.S.C. § 1665a (1982); see 3 Peat Marwick Study, *supra* note 100, at II.9-10 (recommending earlier delivery of the RESPA good faith estimate of closing costs by the lender).

²⁹¹ See 3 Peat Marwick Study, *supra* note 100, at II.4-5 (recommending delivery of a special information booklet by the sales agent during the sales process).

²⁹² In my survey of national homebuilders, *supra* note 141, the builders' standard operating procedure is as follows: once the builder's sales representative narrows down the possible houses to one or two that would be "right" for the prospect, the representative will work through a "cost estimate sheet" that shows the price of the house, probable monthly payments if the buyer finances the house through the builder's allied lender, and estimated closing costs.

The more sophisticated brokers also show buyers the prospective closing costs and probable interest rate before allowing the buyer to sign the sales contract.²⁹³ This better business practice should be mandatory: if the seller or its agent refers the buyer to sources of financing or settlement services, or uses tied-in financing or settlement as part of the sales pitch, then the buyer should at least be given disclosures so that he can compare the representations and recommendations before he becomes committed to the deal.

c. Regulating Brokers and Builders as Arrangers of Credit

Mandating earlier comparative disclosures would require amendment of the Truth-in-Lending Act to expand the definition of "creditor"²⁹⁴ to include brokers and builders that arrange credit. In the Garn Act, enacted in 1982, Congress deleted "arrangers of credit" from the statutory definition so that real estate brokers would not have disclosure duties.²⁹⁵ This decision should be reconsidered. The disclosure duties imposed on real estate agents would only be as onerous as the agents make them: if the agent makes financing or settlement deals part of the sales pitch, he is acting like a lender and should have disclosure duties. More important, failure to impose disclosure duties on sales intermediaries leaves a significant regulatory gap. Brokers regularly orchestrate creative financing deals where the lender is a private person (the seller) who does not regularly extend credit. A striking irony under current law is that these deals present the greatest risks to homebuyers, because they often involve short term balloons on overvalued property, and yet are substantially unregulated, because neither the seller nor his agent is a "creditor" who must provide Truth-in-Lending Act disclosures.

A legal requirement of earlier comparative disclosures, however,

²⁹³ See 1981 RESPA Hearings, *supra* note 140, at 454 (testimony of C. Hilton, Senior Vice-Pres., Coldwell Banker & Co.); *id.* at 461 (testimony of D. Treadwell, First Vice-Pres., Nat'l Ass'n of Realtors) (general practice among Realtors is to provide a total cost estimate before "writing up" the contract on a home sale).

²⁹⁴ See 15 U.S.C. § 1602(f) (1982) ("creditor" as defined by the Act refers only to a person who both (1) regularly extends consumer credit for which the payment of a finance charge may be required, and (2) is the person to whom the debt arising from the consumer credit transaction is initially payable).

²⁹⁵ Pub. L. No. 97-320, § 702, 96 Stat. 1469, 1538 (amending 15 U.S.C. § 1602(f) (Supp. V 1981)).

would probably encounter intense political opposition from bankers, brokers, and builders.²⁹⁶ Therefore, an alternative nonmandatory approach must also be considered. One alternative would be for HUD or another agency to develop a program for periodic gathering and publication of loan and settlement information.²⁹⁷ The information could then be disseminated through the news media, consumer groups, and voluntary cooperation by bankers, brokers, and builders. This sort of voluntary or HUD-centered early disclosure program could be beneficial by calling attention to rate or cost variability, and by encouraging comparative shopping.

B. Standardization of Home Mortgages

Even if the consumer receives early, accurate, and comparative federal disclosures of loan and settlement terms, they still may be difficult for the homebuyer to evaluate because of information overload.²⁹⁸ Under current regulation and practice a loan cannot effectively be compared with other loans unless the consumer knows the APR, the associated settlement costs, the terms of future variation in the interest rate and monthly payments, the due-on-sale and balloon features of the loan, and the contract-based penalty features (default, delinquency, and prepayment). It is hard for most consumers thoroughly to evaluate and synthesize so many different characteristics. Standardization of many mortgage terms would make shopping easier, and could also reduce the administrative burdens on creditors. Indeed, effective consumer evaluation of alternative mortgage instruments may be virtually impossible without greater standardization. Standardization of alternative

²⁹⁶ In 1980 the Federal Reserve Board proposed an alternative to the detailed transaction-oriented disclosures by allowing lenders to give disclosures for "representative transactions" before the consumer applied for a loan. 45 Fed. Reg. 29,702, 29,726, 29,748-49 (1980) (proposing new 12 C.F.R. § 226.11(h)). The great majority of the 230 comments that the Board received were negative, on the ground that earlier disclosures were unnecessary or would result in consumer confusion or creditor expense, and the proposal was dropped. 45 Fed. Reg. 80,648, 80,676 (1980). This intensive industry campaign is evidence of solid and effective opposition to mandated disclosure during the shopping process.

²⁹⁷ See 3 Peat Marwick Study, *supra* note 100, at III.17 (recommending voluntary and community program to distribute loan and settlement information during the shopping process). Dean Whitman observes that HUD considered such an approach in the early 1970's, but was not certain of its feasibility. That many newspapers do this now suggests its feasibility, but many details would remain to be ironed out. Whitman Letter, *supra* note 5, at 5.

²⁹⁸ See *supra* notes 162-64 and accompanying text.

mortgage instruments might be necessary both to reduce the confusing array of choices and to create a range of less risky choices.

1. *Standardization of Ancillary Mortgage Terms*

Congress attempted to reduce this information overload in the Simplification Act of 1980 by focusing disclosure on the finance charge/APR and on plain language summaries of various loan terms. Thus the Federal Reserve Board's model forms for mortgage transactions require disclosures describing the existence of a "demand feature" to the loan, late charges, prepayment penalties, and a due-on-sale clause, but refer the homebuyer to the mortgage agreement for "additional information about nonpayment, default, any required repayment in full before the scheduled date, and prepayment refunds and penalties."²⁹⁹ The consumer is therefore generally informed of the main contract provisions without being burdened by detail.³⁰⁰

Critics complain that the Act provides the consumer with less information, and that creditors might insert unfair provisions in the "fine print."³⁰¹ In light of such criticisms, the Simplification Act should be carried one step further: federal rules should substantially standardize ancillary terms of the mortgage note, thus preempting state regulation in the same way that the Garn Act preempted state rules concerning due-on-sale clauses and alternative mortgage instruments.³⁰²

Professor Jeffrey Davis argues that uniform federal rules are needed to regulate the terms of credit agreements (though his

²⁹⁹ 12 C.F.R. pt. 226, App. H—Closed End Model Forms and Clauses (1984).

³⁰⁰ The congressional goal was to balance "the competing considerations of complete disclosure . . . and the need to avoid providing so much information that the consumer is discouraged from studying it." S. Rep. No. 73, *supra* note 58, at 3, reprinted in 1980 U.S. Code Cong. & Ad. News at 281; see 1979 Simplification Act Hearing, *supra* note 58, at 101-02 (statement of S. Feldman, counsel, Nat'l Retail Merchants Ass'n) (recommending simplification of disclosure requirements); 1978 Simplification Act Hearings, *supra* note 58, at 77-79 (statement of P. Coldwell, Member, Bd. of Governors, Fed. Reserve Sys.) (Truth-in-Lending Act information should be simplified and segregated from other contractual provisions).

³⁰¹ See 1979 Simplification Act Hearing, *supra* note 58, at 30 (statement of R. Hobbs, Nat'l Consumer Law Center) (information overload has not been shown to be a real problem); *id.* at 51-53 (statement of J. Boyle, Tex. Consumer Ass'n) (information overload should not be solved by eliminating useful disclosures, but by simplifying language).

³⁰² See *supra* notes 68-69, 73 and accompanying text.

study does not address home mortgages).³⁰³ State regulation produces too much inconsistency and provides little consumer protection. The consumer is expected to protect himself by careful shopping but actually pays little attention to the ancillary terms, even though these terms may make a real difference in the loan's value. Based upon a survey of creditor practices, Professor Davis concludes that uniform federal contract terms can be established that are sensitive to both creditors' needs and consumer protection.³⁰⁴

Professors Goetz and Scott agree that "preformulated" (standardized) contract terms are often welfare-enhancing, because they can reduce transactions costs and interpretational errors, and create a fairer and more uniform system of communication. But they caution that these advantages may sometimes be offset by new errors or interpretational problems introduced with preformulations, by dangers that the new norms will deteriorate through rote use and encrustation, and by barriers standardization may pose to the development of new formulations responsive to emerging business needs.³⁰⁵ These potential disadvantages of standardized mortgages might be minimized, however, by tying the standardization to terms that FNMA and FHLMC develop in the marketplace. The federal government created these organizations and has structured

³⁰³ Davis, *Revamping Consumer Credit Contract Law*, 68 Va. L. Rev. 1333 (1982). Professor Davis argues that two underlying regulatory assumptions have impeded successful regulation of the terms of "form contracts"—"first, that the regulation of contractual relationships should be left to the states, and second, that parties should be free to contract as they choose." *Id.* at 1348. To make a serious effort at solving the problems, Professor Davis suggests "a completely preemptive federal takeover of the regulation of both pre- and post-contract aspects of the consumer-credit legal relationship." *Id.* at 1353.

³⁰⁴ *Id.* at 1392; see also *id.* at 1360-90 (methodology and results of the empirical survey, which was limited to closed-end, nonrealty-mortgage credit).

Section 501(c) of the Depository Institutions Deregulation and Monetary Control Act of 1980, 12 U.S.C. § 1735f-7 note (1982), for example, adopted this approach for mobile home financing. Such financing is not exempt from usury ceilings unless the mortgage note includes consumer protection provisions concerning balloon payments, prepayment penalties, late charges, deferral fees, limitations on foreclosure actions, and other protections that the FHLBB specifies. See *supra* note 88.

³⁰⁵ Goetz & Scott, *The Dynamics of Contractual Formulation and Interpretation*, Calif. L. Rev. (1985) (forthcoming). The last (barriers to innovation) is the most important problem. Even without standardization, there may not be enough incentive for businesses to develop new formulations because of a free rider problem: the inventor does not receive all of the profit from the new formulation, as it is picked up by others. If standardization is accompanied by state bureaucratic resistance to amending the preformulated terms, it can all but kill market innovation.

them to ensure responsiveness to public policy, but as mortgage buyers they are also sensitive to market needs.³⁰⁶ Thus, in the last decade these secondary market buyers have experimented quite flexibly with various ARM plans before settling on ones that are both acceptable to lenders and less risky for consumers. Their uniform mortgage note and deed of trust³⁰⁷ reflect the needs of the marketplace *and* consumer protection.

For example, the FNMA/FHLMC standard instrument contains a due-on-sale clause that protects the lender from the substitution of a less reliable borrower for the original borrower, thus ensuring that the buyer's alienation does not undermine the original assessment of risk. In fairness to the consumer, however, the mortgage limits the circumstances under which the lender can exercise its due-on-sale rights,³⁰⁸ and prohibits prepayment charges that penalize the homebuyer when the lender accelerates the payment due on the loan.³⁰⁹ The FHLMC/FNMA standard instrument similarly reflects both consumer protection and lender flexibility concerns in

³⁰⁶ FHLMC was initially capitalized through subscriptions by the 12 Federal Home Loan Banks; the FHLBB, which supervises the Home Loan Banks, is also the board of directors of FHLMC. See FHLMC, *The Secondary Market in Residential Mortgages* 10 (rev. ed. 1983). FNMA's stock, in contrast, is publicly traded, but its operations and policy are subject to the regulatory authority of the Secretary of HUD. 12 C.F.R. pt. 81 (1984). FNMA's 15-member board of directors consists of five members elected by the shareholders and 10 appointed by the President of the United States. As a result of this structure, together with specific statutory responsibilities of each, FHLMC and FNMA have actually been "pioneers" in developing new mortgage instruments and mortgage plans that make housing "affordable" for more Americans, without imposing on them excessive risks. See 1984 Secondary Mortgage Market Hearing, *supra* note 41, at 26-27 (statement of D. Maxwell, Chairman, FNMA). On the other hand, each institution pays dividends to its shareholders and is under some pressure to maintain profits. FNMA, for example, was not profitable in 1980-1982, largely due to the unfavorable market conditions, but through careful planning was able to turn a \$75.5 million profit in 1983. *Id.* at 27.

³⁰⁷ FNMA/FHLMC Uniform Instrument, Note and a Deed of Trust (rev. 1977 & 1979) (copy on file with the Virginia Law Review Association). In recent years, FNMA and FHLMC have developed new plain language forms for ARMs. See FHLMC Adjustable Rate Mortgage Note (1981), reprinted in Browne, *supra* note 70, at 217-24; FNMA Adjustable Rate Note (1983) (copy on file with the Virginia Law Review Association).

³⁰⁸ The acceleration of payment cannot be triggered by short term leases of the property, second mortgages, and other transactions not impairing the lender's security or negating its original risk assessment. FNMA/FHLMC Uniform Instrument, *supra* note 307, ¶ 17; see FHLMC Adjustable Rate Mortgage Note, *supra* note 307, ¶ 10; FNMA Adjustable Rate Mortgage Note, *supra* note 307, ¶ 11.

³⁰⁹ FNMA/FHLMC Uniform Instrument, *supra* note 307, ¶ 4; see FHLMC Adjustable Rate Mortgage Note, *supra* note 307, ¶ 3(B); FNMA Adjustable Rate Mortgage Note, *supra* note 307, ¶ 5.

its provisions relating to avoidable future charges or occurrences. Delinquency charges are only assessed after a grace period (usually fifteen days) has elapsed and the penalty is in practice limited to 5% or less of the amount due.³¹⁰ The homebuyer also cannot be found in default unless he has both received actual notice of default and has had at least thirty days to cure the default.³¹¹

The provisions that FNMA and FHLMC adopted for their standard mortgage agreements have not only been followed by lenders originating loans to be sold to these organizations, but have also been followed in many loans held by originating lenders for their own portfolios. These lenders adopt these agreements either because they want the option of later selling to FNMA or FHLMC, or because they want to standardize their documents.³¹² This is some indication that FNMA and FHLMC instruments do not conflict with market demands.

There would be at least two advantages to generalizing the FNMA and FHLMC standardized contracts. First, *all* consumers would receive the protections now afforded only to those whose mortgages are sold on the secondary market or whose lenders have adopted the secondary market standards. When lenders deviate from these standards, the consumer usually suffers through prepayment penalties, strict provisions concerning monthly payments, and due-on-sale clauses triggered by liens on or leases of the mortgaged property.³¹³ Second, standardizing contractual terms would

³¹⁰ FNMA/FHLMC Uniform Instrument, *supra* note 307, ¶ 3; see FHLMC Adjustable Rate Mortgage Note, *supra* note 307, ¶ 5(A); FNMA Adjustable Rate Mortgage Note, *supra* note 307, ¶ 7(A).

³¹¹ FNMA/FHLMC Uniform Instrument, *supra* note 307, ¶ 18; see FHLMC Adjustable Rate Mortgage Note, *supra* note 307, ¶ 5(B)-(C); FNMA Adjustable Rate Mortgage Note, *supra* note 307, ¶ 7(C). There is, moreover, no proviso unfairly facilitating lender prosecution of default, such as cognovit clauses where the borrower waives any defenses, even notice, if he does not make payments on time.

³¹² 2 Peat Marwick Study, *supra* note 100, at III.4-6; see Secondary Mortgage Market Hearing, *supra* note 41, at 94 (testimony of K. Thygeson, President, FHLMC) (FHLMC's "mortgage and security instruments, underwriting and appraisal guidelines and standardized documentation have been widely used throughout [the mortgage] industry and serve as prototypes for many institutions and private [secondary market] conduits.").

³¹³ The Peat Marwick Study found the least variability from secondary market standards in requirements that reduced lender risk—credit report requirement (1.8%), title insurance requirement (0.9%), mortgage insurance requirement (5.7%)—and the most variability in the terms of the secondary market that help homebuyers—different interest rates (19.6%), loan-to-value ratio (14.4%), and no prepayment penalty (18.2%). 2 Peat Marwick Study, *supra* note 100, at III.5. My experience is that lenders sometimes put special "riders" onto

help relieve the consumer of information overload. Disclosure forms could be further simplified if there were no significant variation in prepayment, due-on-sale, and other ancillary terms, and the consumer's attention would therefore be more tightly focused on the APR and the itemized closing cost estimates. Narrowing the consumer's shopping criteria would not only facilitate decision-making, but would make the mortgage market more competitive. The Peat Marwick Study, for example, concluded that one reason the mortgage market may not be perfectly competitive is that the product is not homogeneous—lenders are selling both an interest rate and a bundle of contract terms.³¹⁴ Reducing this product diversity should facilitate competition.

2. *Standardization of Alternative Mortgage Instrument Options*

The case for greater standardization is even more compelling for alternative mortgage instruments. The proliferation of a veritable alphabet soup of alternatives—ARMs, GPMs, GEMs, PLAMs, RAMs, SAMs, GPAMLs—has engendered enormous confusion among borrowers, portfolio investors, brokers, builders, and lenders themselves.³¹⁵ Buyers find that the endless variety of differences, even within single instruments, makes comparative shopping extremely difficult. An ARM that offers a lower initial rate may not be as good a deal as a mortgage that offers a higher initial rate, if the latter is tied to a less volatile index *or* permits less frequent rate adjustment *or* has a cap on either the interest rate *or* the monthly payment increases over each year *or* has cap on rate adjustments over the life of the loan *or* has no prepayment penalty *or* contains any number of other variable features. This diversity undermines the purpose of early comparative disclosures by making mortgage evaluation more difficult. Because many consumers are confused by the plethora of characteristics and choices, they

mortgage notes that they do not expect to sell on the secondary market and that the riders generally impose extra costs or burdens upon borrowers.

³¹⁴ *Id.* at X.6 (absence of homogeneity in terms and services impairs the consumer's ability to shop).

³¹⁵ See Guttentag, *supra* note 231, at 229-30 (because of multiplicity of alternative mortgage instruments "confusion reigns" among borrowers and even intermediaries); Lea, *supra* note 242, at 11, 13 (61% of lenders surveyed do not believe that their borrowers understand ARMS; case interviews indicate that most lenders feel that other lenders and Realtors do not understand many ARM features, including margins, indices, and discounts).

may assume a riskier loan than they want. Moreover, sales agents and even lenders find the variety confusing. In many cases where an intermediary recommends an excessively risky instrument, it is because he, like the homebuyer, underestimates those risks due to confusion.

Federal rules have encouraged the proliferation of choices, rationalizing that the market needs "breathing room" to experiment with different mixtures of indices, payment caps, and negative amortization.³¹⁶ This policy may have addressed a valid concern in 1980 or 1981, when it was not clear which instruments would be successful in the market. There is some indication, however, that general precepts about the success of certain instruments are beginning to emerge from this experimentation. For example, based on market experience and sophisticated polling of consumer and intermediary opinion,³¹⁷ FNMA and FHLMC announced a simplified series of ARMs in 1983.³¹⁸ This winnowing process can be expected to continue as some of the currently available mortgage products lose acceptance with consumers.³¹⁹

It does not appear, however, that left to its own evolution, the market will yield the standardization needed for consumers to make effective choices. Lenders still strive to differentiate their mortgage offerings, either to increase their volume by teaser rate or other "bargain" loans, or to distinguish their product and pro-

³¹⁶ 48 Fed. Reg. 9506, 9508 (1983) (Comptroller General); 47 Fed. Reg. 36,612 (1982) (FHLBB).

³¹⁷ The polling results are reported in Fannie May Surveys Lenders, Housing Fin., May 1983, at 1; Lea, *supra* note 242 (FHLMC survey of lenders, borrowers, and Realtors).

³¹⁸ The FNMA plans promulgated in May 1983 had the following characteristics:

<u>Index</u>	<u>Rate & Payment Adjustments</u>	<u>Payment Caps</u>	<u>Graduated Payment Period</u>	<u>Buydown Option?</u>
1-year Treasury Securities	1 time per year	7.5% p.a.	3 years	No
3-year Treasury Securities	Once every 3 years	7.5% graduated	3 years	Yes
5-year Treasury Securities	Once every 5 years	7.5% graduated	3 years	Yes

³¹⁹ See Marcis, *The Shakeout in Alternative Mortgage Instruments*, Real Est. Rev., Spring 1983, at 29, 31.

mote institutional identity. As a result, there may be as many as 400 to 500 separate alternative mortgage instruments in the contemporary financing market.³²⁰ Market needs do not justify this tremendous diversity. For example, there is no defensible business reason for using dozens of different market indices as the basis for rate adjustments in different ARMs. Lender options would not be meaningfully narrowed if federal rules standardized the range of indices to three: one index stable over time, one fairly volatile in response to short term interest-rate fluctuations, and one moderately stable. To extend the concept of standardization, federal regulators should develop and limit lenders to several well-defined "menus" of alternative mortgage terms.³²¹

Professor Guttentag has cogently demonstrated that a series of seven adjustable rate instruments would fulfill most of the risk preferences of borrowers without impairing the lender's desire to protect against financial reverses if interest rates increased over time.³²² The riskiest menu of mortgage terms would permit fre-

³²⁰ See J. Guttentag, *supra* note 76, at 21-22. The lender incentive to differentiate the loan product can create a market of monopolistic competition, in which higher prices can be charged, because consumers find it hard to shop and compare alternatives. *Id.* at 23; see also H. Snyder, *supra* note 70, at 13 (California Ass'n of Realtors reports that there are 150 different ARMS in the California market and that the number is growing); Lancaster, *Socially Optimal Product Differentiation*, 65 *Am. Econ. Rev.* 567 (1975) (divergence from socially optimal degree of product differentiation increases the resources consumers need to attain specified level of welfare).

³²¹ The concept of "menus" of alternative mixes of terms is not new to commercial law and practice. For example, the International Chamber of Commerce codified international export practice with its Incoterms, first published in the 1930's. See Int'l Chamber of Commerce, *Incoterms* (rev. ed. 1980). Each different "menu"—each Incoterm—places different duties on the buyer and seller. The existence of a limited number of standardized and well-understood menus has simplified the negotiation and reduced misunderstandings surrounding the export sales transaction.

³²² See Guttentag, *supra* note 231, at 247, table 5:

Plan	Treas. Interest Rate Index	Payment and Rate Adjustment Pd.	Maximum Payment Change	Maximum Rate Change (Life)
1A	6 months	6 months	None	None
1B	3 years	3 years	None	None
2B	3 years	3 years	15%	None
3B	3 years	3 years	15%	5%
1C	5 years	5 years	None	None
2C	5 years	5 years	20%	None
3C	5 years	5 years	20%	5%

quent rate adjustments (twice per year), without any payment or rate caps. This menu might encourage lenders to offer mortgages at a relatively low initial rate. Lenders might charge a higher initial rate for borrowers wanting to acquire the safer menus, which protect against the risks of payment instability. Borrowers who want protection against large jumps in the monthly payment, but also seek lower initial rates than the more conservative rate menus, could choose menus that adjust rates every three-to-five years and have payment caps of 15-20% for each adjustment period. Because these menus have no total rate cap, there is the possibility of negative amortization and upward payment drift. The most risk-averse consumers could pay a higher initial rate and choose between two menus offering adjustments every three-to-five years, plus payment and rate caps. Similarly, Professor Guttentag suggests four basic menus for GPMs. These menus would offer two graduation rates and two graduation periods to present different mixes of advantages (ease of qualifying) and risks (budget and mobility problems).³²³ The Guttentag menus demonstrate the feasibility of reducing the number of alternative mortgages from hundreds to a handful.

3. Federal Prophylactic Rules to Protect Against Excessive Optimism About Risk

Standardization could not only reduce the confusing diversity of choice among alternative mortgage instruments, but could also create a range of less risky choices for the homebuyer. Current federal regulation contains some consumer protections, such as the requirement that the rate adjustment index be readily available to and verifiable by the borrower, and be beyond the lender's control.³²⁴ Other consumer protection requirements, such as rate and payment caps, have been eliminated from federal rules on the ground that consumers educated by disclosure statements are in a better position to decide what level of risk is best for them, and

³²³ *Id.* at 244-46. Adding different terms of prepayment and assumption introduces further variation, yielding 16 menus in all.

³²⁴ 12 C.F.R. § 29.3 (1984) (FHLBB); *id.* § 545.33(e)(1) (Comptroller General). Another consumer protection, for national bank ARMs, is the prohibition of prepayment fees when the borrower pays the principal ahead of schedule. *Id.* § 29.6. These protections are justified because they relate to minor matters on which the consumer is unlikely to focus during the shopping process.

the market will then respond by offering the appropriate instruments.³²⁵ This is an unrealistic view given the problems with current disclosures. Even with improved disclosures, there is reason to believe that in certain periods many homebuyers are too optimistic about future risks.

In the context of consumer default on installment payments for products, Professors Schwartz and Wilde demonstrate that consumers use inferior theories to evaluate the probability of their own default. They further argue that there is insufficient reason to think that these faulty theories routinely lead to optimistic predictions, because in many instances the theories generate excessive pessimism.³²⁶ These same arguments might apply to home mortgages. For example, using the representativeness heuristic, many homebuyers will overgeneralize the good experience their friends or relatives had with ARMs and enter into risky ones; other homebuyers know families whose budgets have been pinched by rising adjustable rates and will overgeneralize in a pessimistic direction. The availability heuristic might generally create pessimism: homebuyers read about people who lose their homes (the "horror stories") but do not read about homebuyers who bought a more expensive house because of the lower initial rates and then sold before rates were adjusted upward (the "success stories"). Publicized failures tend to be more vivid and therefore more available to the decisionmaker.

Yet data for 1983 suggest that actual and prospective homebuyers were overly optimistic about the future: they thought that mortgage rates would go down (they have not overall), home values would appreciate substantially (they have not), and they would be able to handle balloon and adjustable mortgages (which remains to be seen).³²⁷ It appears that over the last decade homebuyers have often underestimated the problems with novel mortgage instruments. One reason for consumer misjudgment is the sales pitch, in which the optimistic agent fits the homebuyer into a loan that will facilitate the purchase of the desired home

³²⁵ See E. Gray, *supra* note 70, at 9-10.

³²⁶ Schwartz & Wilde, *Imperfect Information*, *supra* note 95, at 1431-45.

³²⁷ See Consumers Upbeat About Economy and Homebuying, *Housing Fin.*, June 1983, at 1, 2.

(and the sales agent's commission).³²⁸ Another reason may lie in homebuyer psychology. To own a home is still part of the American dream, even though renting may make better economic sense. Because they have anchored their decisionmaking to the prime directive of buying an appropriate house, consumers may underestimate future risks to buy the home. Cognitive dissonance leads them to overlook or denigrate information pointing out disadvantages to their prime decision.³²⁹

Another psychological mechanism that may contribute to excessive homebuyer optimism, at least during certain periods, is the "fundamental attribution error," in which people attribute conduct too much to personal characteristics of the actor and too little to situational factors.³³⁰ If most homebuyers view themselves as rela-

³²⁸ Numerous psychological studies have suggested that people will tend to place significantly greater emphasis on face-to-face statements about the future than on statistics and other information that they read or encounter more casually. See, e.g., Borgida & Nisbett, *The Differential Impact of Abstract Versus Concrete Information on Decisions*, 7 *J. Applied Soc. Psychology* 258 (1977); Nisbett, Borgida, Crandall & Reed, *Popular Induction: Information Is Not Necessarily Informative*, in *Judgment Under Uncertainty: Heuristics and Biases*, supra note 114, at 101. Thus, an automobile buyer may be attracted to a Saab because of the statistically impressive performance of these cars, but will ultimately decide not to purchase one if a friend tells him of problems he had. See *id.* at 112-13. What the sales pitch tries to do, often successfully, is to monopolize and direct the flow of highly available, emotive information about housing and mortgage alternatives. To the extent that the sales pitch is optimistic about the risks involved in a GPM or ARM, it will be more persuasive than statistics to the contrary, though it may be negated by the equally emotive (and more credible) experience of the homebuyer's friends and relatives.

³²⁹ See supra notes 148-49 and accompanying text.

³³⁰ See R. Nisbett & L. Ross, supra note 114, at 202-17; Ross & Anderson, *Shortcomings in the Attribution Process: On the Origins and Maintenance of Erroneous Social Assessments*, in *Judgment Under Uncertainty: Heuristics and Biases*, supra note 114, at 129, 135-40. As Schwartz and Wilde state:

Environments may, in short, influence behavior more than many people believe. Regarding the risk of default, one might suppose that consumers, when assessing this risk, place too much weight on their own traits such as prudence and too little weight on situational factors such as a shaky economy. If people ordinarily think highly of their abilities, they will then be more sanguine about their repayment prospects than their circumstances actually warrant.

Schwartz & Wilde, *Imperfect Information*, supra note 95, at 1444. There is evidence that actors accounting for their own behavior are relatively more inclined to cite situational factors and less inclined to cite dispositional factors than are observers of such behavior, however. See Jones & Nisbett, *The Actor and the Observer: Divergent Perceptions of the Causes of Behavior*, in E. Jones, D. Kanouse, H. Kelley, R. Nisbett, S. Valins & B. Weiner, *Attribution: Perceiving the Causes of Behavior* 9, 11-12 (1971); Watson, *The Actor and the Observer: How Are Their Perceptions of Causality Divergent?*, 92 *Psychological Bull.* 682 (1982).

tively prudent and adaptable (an unprovable assumption but intuitively appealing), they would tend to overvalue their ability to adjust to adverse economic conditions, such as a steep rise in interest rates and fall in home prices, and to underappreciate the risk of default. Although it is impossible to gauge the importance of the bias, the theory suggests that on balance the most vulnerable homebuyers—first-timers—may underestimate the risks involved with alternative mortgage instruments.

The dangers of alternative mortgage instruments should not be overstated. The risks of ARMs relate mainly to the possibility of steep rate increases. Interest rates also go down, and in that event holders of ARMs would usually see their mortgage rate decline. (This does not apply to GPMs, though.) Thus, in many instances, consumers' objectively questionable optimism will be borne out. Risk regulation is still justified because consumer biases and market mechanisms tend to expose too many homebuyers to downside risks in certain periods. More important, the bad consequences of taking on too much risk if rates go up are quite extreme (loss of the home or severely constrained budgets), whereas the good consequences of risk if rates go down are milder (more disposable income than expected). As a result, either Congress or agency regulators should impose new consumer protection rules on alternative mortgage instruments.³³¹ Suggested rules include a grace period and rate caps, limits on negative amortization and payment caps, and limits on balloons.

a. Grace Period and Rate Caps

Many lenders and builders offer ARMs that bear an initial rate well below the market rate. After one or two years, the rate on these mortgages may jump sharply. Often the homebuyer loses sight of the prospect of a big rate jump, or fails to appreciate that a low initial rate ARM may be especially risky over time. To protect against budget shock and discourage teaser rates, there should

³³¹ The proposals might be seen as a return to the concern for consumers of the late 1970's, when rate caps and other consumer protections were carefully justified as "sound and necessary" to ensure against excessive risk for borrowers, without undermining the adjustable rate instrument as a tool to avoid lender disintermediation. See 1981 ARM Hearings, *supra* note 233, at 285-90 (statement of Rep. Rosenthal); *id.* at 305-12 (statement of FHLBB Office of General Counsel); Kaplan, *supra* note 231, at I-7 to -10; Weinrobe, *supra* note 231, at XXI-11 to -33.

be a two-year grace period in which the initial rate applies. Also, the interest rate should be adjusted no more than once every year, and no rate change should exceed 1% per year. To protect against an upward payment drift, there should be an overall 5% cap on the top rate the ARM can reach.³³² These constraints on the variability of mortgage rates should have little effect on lenders' yields over time, but will protect the consumer who might be severely harmed by short term fluctuations.³³³

b. Limits on Negative Amortization and Payment Caps

The negative amortization associated with GPMs may be troublesome because it may prevent a homebuyer from building up sufficient equity in his home to enable him to move. It also might encourage default: as negative amortization eats away at the homeowner's equity, he will have an increased incentive to walk away from the obligation.³³⁴ These risks for both lenders and borrowers are even more troubling in light of poor prospects for home value appreciation in the next several years. Some state usury laws and early proposed FHLBB regulations limited negative amortization to 110% of the principal, and a similar limit should be reintroduced into the regulatory scheme.³³⁵ Because negative amortization

³³² Compare the similar protections promulgated by the FHA for ARMs. 49 Fed. Reg. 23,580 (June 6, 1984) (to be codified at 24 C.F.R. § 203.49).

³³³ The sophisticated simulation models developed by Weinrobe, *supra* note 231, at XXI-4 to -21, measured the effects of limitations on adjustment periodicity, the maximum adjustment in each period (50 basis points), and the maximum adjustment over time (250 basis points). Weinrobe concluded from the simulations that where interest rates are fairly stable over time, the consumer protections have no effect on lender yields; where there is moderate interest rate inflation, the limitation on annual adjustments has a small effect on lender yields, and the life-of-loan limitation has no effect; where interest rates spurt upward and then fluctuate at high levels, the 50/250 (periodic/maximum rate change) rule is very effective in limiting changes in payments and preventing budget shock for consumers, without prohibiting lenders from obtaining a yield that is substantially responsive to the increased cost of money. *Id.* at XXI-2 to -22. "The 250-basis-point cap on changes in the debit rate offers some element of security to the borrower without greatly affecting the desirability of a VRM for lenders. This is true even in very extreme situations." *Id.* at XXI-22.

³³⁴ See *id.* at XXI-34; see also sources cited *supra* note 234.

³³⁵ See, e.g., 1979 La. Acts 764 (codified at La. Rev. Stat. Ann. § 9:3504(C) (West 1983) (amended by 1982 La. Acts 424, 767)) (preempted by the Garn Act). Consumers Union takes the position that negative amortization ought to be prohibited. See H. Snyder, *supra* note 70, at 10. This result would all but abolish GPMs, which have been useful mechanisms for many first-time homebuyers to enter the housing market. See Weinrobe, *supra* note 231, at XXI-36 to -42 (concluding that a safeguard against all negative amortization "would be oti-

limits might lead to large unanticipated increases in the monthly payment,³³⁶ there should also be a payment cap of 7.5% per year. Such a cap would not only prevent budget shock, but would also set limits on the use of seller buydowns, teaser rates in ARMs and GPMs, all of which tend to lure homebuyers into low initial rate loans whose risk is minimized either by the sales process or by the homebuyer's decisional biases.

c. Limits on Balloons

Short-term (three-to-ten year) balloons must be controlled because they create dangers of default in periods of high rates and low housing demand.³³⁷ These balloons are unnecessary for ARMs and GPMs, because professional lenders can offer reduced payments by having the seller pay points or by waiting until the loan is paid off to collect the negative amortization (loans usually are paid off within seven to twelve years of origination).³³⁸ As a result, professional lenders should be required to refinance or roll over—at a rate not more than a certain percentage higher than the original loan rate—any short term loan. This requirement would give them an incentive not to push balloons that may be beyond the capacity of their borrowers.³³⁹

ose, at best"). My view is that if teaser rates can be controlled through a 7.5% payment cap (the next proposal in text), then homebuyers ought to have some room to choose mortgages whose initial rate is low enough to enable them to qualify for a slightly more expensive mortgage.

³³⁶ That is, unless there is also a payment cap, once the negative amortization cap is reached, the excess interest is then included in the monthly payment, thus creating the possibility of sharp and unplanned increases in the monthly payment.

³³⁷ Indeed, in the 1930's (and, to a lesser extent, in 1981-1983), extensive foreclosures occurred when borrowers found themselves unable to pay sizeable balloons, or sell their houses, as the balloons fell due. See Kaplan, *supra* note 231, at I-3 to -4 (balloons should be prohibited, citing their contribution to the real estate crash of the 1930's).

³³⁸ Balloons are required for one instrument, the shared appreciation mortgage, which requires the buyer to pay part of the property's appreciation after a number of years, whether or not he wants to sell at that time, thus forcing the buyer to take out a costly second mortgage or sell early. Also, under some instruments, the buyer is liable for an additional amount of interest even if the property does not appreciate. See FTC Mortgage Money Guide, *supra* note 79, at 9. These features are likely to surprise buyers and are not necessary to the shared appreciation concept. They should be regulated out of existence.

³³⁹ See generally Weinrobe, *supra* note 231, at XXI-83 to -85 (eliminating balloons for professional lenders or imposing a refinancing obligation would offer marginal benefits to borrowers and few costs to lenders, but would reduce the range of options available to the borrower).

Individual sellers taking back short term balloon first or second mortgages are in a different situation. They have a greater need to be paid off at the end of the balloon period because they usually cannot refinance. Such balloons might be prohibited entirely, but for these noninstitutional lenders there may be no other way to structure the deal. Given this constraint, a useful rule would be to require no less than a 20% downpayment when sellers take back short term balloons. An alternative would be to require the buyer to obtain private mortgage insurance to insure the seller against default. Further experience with seller-financed balloon mortgages might justify eliminating them entirely. At this point, however, this article proposes only limiting such balloons. If enacted, this proposal, as well as those regarding rate caps, limits on negative amortization, and payment caps, should significantly protect homebuyers against the excessive risk of alternative mortgage instruments.

The chart on the following page summarizes the consumer protections proposed by this article for alternative mortgage instruments, and compares them to existing FHLBB rules.

C. Structural Consumer Protection

Even with the proposed reforms, the homebuyer might still pay excessive prices or enter into disadvantageous mortgages, because market structures and the decisionmaking process remain systematically biased. Structural flaws might justify further government intervention to assure fair dealing to consumers. Three such flaws can be identified: the homebuyer's vulnerability to manipulation by the sales pitch, the effective elimination of many consumer choices in the formally integrated transaction, and patterns of cooperation and anticompetitive conduct in the real estate industry. Because of their structural dimension, these problems are not going to be "solved" immediately, if ever. Constructive directions for regulation are explored here, including more specific fiduciary duties for intermediaries who give advice to homebuyers, the right of homebuyers to opt out of the formally integrated transaction, and injection of more competitive conduct into the relevant markets.

CHART 2

Comparison of 1982 FHLBB Rules and Proposed Rules

<i>Alternative Mortgage</i>	<i>1982 FHLBB Rules</i>	<i>New Proposal</i>
Choice of Index	Any Index Readily Accessible to Buyer and Beyond the Lender's Control	Treasury Rate
Frequency of Change	None	Not More than Once Every Year
Maximum Percent Change per Year	None	1.0%
Maximum Overall Percent Change	None	5.0%
Initial Grace Period of No Changes	None	2 Years
Limits on Negative Amortization	None	110% of Principal
Maximum Monthly Payment Change	None	7.5% per Year
Obligation to Refinance Short-Term Balloons	No	Yes
Balloons (Non-Institutional Lenders)	Not Regulated	Prohibited Unless There Is Mortgage Insurance or 20% Downpayment

1. *The Duty of Intermediaries to Warn and Inform*

The disclosure and standardization proposals outlined above will leave many information problems unresolved because sales agents will still be a major source of information on financing and settlement costs for many homebuyers. Their oral explanations will often be much more vivid to homebuyers than the dull paper disclosures that will be handed to them and often thrown away. Intermediaries' recommendations will sometimes carry disproportionate weight because homebuyers tend to shift responsibility to them. In short, there will always be opportunities for sophisticated agents, as part of their sales pitch, to manipulate unsophisticated buyers, despite the early promulgation of better-calibrated APRs, worst case hypotheticals, and comparative price lists.

On the other hand, due to their experience in the home sale and loan transaction, sophisticated intermediaries are uniquely situated to educate homebuyers in ways that disclosures cannot. They can answer questions the disclosures raise, suggest options tailored to the particular homebuyer's desires, and narrow the shopping process to make it less overwhelming. In many instances the real estate professional performs this educational function, and the consumer receives a fair deal. How can the sales process be directed more systematically toward educating rather than misleading the consumer? Two means will be examined: buyers' agents and state and federal fiduciary duties for sales agents.

a. Buyers' Agents

The most interesting approach to the consumer education dilemma lies in the market and not the law. Some homebuyers now explicitly retain and pay their own brokers or attorneys to help them shop for a house, negotiate a price, obtain financing, and guide them through the settlement.³⁴⁰ Buyers' agents have a clear duty to represent only buyers, and therefore have no built-in conflict of interest; they are generally not paid on a commission basis and, as a result, do not have an incentive to push buyers into unfa-

³⁴⁰ See Levine, *Does the Home Buyer Need His Own Broker?*, *Real Est. Rev.*, Spring 1983, at 98; Miller, *Who Can Help You Buy a House*, *Washingtonian*, Nov. 1982, at 269; Mariano, *Idea of 'Buyers' Brokerage' Gains Advocates*, *Wash. Post*, June 30, 1984, at F1, col. 3; 2 Peat Marwick Study, *supra* note 100, at VI.6-.77 (use of attorneys varies widely from area to area).

orable deals. Unlike the average buyer, buyers' agents are capable of representing buyers' interests in the complex market sales. The sophisticated buyers' agents will not be fooled by gimmicky advertising and points schemes. They should be able to shop and compare prices for homes, loans, and settlement services more effectively, and are better able to explain to homebuyers the risks and advantages of alternative mortgage instruments.

Despite some positive initial experience with buyers' agents, their use is apparently not widespread, nor is it expected to be in the near future. Even if they know about buyers' agents (and most do not), homebuyers are generally reluctant to pay a buyer's agent for what may appear to be the same services the seller has already purchased. In most cases this is an illusory disadvantage. The cost of a buyer's agent should be offset by his effective representation of the buyer in the transaction. In fact, a buyer's agent can usually get the seller to pay his commission through negotiating a lower sale price, or by splitting the 6% commission that the seller's broker charges.³⁴¹ However illusory the disadvantage might be, it probably discourages naive and average homebuyers (those most in need of assistance) from hiring their own agents.

There may be a second reason hindering the spread of buyers' brokers: professional resistance. The philosophy of most multiple listing services is that once the property is listed, other brokers who show the property have a duty to cooperate with the listing broker. Although the National Association of Realtors has officially encouraged cooperation with buyers' brokers,³⁴² the FTC Brokers Study found that many brokers still disparage the idea of buyers' representatives.³⁴³ In addition, the constant interaction between

³⁴¹ The buyer's broker may, functionally, take the place of the cooperating broker, the agent of the seller who actually sells the house but must split the 6% commission with the listing broker. See Levine, *supra* note 340, at 99-100; Miller, *supra* note 340, at 269. Attorneys who are not members of multiple listing services, though, might have more difficulty achieving this result.

³⁴² The National Association of Realtors has apparently sanctioned the ability of a buyer's broker to qualify as a "procuring cause" and receive the standard commission split. NAR, Official Interpretation of Art. 1 § 2, By Laws of the Nat'l Assoc., Interp. No. 31, reprinted in 1 FTC Brokers Study, *supra* note 118, at 340-41.

³⁴³ 1 FTC Brokers Study, *supra* note 118, at 339-40. Some argue that the National Association of Realtors is attempting to "smother the single-agency [buyers' broker] concept, while maintaining the inherently misleading practice of working with a buyer on a co-op basis and having a fiduciary duty to the seller." Mariano, *supra* note 340, at F12.

brokers and lenders discourages many brokers from actually representing buyers, since they do not want to disrupt their more important ongoing relationship.³⁴⁴ A final reason for broker resistance is that brokers see their profession as a sales profession. They view representation very casually—as ancillary to the main goal of selling homes.³⁴⁵ As one broker recently stated, “[f]rom an agent’s point of view . . . it is a lot easier to make a living when you can control both sides of the process.”³⁴⁶ Because attorneys are more professionally committed to representing rather than selling, they may be more appropriate buyers’ agents than real estate brokers, though there appears to be no great rush of attorneys to this role.

b. State Law Fiduciary Duties

State law may enforce more balanced disclosures to buyers by requiring sales agents to be more forthright. Although state law is often vague about the nature of the broker’s agency duties,³⁴⁷ tort law in most jurisdictions would support even a seller’s agent’s “duty to deal fairly and honestly with the prospective buyer.”³⁴⁸ This duty may be breached when the agent makes representations that he knows (or should know) are false, or conceals material adverse information from the homebuyer after having made partial and fragmentary representations inconsistent with the concealed facts.³⁴⁹ Although the law of fraud and misrepresentation has tra-

³⁴⁴ See Whitman Letter, *supra* note 5, at 6.

³⁴⁵ See 1 FTC Brokers Study, *supra* note 118, at 346 (“Over the years, brokers have carried on the business of brokerage by dealing with both parties without much concern about the technical legal requirements of agency law and fiduciary relationships.”).

³⁴⁶ Quoted in Mariano, *supra* note 340, at F12.

³⁴⁷ See *supra* notes 134-35 and accompanying text.

³⁴⁸ *Funk v. Tift*, 515 F.2d 23 (9th Cir. 1975); see *Neff v. Bud Lewis Co.*, 89 N.M. 145, 548 P.2d 107 (Ct. App. 1976) (broker owes fiduciary duty to buyer); *Emily v. Bayne*, 371 S.W.2d 663, 670-71 (Mo. Ct. App. 1963) (similar).

³⁴⁹ See, e.g., *Lingsch v. Savage*, 213 Cal. App. 2d 729, 735-36, 29 Cal. Rptr. 201, 204-05 (1963) (broker liable for “negative fraud” when he fails to disclose material facts); *Dicker v. Smith*, 215 Kan. 212, 523 P.2d 371 (1974) (broker could be liable for suppressing unfavorable termite report); *DeSoto v. Ellis*, 393 So. 2d 847 (La. Ct. App. 1981) (broker has duty to reveal to buyer any material defect of home under consideration); *Nelson v. Real Estate Comm’n*, 35 Md. App. 334, 370 A.2d 608 (1977) (broker liable for erroneous statement that unit could be used as an apartment); *Beavers v. Lamplighters Realty*, 556 P.2d 1328 (Okla. Ct. App. 1976); *Tennant v. Lawton*, 26 Wash. App. 701, 615 P.2d 1305 (1980) (broker required to make reasonable effort to refute information from seller which he knows or should know is false and is pivotal to the buyer’s decision); see generally W. Prosser & W. Keeton, *The Law of Torts* § 106, at 736-40 (5th ed. 1984) (party may be liable for words or acts that create a false impression through active misrepresentation or passive misleading).

ditionally reprehended only misstatements of fact, some courts have held agents liable for misleading statements of opinion (e.g., value of the home) when made to persons not having roughly equal knowledge.³⁵⁰ Sellers' agents have a further duty to disclose their loyalty. They cannot mislead the buyer into thinking that the agent is protecting the buyer's interest if he is not.³⁵¹

An important question is whether the agent should be liable only for intentional misrepresentations to homebuyers, or should also be liable for negligent advice or recommendations upon which homebuyers justifiably rely. Realtors' codes of conduct typically prohibit only the former, and there is substantial case law to the same effect.³⁵² On the other hand, in some fraud cases brokers and builders have been found liable for excessive optimism in the sales pitch.³⁵³ For example, California brokers have been held liable in fraud suits for recommending creative financing that proved disas-

³⁵⁰ In California, for example, the law of fraud requires the broker or agent representing the seller to disclose "facts materially affecting the value or the desirability of property offered for sale" where the broker knows or has access to such facts, and knows that the buyer is unaware of them. *Cooper v. Jevne*, 56 Cal. App. 3d 860, 866, 128 Cal. Rptr. 724, 727 (1976); see *Peterson v. Auvel*, 275 Or. 633, 552 P.2d 538 (1976); Restatement (Second) of Torts § 542 (1976) (vendor's opinion can be the basis for a fraud suit when the vendor "(a) purports to have special knowledge of the matter that the recipient does not have, or . . . (c) has successfully endeavored to secure the confidence of the recipient"). Other courts reject this view. See, e.g., *Coleman v. Goran*, 26 Ill. App. 2d 288, 168 N.E.2d 56 (1960); *Appel v. Hupfield*, 198 Md. 374, 84 A.2d 94 (1951) (real estate broker's representations of home value are not actionable in fraud); *Eaton v. Sontag*, 387 A.2d 33, 37 (Me. 1978). Even these jurisdictions, however, have found broker fraud where the representation of value is backed up by specific misrepresentations of fact. See *Willis v. Fowler*, 102 Fla. 35, 136 So. 358 (1931); *Fowler v. Benton*, 229 Md. 571, 185 A.2d 344 (1962), cert. denied, 375 U.S. 845 (1963); see also *W. Prosser & W. Keeton*, supra note 349, § 109, at 758 (trend among courts is to convert misrepresentation-of-value cases into misrepresentation-of-fact ones); cf. *Wisconsin Steel Treating & Blasting Co. v. Donlin*, 23 Wis. 2d 379, 127 N.W.2d 5 (1964) (false representation by seller that he was selling property at actual cost is fraud).

³⁵¹ *Meerdink v. Krieger*, 15 Wash. App. 540, 550 P.2d 42 (1976).

³⁵² *M. Levine, Realtors' Liability* ch. 2 (1979); Nat'l Ass'n Realtors, Code of Ethics art. 3 (1984) (duty of Realtor to protect against "fraud, misrepresentation, and unethical practices in real estate transactions"); id. art. 9 (Realtor "shall avoid exaggeration, misrepresentation, or concealment of pertinent facts"); see *Vulcan Metals Co. v. Simmons Mfg. Co.*, 248 F. 853, 856 (2d Cir.) (L. Hand, J.), cert. denied, 247 U.S. 507 (1918) (seller's "puffery" cannot be basis for fraud suit); *W. Prosser & W. Keeton*, supra note 349, § 109, at 755 ("There can be no recovery, for example, for a statement that the plaintiff is being offered an exceptionally good bargain.").

³⁵³ See *infra* notes 354-57 and accompanying text.

trously risky.³⁵⁴ These cases reflect the practical expansion of fraud to create a common-law cause of action for unsuitable recommendations. Thus, a broker might be found liable in fraud upon theories of (1) explicit misrepresentation, (2) implicit misrepresentation, or (3) concealment, upon recommending an unsuitable loan and then discouraging the homebuyer from shopping or making further inquiry.³⁵⁵ The description of the sales process set forth here suggests that these theories could often be used against real estate intermediaries.

The modern trend in fraud cases finds a parallel in state agency cases, suggesting that the real estate intermediary may in many instances be found to be the buyer's agent. In such cases, the intermediary has a fiduciary duty of honest and nonnegligent advice-giving to the buyer because of the relationship of confidence that exists. Notwithstanding the traditional view that the homebuilder's salesperson and the cooperating broker are sellers' agents, there is a tendency

for the court to examine the specific facts and then to resolve the issue of agency in line with the reasonable expectations of the principals and principles of fairness and justice. In a few cases this results in the broker being held to be the agent of both buyer and seller, or in the broker being held to be the agent of the buyer, even though his commission is paid out of the proceeds of the seller.³⁵⁶

³⁵⁴ Andrew, *Suits Against Realtors Grow as Financing Balloons Burst*, Wall St. J., Sept. 1, 1982, § 2, at 17, col. 1.

³⁵⁵ Support for one or more of these theories can be found in *Anderson v. Knox*, 297 F.2d 702 (9th Cir. 1961), cert. denied, 370 U.S. 915 (1962) (unsuitable recommendation by insurance salesperson; district court finding of liability under theory one, court of appeals under theory two); *Southern v. Floyd*, 89 Ga. App. 602, 80 S.E.2d 490 (1954) (home sale, theory three; evasive answer to questions about a problem is concealment); *Fairfield Sav. & Loan Ass'n v. Kroll*, 106 Ill. App. 2d 296, 246 N.E.2d 327 (1969) (home mortgage, theory one or two; fiduciary responsibility of broker to buyer because of the latter's inexperience and the former's efforts in finding a loan); *Barylski v. Andrews*, 439 S.W.2d 536 (Mo. Ct. App. 1969) (home sale, theory two or three; statement that "house is in fine condition" was concealment or implied representation of fitness); cases cited *supra* notes 349-50; cf. *Leatherberry, Remedies for the Buyer or Beneficiary of an Unsuitable Life Insurance Plan*, 32 Rutgers L. Rev. 431, 445-57 (1980) (fraud theories to use against life insurance salesperson recommending an unsuitable policy).

³⁵⁶ B. Brown & E. Green, *The Role of the Broker in Residential Real Estate Transactions: A Report to the Federal Trade Commission on the Status of State Agency Law as It Affects the Role of Residential Real Estate Brokers* 19 (1983); see *Cashion v. Ahamadi*, 345 So. 2d 268 (Ala. 1977) (whether cooperating broker contacted by home purchaser is agent of seller

The Louisiana Civil Code provides an example of this approach. The Code characterizes a broker as a "mandatary" (agent) of both the buyer and the seller.³⁵⁷ As the mandatary of both parties, the broker "should observe the same fidehty towards all parties, and not favor one more than another."³⁵⁸ The duty of fidelity includes responsibility "not only for unfaithfulness [fraud] in his management, but also for his fault or neglect."³⁵⁹

A recent California appellate decision, *Easton v. Strassburger*,³⁶⁰ reached the same result as the Louisiana statute through a synthesis of tort and agency principles. Without holding that real estate agents are necessarily agents for the buyer, the court held the broker liable for negligently failing to conduct a reasonable inquiry into the value of a home recommended for sale, and for failing to disclose all facts materially affecting the value or desirability of the property that such an investigation would reveal. The court lik-

is a question for the jury; caution that a broker who seeks to establish a confidential relationship with the buyer to procure a sale cannot assume that he remains the seller's agent); *Grandchamp v. Patzer*, 39 Mich. App. 350, 197 N.W.2d 537 (1972) (agency relationship between broker and homebuyer because the former assured the latter that "I'm taking care of everything"); *Pumphrey v. Quillen*, 102 Ohio App. 173, 141 N.E.2d 675, aff'd, 165 Ohio 343, 135 N.E.2d 328 (1956) (cooperating broker, but not listing broker, found to be purchaser's agent). The court in *Wise v. Dawson*, 353 A.2d 207 (Del. Super. Ct. 1975), indicated that unless clearly proven otherwise a multiple listing arrangement for selling homes does not create an agent-subagent relationship between the listing and cooperating brokers and that the cooperating broker is presumptively the agent for the buyer. Although I find the *Wise* result to be correct in light of the psychological dynamics of the transaction, it goes beyond the reasoning in other cases and is contrary to cases holding that multiple listing services for home sales generally assume that the cooperating broker is the seller's agent. See, e.g., *Marra v. Katz*, 74 Misc. 2d 1010 (N.Y. Sup. Ct. 1973) (multiple listing services generally assume that the cooperating broker is the subagent of the listing broker, thus the agent of the seller); *Frisell v. Newman*, 71 Wash. 2d 520, 429 P.2d 864 (1967) (cooperating broker is subagent of listing broker, notwithstanding multiple listing bureau rule that the cooperating broker is the agent of the buyer); authorities cited supra note 134.

³⁵⁷ La. Civ. Code Ann. art. 3016 (West 1983) (broker is employed to negotiate a matter between two parties and is considered mandatary of both); see *Uhlich v. Medallion Realty*, 334 So. 2d 788 (La. Ct. App. 1976) (art. 3016 applies to real estate brokers); *Treadaway v. Piazza*, 156 So. 2d 328 (La. Ct. App. 1963) (similar). Contra *Leggio v. Realty Mart, Inc.*, 303 So. 2d 920 (La. Ct. App. 1974).

³⁵⁸ La. Civ. Code Ann. art. 3017 (West 1983).

³⁵⁹ Id. art. 3033 ("Mandatary's liability for fault or negligence"); see *Davis v. Davis*, 353 So. 2d 1060 (La. Ct. App. 1977) (neither listing nor cooperating broker liable to buyer for flood damage because they did not know of the damage); cf. La. Civ. Code Ann. art. 3018 (West 1983) ("Brokers are not responsible for events which arise in the affairs in which they are employed; they are only, as other agents, answerable for fraud or faults.").

³⁶⁰ 152 Cal. App. 3d 90, 199 Cal. Rptr. 383 (1984).

ened the broker-buyer relationship to the attorney-client relationship, noting that " 'the buyer, like the client, relies heavily on another's acquired skill and knowledge . . . because of the complexity of the transaction and . . . because of his own dearth of experience.' " ³⁶¹ The court suggested that the duty of investigation might not exist if the buyer were customarily represented by his own agent. ³⁶²

For loans and settlement services, the real estate agent should have fiduciary duties of loyalty and due care for the interests of the homebuyer to the extent that the agent gives advice on these matters. Specifically, the agent should have duties (1) to tell the complete truth about the marketing techniques used in an integrated transaction, the range of prices available, and any special arrangement with a provider; (2) to reveal disadvantages and risks of bought-down financing, teaser rate mortgages, alternative mortgage instruments, and creative seller financing; and (3) to make honest recommendations tailored to the homebuyer's needs and preferences, rather than the agent's self-interest. These common-law duties should be enforceable in lawsuits for damages, or in administrative or disciplinary proceedings.

c. Federal Suitability Rule

The development of these fiduciary duties should not be left entirely to ad hoc state law evolution because that process may not have a systematic impact on broker behavior. A federal rule might be created along the lines of the federal suitability rule for stockbrokers established by the National Association of Securities Dealers and the Securities and Exchange Commission.

A special consumer protection rule is necessary because the stockbroker (like the real estate broker) has a potential conflict of interest when recommending investments to the customer: the broker receives a commission only if the customer buys stock; the

³⁶¹ Id. at 100, 199 Cal. Rptr. at 388 (quoting Comment, A Reexamination of the Real Estate Broker-Buyer-Seller Relationship, 18 Wayne L. Rev. 1343 (1972)); see Sinclair, The Duty of the Broker to Purchasers and Prospective Purchasers of Real Property in Illinois, 69 Ill. B.J. 260, 263-64 (1981) (discussing the extent to which buyer relies on seller's broker for vital information); Comment, Dual Agency in Residential Real Estate Brokerage: Conflict of Interest and Interests in Conflict, 12 Golden Gate L. Rev. 379 (1982) (discussing nature of broker-homebuyer relationship).

³⁶² 152 Cal. App. 3d at 102 n.8, 199 Cal. Rptr. at 390 n.8.

more expensive the purchase, the larger the commission. This conflict is especially serious since the stockbroker holds himself out as an expert in complex financial matters. Thus, consumers tend to shift responsibility for making decisions to brokers.³⁶³ The suitability rule requires that the stockbroker who recommends a purchase, sale, or exchange of a security have "reasonable grounds" for believing that the recommendation is "suitable" for the customer. The "reasonable grounds" must be based on information furnished by the customer after reasonable inquiry concerning the customer's investment objectives, financial situation and needs, and other important information.³⁶⁴

The same reasoning would support a rule that real estate intermediaries must not only provide buyers with required disclosures, but must also have reasonable grounds for believing that their recommendations for mortgage credit and settlement services are suitable for the homebuyer. As with the securities suitability rule, any recommendations must be made on the basis of both information furnished by the buyer after reasonable inquiry, and information readily available to the intermediary.

This rule should be enforced through a private suit for damages.³⁶⁵ Damage actions are traditionally available for professional malpractice to compensate consumers and deter professional negli-

³⁶³ See *Hanley v. SEC*, 415 F.2d 589 (2d Cir. 1969) (by "hanging out his shingle" broker represents himself as an expert in investment matters); *In re Hughes*, 27 S.E.C. 629, 634-39 (1948), *aff'd*, 174 F.2d 969 (D.C. Cir. 1949) (by holding themselves out to the public as possessing specialized skills/knowledge, brokers cultivate a relationship of special "trust and confidence").

³⁶⁴ SEC Rule 15b10-3, 17 C.F.R. § 240.15b10-3 (1984); NASD, National Association of Securities Dealers, Inc. Manual ¶ 2152 (1976). Excellent background and analysis of these rules may be found in Cohen, *The Suitability Doctrine: Defining Stockbrokers' Professional Responsibilities*, 3 J. Corp. L. 533 (1978).

³⁶⁵ The stockbroker suitability rules are generally not enforceable through a private damages remedy, see *Utah State Univ. of Agriculture & Applied Science v. Bear Stearns & Co.*, 549 F.2d 164 (10th Cir.), *cert. denied*, 434 U.S. 890 (1977), based in part on industry arguments that "greedy old ladies," who lost money speculating on the market would sue as "sweet trusting widows," whose nasty churning brokers had lost their life savings. See Mundheim, *Professional Responsibilities of Broker-Dealers: The Suitability Doctrine*, 1965 Duke L.J. 445, 463-72. But see *Buttrey v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 410 F.2d 135 (7th Cir.), *cert. denied*, 396 U.S. 838 (1969). Recent commentary urges the adoption of a private damages remedy, however. See, e.g., Cohen, *supra* note 364, at 552-59; Fishman, *Broker-Dealer Obligations to Customers—The NASD Suitability Rule*, 51 Minn. L. Rev. 233, 244-48 (1966).

gence.³⁶⁶ Although the traditional arguments against a private suitability damage action are unpersuasive, the remedy would produce some trade-offs.³⁶⁷ For example, an enforceable suitability rule would probably make real estate intermediaries less inclined to give oral advice to homebuyers. Having to rely more on complicated written disclosures, without intermediaries' guidance, would be a hardship for some consumers and might discourage others from buying a home. On the other hand, more caution and less advice would be beneficial if it encouraged buyers to increase their shopping. There are other advantages to a bias favoring caution, especially with regard to alternative mortgage instruments: when the stakes are so high, many homebuyers would be best served by a risk-averse strategy.

It is difficult to frame suitability standards that are detailed enough to have an impact on intermediary behavior, but not so technical as to stimulate liability for nonmaterial errors.³⁶⁸ Regulations should clearly state that the real estate intermediary is liable only if his recommendation was materially unsuitable *and* he either had no reasonable grounds for believing that the recommendation was suitable, or failed to investigate the customer's financial situation and needs. Standards might also include a presumption that the sales agent meets the suitability obligations if the buyer is

³⁶⁶ See, e.g., *Broyles v. Brown Engineering Co.*, 275 Ala. 35, 151 So. 2d 767 (1963) (implied warranty by engineers that specifications for proposed subdivision would improve drainage). Thus, even if the stockbroker's suitability requirements do not give rise to an independent damage action, see *supra* note 365, some courts have found that violation of suitability standards is evidence of common-law fraud or negligence. See, e.g., *Piper, Jaffray & Hopwood, Inc. v. Ladin*, 399 F. Supp. 292, 299 (S.D. Iowa 1975); *Twomey v. Mitchum, Jones & Templeton, Inc.*, 262 Cal. App. 2d 690, 720-22, 69 Cal. Rptr. 222 (1968). Indeed, the *Easton* decision relied on guidelines similar to suitability found in the Realtors' Code of Ethics. See *Easton v. Strassburger*, 152 Cal. App. 3d at 101-02, 199 Cal. Rptr. at 389-90.

³⁶⁷ Contrast Conard, *A Behavioral Analysis of Directors' Liability for Negligence*, 1972 Duke L.J. 895, which criticizes damage liability for corporate directors because it makes them too cautious and paperwork-oriented. That may be a fair criticism because corporations are expected to take risks. Homebuyers, on the other hand, can see their lives shattered by risky mortgages. A risk-averse strategy fits their needs better.

³⁶⁸ Although the Truth-in-Lending Act disclaims liability for a violation that "was not intentional and resulted from a bona fide error," 15 U.S.C. § 1640(c) (1982); see *id.* § 1640(f) (no liability for good faith reliance on a Federal Reserve Board rule or interpretation), it has produced a good deal of litigation based on technical infractions. See Miller, *Truth in Lending Act*, 34 Bus. Law. 1405, 1420-21 (1979). One reason the suitability doctrine has not had greater impact in the securities field is that it is too vague in its standards. See Cohen, *supra* note 364, at 542-59.

advised by his own broker or attorney. Such a presumption could give intermediaries an incentive to urge buyers to retain their own agents.

The suitability rule's standards and enforcement by consumer suits should be supplemented with a government campaign to monitor sales practices and educate the real estate community. In 1983, a similar FTC campaign reportedly increased real estate advertisement compliance from 13% to 84% in the targeted areas.³⁶⁹ The program not only pinpointed violations, but achieved a high level of voluntary compliance through a "Manual for Businesses" that could be used in builder and broker operations.³⁷⁰ Federal enforcement of suitability standards could take advantage of the increasing domination of the market by multi-office brokerage firms and regional or national homebuilders.³⁷¹ Voluntary programs could be created where these entities would incorporate federal sales materials into their regular training programs and seminars. The concrete examples of unsuitable recommendations and the penalties set forth in the federal materials could be a partial antidote to the philosophy of action selling.

2. *Opting Out of Parts of the Formally Integrated Transaction (The Problem of "Controlled Companies")*

In 1981 hearings, Congress considered amending RESPA to prohibit lenders and brokers from having a business interest in title

³⁶⁹ Div. of Credit Practices, Bureau of Consumer Protection, FTC, Real Estate Credit Advertising Voluntary Compliance Report 1 (June 1983) (copy on file with the Virginia Law Review Association).

³⁷⁰ See *id.* at 2-6. When violations were found, the FTC contacted advertisers and outlined the steps necessary to correct the ads (recontacting the advertisers if mistakes continued). The staff also gained the cooperation of broker and homebuilder trade associations to promulgate the manual, *How to Advertise Consumer Credit* (copy on file with the Virginia Law Review Association).

³⁷¹ By 1982, 28.7% of all real estate brokers were associated with firms of more than 100 salespeople, and another 22.3% were associated with medium-sized firms (20-100 salespeople). Trends in Real Estate Firm Size, Real Est. Q., Spring 1983, at 19, 20. In the late 1970's multicity broker franchises grew rapidly: Century 21 expanded from 3000 affiliated firms to 6900, Electronic Realty Associates from 1050 to 2500, Realty World from 400 to 1500, Red Carpet from 680 to 1050, and Gallery of Homes from 530 to 800. See Haney, *supra* note 13, at 36-37. In 1981, almost one-third of the new homes built were produced by national or interregional homebuilding companies having sales volume of \$15 million or more. See *America's Giants in Housing*, Prof. Builder, July 1981, at 114, 116; Homebuildings' New Look, *supra* note 183, at 92.

companies to which they referred homebuyers. Those favoring this prohibition argued that this tie-in gives controlled companies an artificial business advantage, which allows them to charge higher prices and still drive other providers out of business: consumers will go to the controlled company because they are not aware that better deals exist (bolstering), or defer to the expertise of the broker or lender (shifting responsibility).³⁷²

Although the 1981 congressional hearings were limited to broker-or lender-controlled title agencies, the phenomenon may be a broader one. Thus it appears that many lenders engage in differential pricing for a broad range of settlement services—charging higher prices for services for which demand is relatively inelastic.³⁷³ The same criticism might be made of the formally integrated transaction established by many national builders and brokerage firms. The builder or broker can charge higher prices on services for which demand is inelastic.³⁷⁴

On the other hand, it is not clear that controlled companies should be prohibited, as some have argued, because the formally

³⁷² See *supra* notes 217-19 and accompanying text. The Title Insurance Company of Minnesota provides a graphic example. In April 1979, it did the title work for 81.1% of the mortgages financed by Twin City Federal Savings & Loan, the largest mortgage lender in the state. In March of 1979, Twin City acquired majority ownership of rival firm Northstar Abstract and Title Company. By August 1980, Northstar did the title insurance for 83.3% of the mortgages financed by Twin City; Title Insurance Company was reduced to a 9.8% market share. 1981 RESPA Hearings, *supra* note 140, at 604-05. Other evidence suggested that this phenomenon was commonplace in the two largest housing markets in the country—Southern California and Northern Illinois. See *id.* at 145-52 (statement of C. Guggenberger, President, Valley Title Co., San Jose, Cal.) (dealing with situation where brokers formed their own title companies); *id.* at 193-94 (statement of S. Daley, President, Intercounty Title Co. of Ill., Chicago, Ill.) (Coldwell Banker Title Service, a broker-owned title agency, snapped up 20% of the DuPage County market based upon referrals from Coldwell Banker Realtors); see also *id.* at 188-92 (letter from Z. Sullivan, President, American Land Title Cos. of Missoula) (similar problem in Montana).

³⁷³ See Wallace, *supra* note 54, at 200-02, 212-14.

³⁷⁴ Thus, the builder could offer a low APR by jiggling the home price up, or could charge an average price and APR but make extra profits by charging high prices for settlement services it provides or by obtaining kickbacks from allied settlement providers, who pass on the extra costs to the homebuyer. Experience teaches that there will be a tendency in the direction of higher prices whenever markets are foreclosed, as they assuredly are when the builder directs all of its lending and settlement business to controlled providers. I. Plotkin, *supra* note 217, at 514-15. Additionally, it is worth noting that in the midst of the worst housing depression since the 1930's, the major homebuilders have recently been making substantial profits from their mortgage banking subsidiaries. See Breckenfeld, *supra* note 12, at 121-22.

integrated transaction offers the opportunity for economies of scale. As a result of being integrated into standardized options, the lender's controlled title company need not advertise. It therefore has lower overhead than its competitors, and may charge lower prices.³⁷⁵ Besides the overhead advantages of the captive market, the mortgage subsidiary of a national homebuilder or brokerage firm usually can obtain the best mortgage rates available on the secondary market because it buys large blocks of money or is able to float bonds backed by mortgages.³⁷⁶ If the homebuilder also arranges for settlement services, it should be able to bargain for a low rate for each settlement because the large business volume would be important to the provider, which can economize as it gains experience with the builder's operations. In short, the integrated transaction can provide lower prices to consumers. Even if the price were the same as that of the nonintegrated transaction, the no-hassle loan and settlement saves consumers time and energy. Consequently, one should hesitate before disrupting the housing industry's trend toward vertical integration, especially if there are less intrusive ways to discourage price and quality abuses.

The disclosure and fiduciary duty rules proposed in this article would allow this trend to continue, but would also increase competitive pressures on controlled providers. The rules would allow the homebuyer to see at a glance whether the integrated transaction really offers a better deal.³⁷⁷ The procompetitive effect of these disclosures can be reinforced by providing consumers with a right to opt out of portions of the integrated transaction.

RESPA now prevents lenders from requiring homebuyers to use

³⁷⁵ See 3 Peat Marwick Study, *supra* note 100, at III.47-49 (controlled title companies should not be prohibited; no reason to believe prices would fall); cf. Craswell, *supra* note 95, at 681-87 ("tie-ins" may offer consumer efficiencies, e.g., when two products are cheaper to process/distribute as a single unit).

³⁷⁶ See Breckenfeld, *supra* note 12, at 122, 124.

³⁷⁷ The traditional objection to controlled title companies is that although vertical integration may produce consumer efficiencies in many other, more price-competitive markets, "the ancillary nature of the (settlement) services combined with consumer ignorance has meant high, not low, charges in the past." 1981 RESPA Hearings, *supra* note 140, at 615 (statement of D. Ford, Professor of Fin., Univ. of Baltimore). A disclosure-oriented approach meets this objection: when the consumer is aware of comparative settlement costs and when the APR includes these charges, the consumer is certainly no longer "ignorant" of the market, and the services assume a somewhat greater significance in the transaction if the disclosures reveal a substantial differential among providers.

a particular title company.³⁷⁸ This precept should be generalized. The intermediary should have an obligation not only to provide the homebuyer with comparative data regarding loan-related costs but also to make clear that the homebuyer need not obtain his loan from the intermediary's mortgage subsidiary, that he need not retain the attorney and title company allied with or controlled by the intermediary, and that he need not choose the mortgage insurer suggested by the intermediary. Although most homebuyers will not exercise this option, allowing them to opt out, combined with improved disclosures, should give intermediaries an incentive to offer better deals.

This disclosure/opt out approach would discourage price-gouging, but might not address the following problem: poor service by the controlled provider might result not only from insufficient competitive pressures, but also from a subtle conflict of interest.³⁷⁹ For example, a broker-controlled title agency may have a conflict between the brokerage firm's interest in minimizing title problems that could thwart the sale, versus the purchaser's and underwriter's interest in identifying title problems before sale.³⁸⁰ A builder-controlled mortgage company may have a conflict between the builder's interest in qualifying the homebuyer for some kind of loan so that the home can be sold, versus the secondary market's interest in having sound mortgage lending practices yielding few defaults and delinquencies.³⁸¹ In theory, this could be a basis for prohibiting referrals to controlled title or mortgage companies, but there is simply not enough evidence that this phenomenon occurs very often.

³⁷⁸ RESPA § 9(a), 12 U.S.C. § 2608(a) (1982).

³⁷⁹ See Am. Land Title Ass'n, *supra* note 217, at 70-78; Dep't of Justice Report to the Task Group on Antitrust Immunities, *The Pricing and Marketing of Insurance* (1977), reprinted in 1981 RESPA Hearings, *supra* note 140, at 212, 249 [hereinafter cited as *Dep't Justice Study*].

³⁸⁰ Am. Land Title Ass'n, *supra* note 217, at 71-72; Hofflander & Shulman, *The Distribution of Title Insurance: The Unregulated Intermediary*, 44 J. Risk & Ins. 435, 444-45 (1977).

³⁸¹ Most secondary market buyers have limits on qualification standards for the mortgages they will purchase, which provide a palpable constraint on originators of such mortgages. The initial calculation of the homebuyer's annual income, the expected stability of that income, the prior credit history, and other debts and liabilities, however, is done by the builder- or broker-controlled mortgage company and thus may be subject to substantial manipulation.

3. *Reforming Markets by Attacking Patterns of Cooperation*

Improving consumer awareness of prices and choices in the integrated home sale and loan transaction would likely pressure lenders and settlement providers to engage in greater price competition. Even so, lower prices may not follow for some of the loan-related services because anticompetitive patterns of cooperation are entrenched in the real estate industry.³⁸² These patterns penalize consumers by discouraging low prices and comparative shopping for loan-related services. This article examines three of these patterns: price leadership among mortgage and title insurers, group cooperation among brokers participating in multiple listing services, and appraiser accommodation to the selling strategies of builders and brokers. It also suggests ways to start tackling them.

a. More Competition for Title and Mortgage Insurance

Even with greater consumer shopping, prices might remain high in the settlement service markets that have anticompetitive structures. The best example of such a structure is mortgage insurance. The mortgage insurance industry is dominated by seven firms and appears to follow the classic oligopoly pricing pattern. The price leader (MGIC) sets a price, and the few other firms charge the same price whatever the market conditions. These firms know that if they cut prices to obtain a higher market share, MGIC and the others will automatically follow, thus lowering profits for everyone, without changing the market shares.³⁸³ Consequently, even if homebuyers had the right to choose mortgage insurance providers and were apprised of the different deals and rates offered, they might still have to pay high prices.

Although state- and market-imposed capitalization requirements may make new entry difficult,³⁸⁴ existing small firms might try to

³⁸² On the perseverance of cooperation as an inherent trend in human institutions, see R. Axelrod, *The Evolution of Cooperation* (1984) (reviewed and summarized in 93 Yale L.J. 1147 (1984)).

³⁸³ See 2 Peat Marwick Study, *supra* note 100, at XI.26 (price for the most popular mortgage insurance plan is about the same for all carriers). For example, in 1975 one of the mortgage insurance firms eliminated the \$20 insurance application and review fee that had been used since the late 1950's by all of the insurers—each of the firms immediately eliminated the \$20 fee, thus heading off any probable market share increase for the price-cutter. *Id.* at XI.25.

³⁸⁴ *Id.* at XI.23. All states require that 50% of all premium dollars earned by a new firm

increase their market share through lower prices if homebuyers were inclined to shop—thus putting pressure on the top seven to cut prices to remain competitive. On the other hand, even with consumer shopping, bankers might veto small insurers by redefining their insurance requirements to be tailored to the ancillary services the big firms offer. Also, the managers of the top seven firms assert that they would respond to direct competition, not by cutting prices, but by an advertising campaign to attract consumers' attention.³⁸⁵ Like the broad range of services, smaller firms could not match these campaigns. Thus, the mortgage insurance industry would remain concentrated. With added advertising costs, the price might actually increase.³⁸⁶

Conceivably, this phenomenon could also minimize or negate the effect of greater title insurance shopping, though not on title search and conveyancing costs, because these latter providers are not part of a concentrated industry.³⁸⁷ Less than ten national firms currently provide this service, and start-up costs and regulatory barriers prohibit free entry. One response to this potential problem is evaluation or prosecution under the federal antitrust laws. The McCarran-Ferguson Act, however, exempts the insurance business from federal antitrust scrutiny "except to the extent that such business is not regulated by state law."³⁸⁸

be reserved for a period of 10 years before they can be used (a reserve fund against extraordinary or catastrophic losses). *Id.* at XI.38.

³⁸⁵ *Id.* at XI.37.

³⁸⁶ Although noting this as a possibility, the Peat Marwick Study believed it more likely that the smaller firms would try to compete as to price and would drive the price of mortgage insurance down somewhat. *Id.* at XI.37, .51-.52.

³⁸⁷ *Id.* at IV.19 (30-34% of surveyed lenders believed greater shopping for title searches and title assurance would result in lower prices; 17% had the same level of confidence for mortgage insurance).

³⁸⁸ 15 U.S.C. § 1012 (1982). Many of the cases in which this exemption is invoked have been prosecutions against title insurers, and these authorities might equally well protect mortgage insurers. See *Lawyer's Realty Corp. v. Peninsular Title Ins. Co.*, 428 F. Supp. 1288 (E.D. La.), *aff'd*, 550 F.2d 1035 (5th Cir. 1977) (alleged conspiracy of title companies to exclude plaintiff was not actionable under federal antitrust laws because such conduct may be actionable under state insurance code); *Schwartz v. Common Land Title Ins. Co.*, 374 F. Supp. 564 (E.D. Pa. 1974) (even if seller charges imposed by title insurers were not actually regulated by state insurance law, the exemption would be effective against allegations of price-fixing so long as the mechanism for regulation was available); cf. *United States v. Title Ins. Rating Bureau*, 517 F. Supp. 1053 (D. Ariz. 1981), *aff'd*, 700 F.2d 1247 (9th Cir. 1983), *cert. denied*, 104 S. Ct. 3509 (1984) (provision of escrow services by title companies may be object of antitrust suit because not "business of insurance").

Most states regulate the rates charged by mortgage and title insurance companies, but the perfunctory nature of most state regulations (the rate is filed and routinely approved)³⁸⁹ hardly justifies the continued exemption from antitrust scrutiny. Indeed, state insurance regulation may itself have anticompetitive effects. A 1977 Justice Department study found that in many cases, state insurance departments protected industry participants and tolerated excessive filed rates.³⁹⁰ Furthermore, public rate filing ensures that all firms in an oligopoly can react immediately to an attempt by any one firm to obtain a larger market share by cutting prices.

The McCarran-Ferguson Act has long outlived its usefulness (if ever it had any) and should be repealed, so that the federal antitrust laws will apply to the insurance industry. Parallel pricing and price leadership could be prosecuted on grounds of explicit or implicit collusion among a few competitors and, if problems persisted, the largest firms might be broken up to ensure a broader spectrum of competitors.³⁹¹ More open competition through consumer choice among several insurance options, earlier disclosure of comparative price data, and antitrust scrutiny of the industry should mitigate reverse competition and its effect on prices. To the extent that these reforms do not lead to greater competitive pressure on national insurers, direct federal regulation of mortgage and title insurance should be explored.³⁹²

³⁸⁹ Four different regulatory regimes for mortgage insurance were represented in the ten states surveyed by the Peat Marwick Study: (1) *open competition*, in which there is no regulation of rates (California and Colorado); (2) a *filed rate system*, in which the insurer simply files its proposed rate with the regulatory agency, and the rate goes into effect automatically unless the agency vetoes it (D.C., Florida, Massachusetts, Missouri, Virginia, and Washington); (3) a *file and approval system*, in which a revised rate schedule does not go into effect unless the agency actually approves it (Maryland); and (4) *state rate-fixing*, in which the agency determines a fair rate based upon evidence submitted to it (Texas).

³⁹⁰ For these reasons, the Department of Justice urged deregulation ("open competition") for the insurance industry—except for title and credit life/health insurance. The Department excepted those segments because of their reliance on reverse competition—because referrers were not price-sensitive, they would not respond perfectly to open competition. Dep't Justice Study, *supra* note 379; accord 3 Peat Marwick Study, *supra* note 100, at III.38-40. To the extent that the disclosure and buyer's agent proposal of this article circumvent reverse competition, however, the Department's arguments would be inapplicable.

³⁹¹ See 3 P. Areeda & D. Turner, *Antitrust Law: An Analysis of Antitrust Principles and Their Application* ¶ 841 (1978).

³⁹² 3 Peat Marwick Study, *supra* note 100, considered federal insurance regulation—including requirements that the lender partially absorb mortgage insurance costs, *id.* at III.29-36; that state insurance commissions evaluate mortgage and title insurance charges

b. Opening up Multiple Listing Services

Although the real estate brokerage industry does not look like an oligopoly, it behaves like one. Brokers charge uniform commissions, which do not fluctuate with supply and demand, and firms that charge lower commissions do not prosper.³⁹³ The main reason for this behavior lies in the unique pattern of cooperation found in this industry. In the 1920's, when homebuying started to become a major industry, real estate brokers formed multiple listing services and adopted a credo of cooperation instead of competition. As a result, four-fifths of existing homes sold today are sold through multiple listing services, and two-thirds of those sales involve both a listing and cooperating broker.³⁹⁴

Evidence suggests at least two ill effects from multiple listing services. First, brokerage fees are excessive because low-commission brokerage firms have sometimes been excluded from multiple listing services. Even when they are members, discount brokers have not prospered because other brokers refuse to show their homes, disparage their reputation, and discourage advertisers from running their ads.³⁹⁵ The exclusion or suppression of alternative mortgage firms enables the profession as a whole to charge 6%-7% commissions, which some experts believe to be excessive.³⁹⁶

more carefully, *id.* at III.32-35, 42-47; and that title assurance charges be set by the government, *id.* at III.41-42—but reached few conclusions.

³⁹³ See 1 FTC Brokers Study, *supra* note 118, at 82-108.

³⁹⁴ See *id.* at 68-69 & Figure I-1.

³⁹⁵ Overall, the FTC Brokers Study found that alternative brokers could obtain seller listings easily, but had a hard time selling houses, in part because of the low rate of cooperative sales (29% for multiple listing service brokers, compared with 66% for brokers generally). *Id.* at 154. One reason for the smaller degree of cooperation is that the cooperating broker's split with an alternative broker is typically less (half of the 3%-5% rate, rather than half of the normal 6%-7% rate), thereby discouraging cooperating brokers from pushing property listed with alternative brokers. Other problems that alternative brokers reported included the following: (a) professional disparagement (93% of the alternative brokers experienced disparagement in their first year of operation, and 74% said that it occurred frequently, *id.* at 156); (b) refusals by other brokers to show homes listed with alternative firms and lost or cancelled listings (about two-fifths of the alternative brokers surveyed experienced lost or cancelled listings "frequently" as the result of professional disparagement, *id.* at 159); (c) refusals by the media to run advertisements by alternative brokers, apparently as the result of pressure from other brokers (34% of the alternative brokers surveyed reported this problem, *id.* at 163).

³⁹⁶ See Yinger, A Search Model of Real Estate Broker Behavior, 71 *Am. Econ. Rev.* 591 (1981). A 1979 study by Arthur D. Little, Inc. suggests that even though brokers charge supernormal prices, individual brokers typically do not accrue excessive profits because of their low productivity. See 1 FTC Brokers Study, *supra* note 118, at 107-08.

The lack of price competition gives brokerage firms little incentive to pass on rebates they receive from lenders or profits from their controlled title agencies to consumers in the form of lower commissions. The patterns of cooperation may also be an impediment to the growth of buyers' brokers because of professional disparagement and refusals to cooperate. Limiting multiple listing service membership to brokers impairs the development of buyers' attorneys as shopping aides.

Although they discourage competition, multiple listing services are also useful because they give listed homes exposure to a large number of homebuyers;³⁹⁷ thus, they should not be abolished. Any exclusion of alternative brokerage firms from the services, or any pattern of disparagement or collective refusal to deal, however, should be met with antitrust scrutiny.³⁹⁸ More important, new ways of organizing the listing service should be considered, ways that could preserve the usefulness of the service while removing some of the perverse cooperation.

If the listing service were open to any professional who could pass a HUD-administered competency examination, problems of discriminatory exclusion could be eliminated.³⁹⁹ Open membership might also foster use of buyers' attorneys.⁴⁰⁰ Also, as explained

³⁹⁷ See 1 FTC Brokers Study, *supra* note 118, at 59 (pooled home listings expand the potential exposure of properties to a larger number of buyers, reduce search costs for buyers, lessen the "free rider" problem for brokers who help the seller market the property, and diminish somewhat the advantages of brokers who have a superior ability to attract new listings).

³⁹⁸ In connection with the home sale and loan transaction, lawsuits have already been brought in some localities to challenge minimum fee schedules for attorneys, see, e.g., *Goldfarb v. Virginia State Bar*, 421 U.S. 773 (1975), and exclusive broker practices in connection with multiple listing services. See, e.g., *McLain v. Real Est. Bd.*, 444 U.S. 232 (1980); *United States v. Realty Multi-List, Inc.*, 629 F.2d 1351 (5th Cir. 1980); see Austin, *Real Estate Boards and Multiple Listing Systems as Restraints of Trade*, 70 Colum. L. Rev. 1325 (1970); Siedel, *Antitrust Implications of Trend to National Real Estate Firms*, *Real Est. Rev.*, Spring 1982, at 88.

³⁹⁹ Yinger argues that greater membership access should be a "focal point" of regulatory concern. See Yinger, *supra* note 396, at 603-04. I believe that the commission system and patterns of noncooperation with discount brokers and buyer's agents are more troublesome than the problem of exclusion.

⁴⁰⁰ A variation on this proposal would be for HUD or another appropriate federal agency to promulgate periodic comparative lists of broker services and fees and to publicize the advantages of listing and buying through discount brokers. A rule requiring real estate sales personnel to distribute such a booklet (perhaps with the RESPA special information booklet) would be very useful, even if politically difficult to accomplish.

above, the agency and fiduciary duties of cooperating brokers should be clarified.⁴⁰¹

The most useful and important change, however, might be in the method by which sales agents are compensated. Although commissions are great motivators, they contribute to two problems—the sales pitch and disparagement of discount brokers.⁴⁰² Long term reform of the real estate sales industry must entail consideration of alternatives, including lower commissions fixed by law, a salary system for sales personnel, and perhaps even a listing system entirely open to homebuyers and sellers (thus obviating the need for sales personnel in many instances). Each of these alternatives carries with it significant trade-offs and disadvantages, which might be explored more thoroughly.⁴⁰³

These suggestions will not solve all the problems of real estate brokers' anticompetitive behavior, but may be the start of a general reexamination of the brokerage industry. Ultimately, the patterns of cooperation can probably be broken down only by reforms that are not politically likely in the near future—eliminating the commission basis for reimbursement or converting multiple listing services into public utilities open to everyone, for example. Despite the political problems, this area deserves greater exploration because of its critical importance to the home sale and loan transaction.

⁴⁰¹ See *supra* notes 347-71 and accompanying text.

⁴⁰² See *supra* notes 119-38, 395 and accompanying text.

⁴⁰³ Thus, legally fixed commissions would have some of the same disadvantages usury ceilings have had, such as distortion of resources if the commissions are not set at a realistic level, as well as politicization of an economic issue. Sales personnel paid a salary might have perverse incentives just as those paid commissions. For example, salaried personnel might put just as much pressure on homebuyers to make a specific purchase, so that the sales agent would not have to put as much time and effort into the sale. A listing system open to nonprofessionals (buyers and sellers) might produce some confusion, without reducing the dependence of most buyers and sellers on the assistance of brokers and builders.

As a general matter, any proposal to change the existing commission mode of compensation or the multiple listing service ought to recognize that most buyers and sellers appear to be pleased with the job done by real estate sales personnel. See Econ. & Research Div., Nat'l Ass'n of Realtors, *Inside the Real Estate Business: Practical Information for Real Estate and Non-Real Estate Professionals* 122 (1982) (83% of buyers and 82% of sellers were either "moderately" or "very satisfied" with the performance of their real estate agent).

c. Making Home Appraisals More Rigorous

A recurring problem with the mortgage transaction is its intrinsic connection with the home sale. However rigorously disclosure requirements are tailored to the integrated transaction, there will be room for sellers and their agents to play with the different costs—advertising low loan rates or settlement charges while raising home prices. One way to police the home pricing process—and to reduce bleeding of mortgage costs back into the home price—is to improve the appraisal process, which is now too accommodating to home sellers and their agents. Comparable houses should be more discriminately selected and evaluated. Choosing homes sold by a homebuilder as the comparables for appraising other homes sold by the *same* homebuilder (as is often done now) is clearly a circular means of determining value. It provides no continuing check on the developer's pricing. Instead, the appraiser should select similar homes offered for sale by *competing* homebuilders or should select (appropriately discounted) existing homes.

Appraisers must also evaluate the prices of comparable homes against the backdrop of seller-provided financing. A \$100,000 house in which the seller paid five points to buy down the interest rate is not worth the same as a \$100,000 house in which the seller paid no points.⁴⁰⁴ The more sophisticated appraisers have been considering such variations by collecting paired sales of properties identical in all ways except the terms of financing and then determining the average percentage price adjustment for the desired type of financing.⁴⁰⁵ This method should be the rule rather than

⁴⁰⁴ "[T]he volume of favorably financed homes and the tremendous rise in interest rates have created the need for price adjustments due to financing terms. To estimate the value of property alone, prices of comparables purchased with favorable financing need to be reduced by the premium associated with that financing." Friedman & Harris, *Seller deserves premium for favorable financing*, *Tierra Grande*, Issue 20, at 19 (1983).

⁴⁰⁵ *Id.* at 19-21; see Schwartz, *Influences of Seller Financing Upon Residential Property Sales Prices*, *Real Est. Appraiser & Analyst*, Winter 1982, at 35 (comparing difference in actual cash-equivalent value between seller financed and nonseller financed condominiums). One problem with this approach "is that the type of data needed might not be available. To accurately determine the value of specific financing there must be data for sales of comparable property with and without favorable financing." Friedman & Harris, *supra* note 404, at 20. Without such data, however, the appraiser can still estimate the necessary adjustment by referring to the discount charts used by builders to determine how many "points" they will have to pay to buy down the interest rate from the market rate to the desired rate. See Gallagher, *The Effect of Financing Terms on Residential Property Values*, *Fed. Home Loan Bank Bd. J.*, June 1981, at 20, 21.

the exception. To the extent that the market does not adopt these rules, the government should set down mandatory guidelines, perhaps in connection with the FHA and VA programs and FNMA's and FHLMC's secondary market purchase requirements.

CONCLUSION

As a consequence of their own decisionmaking and cognitive biases, their reliance on intermediaries who have perverse incentives, and their entrapment in markets that are intrinsically imperfect, homebuyers are often misled into entering deals that are not what they appear, regularly pay excessive prices for loans and settlement services, and sometimes take on too much risk. Regulators have perceived, even if dimly, the homebuyers' dilemmas, but their attempts at protecting homebuyers have been deeply flawed and often wholly misplaced. The hundred years of ineptitude in regulating home mortgages, first through state usury laws and now through federal disclosure requirements, is the result of ad hoc legislative, administrative, and judicial responses that have not carefully considered the psychological and economic dynamics of the integrated home sale and loan transaction.

Protecting homebuyers should be a top priority for government regulation. Financing the purchase of a home is a critical event for most Americans, and mistakes can have severe consequences for families' financial and emotional well-being. Government intervention can do an enormous amount of good in this area, if policy sheds its ad hoc approach and grounds reforms upon a more sophisticated understanding of the problems. The government should start with the most immediate problem, namely the one that poses the greatest short term disadvantages, and begin with the most direct solutions. It should build upon these solutions to address the other related problems, through the less intrusive methods first, followed by structural changes if further study justi-

⁴⁰⁶ This approach is suggested because legislators and administrators typically do not approach problems by a "rational comprehensive" method of policy change, but rather by a "successive limited comparisons" method, in which immediate problems are handled first and change is incremental rather than sweeping. See Lindblom, *The Science of "Muddling Through,"* 19 *Pub. Ad. Rev.* 79 (1959). I believe, however, that having a broad policy model, such as the one in this article, helps policymakers formulate incremental responses and recognize their limitations.

fies them.⁴⁰⁸ In terms of priorities for Congress and federal regulators, the following five phases of reform should be considered.

Phase I: Standardize Alternative Mortgage Instruments

The most immediate problem facing American homebuyers is the confusing array of diverse and risky alternative mortgages. The costs to a household of a wrong choice are thousands of dollars in unplanned mortgage payments, severe constraints on budgets or mobility, and, in many cases, default. The most direct solution is standardization. Using a limited range of mortgage menus for ARMs and GPMs would make shopping much easier for homebuyers and intermediaries assisting them, because the choices would be fewer and comparative disclosure using several scenarios could be instituted. Additionally, standardization should include the consumer protection provisions set forth in this article—a grace period and rate caps, limits on negative amortization and payment caps, restrictions on balloon mortgages—because the sales process and intrinsic decisionmaking biases tend to make homebuyers too optimistic.

Phase II: Eliminate Misleading Practices by Amending Disclosure Rules

Misleading advertisements and sales gimmicks are second in importance only to the risks of alternative mortgages, and many of them can be regulated simply by changing current disclosure rules. Teaser rates for adjustable and other mortgages should be controlled by the requirement that the monthly payment cannot increase more than 7.5% per year. “Free” closing costs and seller’s points to buy “bargain” interest rates would be discouraged by including those seller-paid fees in the advertised APR. Consumers may still be misled by the sales pitch, but at least the federal government, through its disclosure rules, will no longer be an unwitting accomplice in deception.

Phase III: Encourage the Use of Buyers’ Agents and Impose Duties of Disclosure and Suitability on Brokers and Builders

This would help homebuyers avoid excessive risk and understand the transactions they are entering. This reform process is already being pursued by court decisions expanding the fiduciary duties of real estate sales agents. Such state law efforts should be

supplemented by federal rules. Any reform of the well-entrenched sales pitch will take time, but even small progress could significantly facilitate ongoing consumer education. Thus, sales agents should have a federally created fiduciary duty to make only suitable recommendations. In advising homebuyers, intermediaries must explain potentially misleading aspects of the sales process, must be honest about the range of prices and any business connection between the intermediary and the referred provider, and must set forth the risks and disadvantages of alternative mortgages. And buyers should be encouraged to retain their own brokers or attorneys to help them make wise choices. This might be done through a combination of a consumer education campaign, legal incentives for sellers' agents to urge buyers to retain their own agents, and reconstituting the now ambiguous role of the cooperating broker in multiple listing services.

Phase IV: Establish Simplified, Early, and Comparative Disclosures

The problem of high loan and settlement service costs is not as important as the problems of risk and confusion. A suboptimal loan might cost the homebuyer a thousand dollars or so extra per year, and excessive closing costs would only be several hundred dollars or less. These costs are small in comparison to the risks of alternative mortgage instruments (or, for that matter, the overall cost of the home), and the violation done to the precepts of fair dealing not so outrageous as the violation through misleading sales gimmicks. The most direct way to attack these excessive costs is earlier, comparative, simplified disclosures. The proposals for calculating the APR, the timing of disclosure, the comparative lists, and the standardization of ancillary mortgage note and deed terms should be instituted as soon as practicable, but need not take precedence over the other proposals.

Phase V: Attack Imperfect Markets

Because they address a less important problem (high closing costs) and take a long time to have effect, the market-correcting proposals for settlement services have the last priority. By then, there may be more concrete evidence concerning the effect of controlled companies on the price and quality of loan and settlement

services, and policymakers might be able to determine whether increased shopping is sufficient to force prices down in the mortgage and title insurance industries. If not, federal antitrust prosecution might be in order. In any event, the McCarran-Ferguson Act should be repealed.

Taken together, the reforms proposed here can help fill some of the gaps in current regulations that allow many homebuyers to be misled and to pay too much for their home loan and settlement services. To the extent that our society is seriously opposed to unfair treatment or manipulation of homebuyers entering into mortgages, its opposition should be articulated through rules grounded in a systematic understanding of the psychological and economic dynamics of the transaction.

Appendix I

PERFORMANCE OF SELECTED ADJUSTABLE-RATE MORTGAGES OVER 10 YEARS													
RATES BORROWERS OF THESE LOANS WOULD PAY UNDER FOUR POSSIBLE SCENARIOS FOR TREASURY INDEX													
YEAR	1-YEAR TREAS. RATE	PROVIDENCE SAVINGS	MORTGAGE FUNDING	NATIONAL PERMANENT	NATIONAL PERMANENT	GOLDOME MORTGAGE	CONTINEN- TAL FEDERAL	UNITED VA. MORTGAGE	SUBURBAN SAVINGS	COLUMBIA FIRST	HOME FEDERAL	PERPETUAL AMERICAN	FIRST FEDERAL
1984	11	9.88	10.38	10.5	10.88	10.5	10.88	10.13	9.75	10.5	11	10.38	10.88
1985	14	14.88	12.38	11.5	12.88	12.5	12.88	12.13	11.75	12.5	13	12.38	12.88
1986	9	11.5	11.8	12.5	11	12	11.5	11.5	11.5	11.4	11.25	11.5	11
1987	10	12.5	12.8	12	12	13	12.5	12.5	12.5	12.4	12.25	12.5	12
1988	11	13.5	13.8	13	13	14	13.5	13.5	13.5	13.4	13.25	13.5	13
1989	14	14.88	13.8	15.5	15	15.5	15.5	15.5	15.5	15.4	15	15.38	15
1990	10	12.5	13.8	13.5	13	13.5	13.5	13.5	13.5	13.4	13	13.38	13
1991	12	14.5	14.8	14	14	15	14.5	14.5	14.5	14.4	14.25	14.5	14
1992	13	14.88	16	15.5	15.88	15.5	15.88	16	15.38	15.5	15	15.38	15.88
1993	8	10.5	14	13.5	13.88	13.5	13.88	14	13.88	13.5	13	13.38	13.88
1984	11	9.88	10.38	10.5	10.88	10.5	10.88	10.13	9.75	10.5	11	10.38	10.88
1985	12	14.5	12.38	11.5	12.88	12.5	12.88	12.13	11.75	12.5	13	12.38	12.88
1986	15	14.88	14.88	12.5	14.88	14.5	14.88	14.13	13.75	14.5	15	14.38	14.88
1987	8	10.5	12.38	10.5	12.88	12.5	12.88	12.13	11.75	12.5	13	12.38	12.88
1988	9	11.5	11.8	11	11	12	11.5	11.5	11.5	11.4	11.25	11.5	11
1989	11	13.5	13.8	13	13	14	13.5	13.5	13.5	13.4	13.25	13.5	13
1990	12	14.5	14.8	14	14	15	14.5	14.5	14.5	14.4	14.25	14.5	14
1991	9	11.5	12.8	12	12	13	12.5	12.5	12.5	12.4	12.25	12.5	12
1992	12	14.5	14.8	14	14	15	14.5	14.5	14.5	14.4	14.25	14.5	14
1993	14	14.88	16	15.5	15.88	15.5	15.88	16	15.88	15.5	15	15.38	15.88
1984	11	9.88	10.38	10.5	10.88	10.5	10.88	10.13	9.75	10.5	11	10.38	10.88
1985	14	14.88	12.38	11.5	12.88	12.5	12.88	12.13	11.75	12.5	13	12.38	12.88
1986	15	14.88	14.88	12.5	14.88	14.5	14.88	14.13	13.75	14.5	15	14.38	14.88
1987	10	12.5	12.8	12	12.88	13	12.88	12.5	12.5	12.5	13	12.5	12.88
1988	9	11.5	11.8	11	11	12	11.5	11.5	11.5	11.4	11.25	11.5	11
1989	11	13.5	13.8	13	13	14	13.5	13.5	13.5	13.4	13.25	13.5	13
1990	12	14.5	14.8	14	14	15	14.5	14.5	14.5	14.4	14.25	14.5	14
1991	14	14.88	16	15.5	15.88	15.5	15.88	16	15.88	15.5	15	15.38	15.88
1992	9	11.5	14	13.5	13.88	13.5	13.88	14	13.88	13.5	13	13.38	13.88
1993	11	13.5	13.8	13	13	14	13.5	13.5	13.5	13.4	13.25	13.5	13
1984	11	9.88	10.38	10.5	10.88	10.5	10.88	10.13	9.75	10.5	11	10.38	10.88
1985	12	14.5	12.38	11.5	12.88	12.5	12.88	12.13	11.75	12.5	13	12.38	12.88
1986	15	14.88	14.88	12.5	14.88	14.5	14.88	14.13	13.75	14.5	15	14.38	14.88
1987	10	12.5	12.8	12	12.88	13	12.88	12.5	12.5	12.5	13	12.5	12.88
1988	9	11.5	11.8	11	11	12	11.5	11.5	11.5	11.4	11.25	11.5	11
1989	11	13.5	13.8	13	13	14	13.5	13.5	13.5	13.4	13.25	13.5	13
1990	12	14.5	14.8	14	14	15	14.5	14.5	14.5	14.4	14.25	14.5	14
1991	14	14.88	16	15.5	15.88	15.5	15.88	16	15.88	15.5	15	15.38	15.88
1992	9	11.5	14	13.5	13.88	13.5	13.88	14	13.88	13.5	13	13.38	13.88
1993	11	13.5	13.8	13	13	14	13.5	13.5	13.5	13.4	13.25	13.5	13
4-YEAR AVG.		12.19	11.84	11.63	11.69	12	11.94	11.56	11.38	11.7	11.88	11.69	11.69
SCENARIO 1		12.44	12.38	11.25	12.88	12.5	12.88	12.13	11.75	12.5	13	12.38	12.88
SCENARIO 2		13.04	12.49	11.63	12.88	12.63	12.88	12.22	11.94	12.5	13	12.41	12.88
SCENARIO 3		11.83	11.59	11.38	11.44	11.73	11.69	11.32	11.13	11.45	11.63	11.44	11.73
SCENARIO 4													
10-YEAR AVG.		12.95	13.56	13.05	13.15	13.5	13.45	13.33	13.23	13.24	13.1	13.23	13.15
SCENARIO 1		13.01	13.35	12.45	13.14	13.45	13.39	13.1	12.94	13.15	13.23	13.14	13.14
SCENARIO 2		13.15	13.41	12.65	13.23	13.45	13.43	13.19	13.05	13.16	13.2	13.13	13.23
SCENARIO 3		11.74	12.02	11.55	11.65	12.2	11.88	11.73	11.65	11.72	11.7	11.78	11.48
SCENARIO 4													

*Indexed to two-, three-, and five-year Treasury issues respectively. Chart assumes a constant spread between them and one-year Treasury rates.

This table originally appeared in Berry, Choosing Mortgage May Be Harder Than Choosing Home: Analysis Shows Different Performance of Adjustable Loans, Wash. Post, Apr. 28, 1984, at E62, cols. 1-4.

TERMS OF SELECTED ADJUSTABLE-RATE MORTGAGES

INSTITUTION	INDEX	SPREAD	INITIAL RATE	MAXIMUM CHANGE	CEILING	FLOOR	POINTS
PROVIDENCE S & L	Treas 1yr	2.5	9.875	NONE	14.875	4.875	3
MORTGAGE FUNDING	Treas 1yr	2.8	10.375	2	16	10.375	2.5
NATIONAL PERMANENT	Treas 1yr	2	10.5	2	15.5	10.5	4
NATIONAL PERMANENT	Treas 1yr	2	10.875	2	15.88	10.88	2
GOLDOME MORTGAGE	Treas 1yr	3	10.5	2	15.5	5.5	3
CONTINENTAL FEDERAL	Treas 1yr	2.5	10.875	2	15.875	5.875	2
UNITED VA. MORTGAGE	Treas 1yr	2.5	10.125	2	16	NONE	3
SUBURBAN S & L	Treas 1yr	2.5	9.75	2	15.875	NONE	3.5
COLUMBIA FIRST FED.	Treas 1yr	2.4	10.5	2	15.5	5.5	3
HOME FEDERAL S & L	Treas 1yr	2.25	11	2	15	10	2
PERPETUAL AMERICAN	Treas 1yr	2.5	10.375	2	15.375	10.375	3
FIRST FEDERAL (VA)	Treas 1yr	2	10.875	2	15.875	5.875	2
MORTGAGE FUNDING	Treas 2yr	2.25	11.5	2	15.5	11.5	3.5
PERPETUAL AMERICAN	Treas 3 yr	2.5	12	2	16.5	12	3
COLUMBIA FIRST FED.	Treas 5yr	2.4	12.5	2.5	17.5	7.5	3

This table originally appeared in id. at E60, cols. 3-6.