Federal Reserve Forum on Consumer Research & Testing: Tools for Evidence-based Policymaking in Financial Services, November 9, 2010
Panel One: Exploring the root disciplines for studying consumer behavior

Susan Woodward:
When we had our conference call for this panel at some point Jeannie said “Susan you're the token economist on this panel,” and I can't tell you how proud I was, and I wanted everyone to know that I had been identified as the token economist.

Now I think I probably need a little...okay now I have had the privilege of studying three different sets of loans in which I studied the detailed closing costs on the loans. The first set was a set of 3,100 loans. They were prime market, a mix of FHA, jumbo, conventional, some fixed, some ARMS, some purchase, some refi, mostly 30 years, and they were originated over the period 1996 to 2001. And so this is to my knowledge the first time anybody ever took a set of HUD-1 settlement statements and took all of the data off it and coded them up so that we could look at who was paying what. The second set of loans I had the opportunity to study was the loans we pulled for the FHA closing cost study. The results of my first effort looking at closing costs provoked FHA to get more interested, and so they pulled the loans from their sample – or rather their universe – and we looked about the 7,500, all 30 year fixed, all for the purchase of a home, all originated in a narrow little window six weeks covering May and June 2001. So we've taken away a lot of things that could make life more complicated and it's a national sample, a mix of brokered and retail loans. So these loans, some of them were made by credit unions and small depositories, some of were made by household- name great big mortgage banks, some by mortgage brokers and some by correspondent banks which essentially operate very much the way mortgage brokers do.

Now the most recent set I have are also extremely interesting and in some ways you'd think really different from these other loans. They're almost all subprime. There are 25,000 of them. They are a mix of fixed and ARMS, including some extremely flaky designed ARMS. And they're purchases and refi's including refi cash-outs and some, in fact the majority of them, have a second loan to go along with the first and that's identifiable clearly in the data because at the point where the loan is made, both the second and a first, they've got the same date on them -- the closing was a single closing. And these were all funded by single lender over the period 2004 through 2007. So uproar, major uproar.

Now the context in which these loans were studied was a legal complaint and the legal complaint comes under a piece of legislation knows as RESPA, the Real Estate Settlement Practices act of 1975 with amendments in 1983. And the question was, was it illegal for the wholesale lender to make a payment to the mortgage broker? Was this an illegal kickback under RESPA? Like for example you might not know that it is illegal for your realtor to make a payment to your lender, or for your lender to make a payment to your realtor or the title insurance company either that provides the title searches, all payments among those guys are illegal under RESPA and so was it illegal for the wholesale lender to make a payment to the mortgage broker, that was the question. And so the economist looks at this and says well, the real issue here is are the cash fees lower when the borrowers implicitly pay this amount of money which is called a yield spread premium, through a higher interest rate on the loan, because when the lender makes this payment it's because the rate on the loan is higher and so one way or another the borrower pays it.

And so being an economist I approached this and I say okay what we really want to know is in a fully informed competitive market the cash fees should [inaudible] by a dollar for each dollar of yield spread premium paid. Do they? The answer is no, no, no they don't. At best, the cash falls by about 50 cents for each dollars of yield spread premium paid, so you pay a slightly higher rate. This allows the wholesale lender to make a payment to the mortgage broker. Do you benefit from that as a borrower? Maybe a little. In the best cases I've seen it's about...we benefit by about 50 cents and in the worst cases your fees are actually higher, you don't get any offset at all, you pay an extra 35 cents in some of these subprime and FHA loans.

So what do I think is going on here? I think some of these customers are pretty confused because there are four consistent patterns I see in this data. The first set I worked on I was the defendant’s expert, and for reasons that I still don't understand, the experts on both sides were given the right to write papers with the data. The outcome of the case was the complainants lost on class certifications so there was a settlement, and the settlement included letting the researchers look at the data, so I immediately went out and geocoded the data and fetched from each borrower’s census track a measure of educational attainment: the fraction of adults in the census track that have a college education. Had good variation – it went all the from zero to close to 100 percent and one of the things I expected is by incorporating education we'd make a dent is the race coefficients. No, that didn't happen at all. We measured them with greater precision, but education itself took on this huge role. The less well educated borrowers get worse deals, and it's about 1,500 dollars for the difference between the high school only folks versus the people were all adults in the census track to have a college education. Now given that the total charges for the broker-lender fees are sort of around 4,042 hundred dollars, this is a big number, not a small number. What's more it's consistent across all four of these data sets. You know the prime loans, the FHA loans, the subprime loans at different points in time – you know this coefficient still comes out in the same range, you know it could be as low as 1,000, as high as 1,800 depending on which subset and which specification. But it's there and it's big and its standard error is less than a tenth of the variable itself so it's really nothing.

But there was another important thing I learned and that was that there was an interesting subset of the loans in each of the sets where for some reason – I don't know why – the borrowers had chosen to get a quote on rate alone, no upfront cash fees, you're just signing up for an interest rate, you don't write a check at closing. And these loans were really a lot cheaper than the other loans. They were like 12 to 18 hundred dollars cheaper. Again a big number and a consistent number; it's robust to specification and it's robust to the data sets but it's really big. Now in each set the no cost loans were sufficiently numerous that I could take just the no cost loans and ask okay let's look at how much the borrowers are charged as related to all of these other things like loan amount and downpayment and education and whether the borrower is a minority. And the very interesting thing is that among the no cost loans, how much the borrowers are charged is not related to education or to race. And I thought oh well this is really very interesting and it suggests that somehow the market is more competitive – by the way the standard deviation of charges is also much lower across these no cost borrowers. Now who ends up there is not...it's not clear to my why, the no cost borrowers are slightly more savvy, they have slightly better credit scores, a few more of them have college educations, slightly fewer of them are minorities so any measure you look at you'd think they would be better prepared but the differences aren't big enough to come anywhere near to explaining the differences in how they're charged.

Now I have one other new fact, the first time I looked at this...of the data, the 3,100 loans there was a peculiar, you know, like 8 to 12, 13 percent of the loans were practically free, like there were no charges to the lender and the broker. And I thought oh well this is a fluke then I got the FHA data and once again you sort of 8 to 13, you know it's like the loans are free. It's like the lender is doing this loan for free. It's like why is this happening? You know this is a fluke too. Okay I get the third data set, the same thing. All right there's something else here that's systematic. These...my guess is that these are the friends and family loans, these are loans that brokers are writing, you know, for their brothers-in-law and little sister and some good friends and some golf buddies. But what it suggests to me is that the actual cost of providing the broker services, getting the paper, shuffling the paper, filling out the paper is fairly low, that this is a business where the biggest cost of doing business is getting the business. And it makes me wonder whether RESPA is really being fulfilled and that there aren't side payments being made among the various folks. But in any case, I mean if you think about it, it's not the kind of market that we would expect to produce a kind of pure competitive outcome that economists are inclined to think about.

And by the way there's one other thing I need to say. The wholesale market in mortgages is extremely tight – I mean when you look at what the different wholesale lenders are quoting the numbers are very close together. And so most of the variation in what the borrowers are being charged is at the broker-lender level; it's not at the wholesale level.

Now we did one other thing with the data. There's a sort of fashion among economists to sort of take all kinds of data and fit it to auction models and what we find when we fit it to auction models is that oops...you know that the borrowers could really save a lot of money by getting one more quote, which is pretty clear from just the width of the distributions, and could save more money still by getting yet another quote. And so this is consistent with the borrowers really only looking at one or two loans, which is also consistent with the Fed and the Federal Trade Commission's survey work on how many loans did you really look at. Fed's answer mode is one; the FTC's answer looking at a very sophisticated county, Montgomery County, is two. But it's not bigger than two.

So it looks as though first borrowers are really confused by the rate-point trade off, and indeed, even for the economists who are students of the mortgage market, the rate-point trade off is hard okay and it's not...it's not easy comparing the terms on loans.

Second borrowers seem to think there's a single price out there. You know after all, the mortgage market is at its heart a securities market and everyone knows the securities markets are very tight. And so like there should be only one price out there, but there's not only one price out there or if there is one price it takes a lot of effort to find it.

Third the borrower's bargaining position is improved a lot when transactions are simpler, meaning the no-cost loans. Who gets there we're not quite sure, why they get there we're not quite sure, but all of our children do. I can assure you that when they go out to shop for a loan, their instructions are get a no-cost loan and some of them come back reporting that the lender said huh, but they produced the no-cost quote and we were pretty satisfied. And so this market appears then to be characterized by a fairly high level of inefficient competition among the brokers searching for the most confused borrower. Think about the most valuable customer to the mortgage broker is going to be rich and poorly informed. And do I see these? I really saw these in the subprime data that I'm looking at now. I mean there's sort of an interesting subset of these loans – you know like 1,000 out of the 25,000 – where the broker's fees are above 40,000 dollars for a single loan. Now do you think those people got a high level of service? I bet you they did. I bet that broker was on their doorstep, you know, continuously until those papers were signed.

So now remember these are three sets of data, covering more than 35,000 loans, fixed, ARMS, purchase, refi's, cash out, credit from excellent to subprime, all states represented, 1996 to 2007 with one little caveat: in 2002 is a year for which I don't have any loans. I don't think that's so important, but these findings are not a fluke they're really persistent. Now things we might consider: ban up-front cash fees, think big simplify disclosure. Now if you look at the typical HUD-1 settlement statement, you see origination fee, discount points, credit report fee, application fee, processing, underwriting, funding, doc prep, wire, commitment, tax service, amortization, courier fees, flood cert. recording fees and this is just a start. When we collected the FHA data we had 32 fields for just the lender-broker alone, and we still had thousands of fees where we had to write in by hand the name of the fee and we had to catalogue them by hand about whether or not they were indeed a lender fee. Now it's not as though any of these functions can be dispensed with on any loan. Or any of these services are services you could obtain from someone other than the lender. There's only one reason these fees are broken out and that is to legitimize the charges that are being charged, and to make it look like something really important is happening.

And then we've also got well you know you allow a carve out for points. And I think Jeannie is the one who made the analogy with the prescription drug system – you know you've got over-the-counter stuff and then you've got prescription drugs and then controlled substances. You know put the points in the category of the prescription drugs where you need to be really rich or talk to a housing counselor or whatever before you pay points. Or you could go even further, ban separate title charges, make the lender roll the title in, so then we've got really effective competition in title, or fix the title system. We've now got this opportunity. I mean we've got such a mess out there we could have a new national set of records for recording ownership and lending and I'm sort out MERS along way too – think really big. I mean, proper recording of ownership has vast economies of scale. Most of the stuff that has big economies of scale, say like water delivery to people's homes or electricity delivery to...we organize those things as public utilities. And why shouldn't we do this in the same way? I mean look at average title charges: California and Texas about 2,000 dollars, North Dakota and North Carolina about 650 dollars, British Columbia 24 dollars. You go to a web site, you type in the property ID, and in 24 hours and you pay your 24 dollars via credit card and in 24 hours they come back with a title report.

Now I want to emphasize that I don't feel like I know everything yet, and I want to make you ponder um, some numbers because these numbers confuse me, I understand a little bit about them but not a lot, and let me explain what this table is. These are from the FHA data because only in the FHA data did we have some loans that were not brokered loans. And so what we did is we took, say, all the loans made by depositories and we asked how are the charges the depositories collect related to borrower and loan characteristics? Then we said okay if we had the depository model and we applied it to the customers ofbig mortgage banks and correspondent lenders and the mortgage brokers, how much would the depositories have charged to the customers of the mortgage brokers? And they're you know they're pretty monotonic, they would have charged the mortgage bank's customers more, and the correspondent banks' customers more yet, and they would have charged the most to the mortgage broker's customers. And part of this is that the loans are larger for the mortgage brokers. But then along the diagonal, this is each...charges from each category to its own customers, and now we get over here to the mortgage broker's charges to their own customers, okay. Now if we apply the mortgage broker's model that they seem to be applying to their customers to the depository customers they would have indeed charged those customers less. And you know but we asked so why...why didn't all of the borrowers go to the small depositories? Would the small depositories have denied their loans? How come some customers ended up with a mortgage broker and others ones with the depositories? I don't know. I suspect part of what's going on is that the depository person who writes up the loan is an employee of the depository, doesn't get the yield spread premium if the customer gets signed up for a higher interest loan so the incentives are different, and, as the economists are fond of saying, incentives matter. Whereas the mortgage brokers and correspondent banks, the incentives are focused absolutely on extracting as much from the customer as can be extracted. So these are some numbers I don't understand. If you have any insights let me know.

Now I'm going to go back here to suggest some other things. An experiment will be underway soon. We're going to nab people who seem to be shopping for a house, get them to answer some questions, suggest that maybe they should buy less house, maybe have a different structured loan, give them some help shopping for a loan and see if this will help. Whether it will or not we don't know yet, but it's ambitious. We're going to try it.

And then I want to finish with a story about the title plant for cars in California. Now California runs a pretty much bullet proof set of records on who owns what car and those of you who are fans of rock and roll or old enough might remember the Beach Boys song "Little Deuce Coupe." And one of the verses is, "She's got a competition clutch with four on the floor, purrs like a kitten till the leg pipes roar, if that ain't enough to make you flip your lid, there's one more thing, I've got the pink slip baby." Now what's important about the pink slip baby? It's a certificate of ownership; you only possess it if you don't have a loan against the car. If you've got a car loan that you're working on, the bank's got the pink slip; it's only delivered to you after the car is paid for. And I have never heard anyone talk about or suggest or try to sell title insurance on cars. And cars move around. You know, they're not quite as valuable as houses, but especially in California, they're pretty valuable. So time to think big. We've got an extraordinary opportunity here. I hope we won't have one like it for a very long time, but it is a chance to fix some things. And so...thank you.