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# Consumer Protection Initiatives in the EU Mortgage Market: A Behavioral Economics Based Critique and Proposal

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# “Consumer Protection Initiatives in the EU Mortgage Market: A Behavioral Economics Based Critique and Proposal”

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## Introduction

In 2005, the Commission of the European Communities (the “Commission”) issued the Green Paper “Mortgage Credit in the EU” (“Green Paper”) which sought to begin the process of assessing the merits of Commission intervention in the EU residential mortgage credit markets through: (i) examining the current condition of the mortgage market in the EU, (ii) soliciting feedback from the Member States and stakeholders on the goals and questions the Commission raised, and (iii) seeking the collection of further data. In 2007, the Commission issued the White Paper “On the Integration of EU Mortgage Credit Markets” (the “White Paper”) which included a useful summary of the feedback received and additional data collected and proposed certain changes to the credit markets that the Commission is considering for a Directive.<sup>1</sup>

This article initially analyzes and critiques the goals articulated and certain of the consumer protection initiatives proposed by the Commission in the White Paper. As will be discussed, some of the goals the Commission articulated are likely to work against each other and be unobtainable under the initiatives as currently proposed in light of certain cognitive phenomena affecting consumers taking out home loans. The article then employs a behavioral economics analysis to demonstrate that while the key consumer protection initiatives tentatively embraced by the Commission represents a step in the right direction, there are additional measures that the Commission should include in any Directive it initiates in order to achieve the Commission’s articulated goal of enhancing consumer confidence and protection. These additional measures are detailed and discussed in this article alongside the measures that the Commission tentatively endorsed.<sup>2</sup>

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<sup>1</sup> A “Directive” is a legislative act of the EU initiated by the Commission and approved by the European Parliament and Council requiring Member States to achieve certain results and allowing the Member States to create national laws to achieve these results.

<sup>2</sup> The Commission noted that it was not yet ready to commit to any reforms for a new Directive and wished to obtain further analysis and consultation with stakeholders before it would make a final political assessment on the most appropriate way forward. Commission of the European Communities, White Paper:

## I. A Critique of the Goals Articulated by the Commission

In the Green Paper, the Commission correctly first focused on the current condition of the EU mortgage credit market to determine what goals the Commission should pursue with respect to this market. The Commission noted that the EU mortgage credit markets, despite sharing some common trends, remains very diverse in terms of size, growth, product variety, borrower profiles, distribution structures, loan durations, home ownership rates and funding mechanisms and that the level of direct cross-border sales is less than 1% of the overall residential mortgage credit activity.<sup>3</sup> The Commission also noted that mortgage credit markets are among the most complex in which consumers engage and that this debt is likely to be the most significant on-going financial commitment for most EU households with the slightest change in interest rates potentially having a significant effect on household budgets and spending capacity.<sup>4</sup> In light of this, the Commission identified as their key goal to make mortgage markets more efficient and competitive for the benefit of all through integrating the markets by ensuring that mortgage credit can be demanded and offered with limited hindrance throughout the EU.<sup>5</sup> The Commission also identified in 2005 as goals to: (i) decrease the costs of a mortgage loan, (ii) enhance market completeness, product diversity, and price convergence, and (iii) to create a more liquid funding market based on modern and flexible funding techniques and products to serve more borrowers, including those with poor and incomplete credit ratings through increased use of the capital markets and insurance.<sup>6</sup> By the time the White Paper was issued in 2007, the goal of providing funds to serve borrowers with poor credit ratings was de-emphasized by the Commission and prudent lending standards was more emphasized due, it appeared, to the sub-prime mortgage crisis in the U.S. that became evident to all that year.<sup>7</sup>

In analyzing the Commission's goals, it is interesting to note that "consumer protection" is not identified as the key goal, but is instead listed as an area to work on in order to achieve the goal of creating an integrated and efficient EU mortgage market.<sup>8</sup> One reason for this may be that the EU mortgage markets in general, unlike the U.S. market, did not have a thriving sub-prime market with divergent pricing which can lead to some consumers being improperly directed into a higher priced loan than they qualified for<sup>9</sup> and that lenders in the EU generally required higher creditworthiness

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Financial Services Policy: 2005-2010, at 5, COM (2005) 629 final (Dec. 1, 2005), available at [http://eur-lex.europa.eu/LexUriServ/site/en/com/2005/com2005\\_0629en01.pdf](http://eur-lex.europa.eu/LexUriServ/site/en/com/2005/com2005_0629en01.pdf).

<sup>3</sup> Commission of the European Communities, Green Paper: Mortgage Credit in the EU, at 5, COM (2005) 327 final (July 19, 2005), available at [http://eur-lex.europa.eu/LexUriServ/site/en/com/2005/com2005\\_0327en01.pdf](http://eur-lex.europa.eu/LexUriServ/site/en/com/2005/com2005_0327en01.pdf).

<sup>4</sup> Id. at 4.

<sup>5</sup> Id. at 3.

<sup>6</sup> Id. at 3-6.

<sup>7</sup> White Paper, *supra* note 2, at 3-4.

<sup>8</sup> Green Paper, *supra* note 3, at 6.

<sup>9</sup> See Elizabeth Warren & Amelia Warren Tyagi, *THE TWO INCOME TRAP: WHY MIDDLE CLASS MOTHERS AND FATHERS ARE GOING BROKE* 135 (Basic Books 2003). Also heavily contributing to home loans in the U.S. being overpriced was the fact that mortgage brokers in the U.S. would often be compensated based on a "yield spread premium" (compensation based on inducing a borrower to enter into a higher priced loan than they qualified for) in which only a small fraction of this payment would be

standards (making sure the borrowers had the means to afford making the loan payments) than did lenders in the U.S where the originating lenders primarily sold off their mortgage loan pools after originating them.<sup>10</sup> Yet it is still troubling that consumer protection is not identified as an independent important goal and is addressed more as a sub-goal to the Commission's key goal of removing barriers to a more integrated and efficient EU mortgage-market. The Commission did note in the White Paper some important consumer protection problems in the EU mortgage-market such as: (i) lack of uniform pre-contractual information (in the form of a European Standardized Information Sheet ["ESIS"]) actually being supplied to consumers before they entered into the loan transaction, causing consumers to not be able to shop around for the loan that best suits their needs and goals,<sup>11</sup> (ii) lack of transparency on matters relating to compensation of mortgage credit intermediaries (i.e. independent mortgage brokers or agents of the lender who assist borrowers in obtaining home loans) and if they are tied to a specific lender or not,<sup>12</sup> (iii) mandatory tying in of the loan with other products (which restricts consumer mobility and weakens competition),<sup>13</sup> (iv) some lenders making loans without verifying the borrower's "creditworthiness" (i.e. ability to repay the debt) leading to a loss of their homes<sup>14</sup> (iv) some borrowers taking on "unsuitable" loans (i.e. loans that they may be able to afford to pay back but not necessarily optimal loans for the borrower based on the

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applied to the borrower's closing costs (Federal Register Vol. 73, No. 222, 68268 (November 17, 2008) citing to an Urban Institute report in 2008 which found that paying one dollar of YSP to a mortgage broker reduced upfront fees by only 7 cents) whereas mortgage broker compensation among the EU Member States tends to be based on a fixed fee or percentage of the loan amount commission. (DG Internal Market and Services Study on Credit Intermediaries in the Internal Market, Final Report by Europe Economics at 108 issued on January 15, 2009)

<sup>10</sup> "As of 2005, about 34% of Americans owned their homes free and clear of any mortgages. Of those with mortgages, about three-quarters have traditional fixed-rate mortgages, and about one-quarter of borrowers have adjustable rate mortgages (about 16% of total homeowners). Most subprime loans were adjustable rate mortgages, thus subprime loans comprise some subset of this 16% of all homeowners." Symposium, *The Law and Economics of Subprime Lending*, 80 U. COLO. L. REV. 1, 3 (2009); Preserving the American Dream: Predatory Lending and Home Foreclosures: Hearing Before the S. Comm. on Banking, Housing and Urban Affairs, 110th Cong. 5 (2007) (written statement of Douglas G. Duncan, Chief Economist, Mortgage Bankers Association), <http://banking.senate.gov/public/files/duncan.pdf>.

<sup>11</sup> Green Paper, *supra* note 3, at 6. See also Commission Staff Working Document Accompanying the White Paper, Impact Assessment, Annex 3: Impact assessment on specific issues ("Impact Assessment Annex 3") at 13. For example, at the end of 2005, institutions representing only 40% of the French mortgage market had subscribed to the voluntary Code of Conduct (which included a form of ESIS to be delivered to borrowers before they entered into the home loan), with even fewer actually implementing it.

<sup>12</sup> Id. at 17-18. Summary of Responses (noting that there was a conflict of interest in the compensation structure and need for greater transparency in disclosing the mortgage brokers' commissions and fees).

<sup>13</sup> Impact Assessment Annex 3, *supra* note 11, at 82. "Tying is particularly prevalent in the European mortgage markets. For example, on average, 39% of new mortgage credits in the EU have current accounts tied to them." Tying is defined as when two or more products are sold together in a package, and at least one of these products is not sold separately. Id. at 81. See, also, White Paper, *supra* note 2, at 5.

<sup>14</sup> Impact Assessment Annex 3, *supra* note 11, at 36 and 39 noting that although mortgage lenders are generally expected to assess the creditworthiness of the consumer in the context of the transaction envisaged, only some Member States require that mortgage lenders assess the creditworthiness of a borrower. The report also noted that when lenders transfer their risks of the borrower defaulting on the home loan through issuing mortgage backed securities or selling the loan portfolio, there is a risk the consumer might be presented with a range of products that is not appropriate for the consumer and that consumers may fail to meet their contractual obligations and thus may eventually lose their home. Id. at 39-40.

borrower's needs and goals),<sup>15</sup> and (v) lack of adequate financial literacy among EU consumers<sup>16</sup> (and information asymmetries) with many borrowers seeking but not receiving adequate advice on the best loan for the consumers' purposes among the variety of loan products being offered to them.<sup>17</sup> In light of these problems,<sup>18</sup> the Commission should have considered consumer protection to be a goal equal in value to the goal of creating a more integrated and efficient EU market. The priority of goals is important because this priority affects the Commission's decision making when it engages in a cost/benefit analysis of different reform options it is considering, including consumer protection measures.

Furthermore, in the White Paper and accompanying impact assessments, the Commission articulated what may in fact be inconsistent goals: "explore ways through which greater product diversity can be combined with strong consumer protection and adequate financial stability."<sup>19</sup> The greater the diversity of loan product available the more difficult it is for a consumer to understand and evaluate the product they have chosen relative to what else is offered and the more difficult to choose the most suitable product for their circumstances.<sup>20</sup> In order to pursue both goals it may be necessary to impose a "suitability" duty on mortgage lenders and intermediaries (a possible measure the Commission considered but has not even tentatively embraced) or to provide for mandatory independent advice (a possible measure the Commission noted but has not even tentatively embraced) before a consumer can choose a home loan product that contains features that are different from a more "standard" form of prudent home loan. The issue of contradictory goals and need for further measures than currently endorsed by the Commission are discussed in Section III.

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<sup>15</sup> See 2009 Study on Credit Intermediaries at iv: "The evidence we have collected suggests that the most significant source of consumer detriment is the recommendation of products that are either unsuitable to the borrower's personal circumstances or else are not price-competitive." The study then stated that the cause for this seemed to be systematic and stemming from the conflict of interest when credit intermediaries are involved and putatively giving expert advice but having an incentive to provide advice that causes the borrower to take the loan so the intermediary can earn her commission. *Id.*

<sup>16</sup> Impact Assessment Annex 3, *supra* note 11, at 29: "Numerous international surveys have demonstrated a low level of understanding of financial matters on the part of consumers. There is also a strong correlation between low levels of functional literacy and the ability to make appropriate financial decisions." *Id.*

<sup>17</sup> For example, it was noted in the Impact Assessment Annex 3 at 37 that 72% of the European consumers surveyed expected financial institutions to give them advice on their home loans but less than half of them trusted the advice given.

<sup>18</sup> It is unfortunate that the Commission was presented with so little data on the extent of these and other potential problems with the functioning of the mortgage market among the Member States from the consumer's perspective. This would have been helpful in a more complete cost/benefit analysis of various reform measures the Commission was considering, with the notable exception of some data collected in the U.K. regarding inadequate consideration of affordability and suitability by lenders in the sub-prime market there that the Commission noted.

<sup>19</sup> White Paper, *supra* note 2, at 4.

<sup>20</sup> See Lussier, D.A. & Olshavsky, R.W. *Task Complexity and Contingent Processing in Brand Choice*, 6 J. CONSUMER RES. 154-165 (1979) [who found that the choices consumers make depends upon the difficulty of deciding between options such that when there are too many options consumers make decisions based upon fewer product attributes; See also Lauren E. Willis, *Decision-Making and the Limits of Disclosure: The Problem of Predatory Lending*, 65 MD. L. REV. 707, 780-81 (2006) [who argued that consumers primarily concentrate on monthly payment when they make home loan decisions and often ignore other important product attributes].

In the next section, this article analyzes the most fundamental reform measure that the Commission indicated that it did preliminarily embrace,<sup>21</sup> that of *mandating* that mortgage lenders and possibly credit intermediaries<sup>22</sup> present to borrowers certain standardized pre-contractual information so the borrower will know the basic terms of the loan being offered and can compare this offer with other loans being offered. Theoretically, if this information were complete and if the information was read and understood by all consumers who then used the information to compare against other loan products in the marketplace, then this information would empower consumers to take out loans that were the most suitable for them (i.e. loans that meet their needs and goals) assuming they have the background information necessary to know what they need and qualify for. For some consumers, then, this mandatory standardized information may be all those consumers need to make sound home loan decisions and to feel confident in their decision-making.<sup>23</sup> However, as will be discussed in the next section, there are numerous cognitive and social psychological phenomena that impede the effectiveness of this pre-contractual information for many consumers.

## II. A Behavioral Economic Analysis of the Revised Mandatory ESIS Preliminarily Embraced by the Commission in the White Paper

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<sup>21</sup> In the Impact Assessment, Annex 3, *supra* note 11, at 28, it compared the various options and concluded that binding legislation mandating the disclosure of certain key pre-contractual information was the best at achieving the goal of providing consumers with the right information at the right time and in particular the only solution to ensure the comparability of the Annual Percentage Rate of Charge. In addition, the Commission initiated as a next step the creation of a revised form of ESIS that would better inform consumers of the loan terms and facilitate price shopping. But as indicated in note 2, *supra*, the Commission in the White Paper was not yet ready to create a Directive with reform measures without first gathering more data and engaging in further consultation with stakeholders. We believe that mandating that ESIS be supplied to consumers before they enter into the loan is a reform that is likely to be included in a Directive because in the Impact Assessment, Annex 3, *supra* note 11, at 23 it noted that a majority of the Member States voiced support for the introduction of binding legislation to supply consumers with ESIS and it noted that the vast majority of Member States also supported the need for a harmonized Annual Percentage Rate of Charge in terms of methodology used to calculate it and the costs included in it (but with a majority supporting a narrow definition of cost).

<sup>22</sup> In the Impact Assessment Annex 3, *supra* note 11, at 24 the report stated: “In principle, credit intermediaries could also be subject to any binding information requirement. However, in the light of the ongoing study, such a decision appears to be premature at this point in time.” Because the study of credit intermediaries published in 2009 indicated among other things that such intermediaries were not providing unbiased advice to borrowers due to a conflict of interest due to their commission based compensation, one would imagine that the Commission would take this into account and apply the binding information requirement to them as well.

<sup>23</sup> Interestingly, consumers in the United States who took out home loans at higher prices than they qualified for had the benefit of standardized pre-contractual information with a uniform APR calculation in the disclosure forms. Notwithstanding the existence of this pre-contractual information, many consumers in the United States failed to use the forms to effectively shop for the best loan they could qualify for due in part to being steered into overpriced loans by mortgage brokers seeking yield spread premiums (D.P. Stark and J.M. Choplin, *A cognitive and social psychological analysis of disclosure laws and call for mortgage counseling to prevent predatory lending*, 16 PSYCHOL. PUB. POL’Y, & L. 90-96 (2010) and who took advantage of consumer cognitive and social psychological vulnerabilities.

Of all the measures considered by the Commission in the White Paper aimed at enhancing consumer confidence in taking out a home loan from a cross-border lender,<sup>24</sup> the most fundamental measure the Commission preliminarily recommended was to create a Directive that would mandate certain pre-contractual information to be provided to borrowers taking out a home loan in the form of a revised standardized form. The mandatory pre-contractual information recommended by the EU Commission is a revised version of the currently voluntary European Standardized Information Sheet (the “Revised ESIS”) tested and reported on in 2009. The purpose of this section is to apply a psychological analysis and critique of the Revised ESIS similar to the analysis and critique that the authors engaged in of U.S. home disclosure forms (hereafter “Psychological Analysis of U.S. Disclosures”).<sup>25</sup>

The Psychological Analysis of U.S. Disclosures article considered 14 psychological phenomena that can create barriers for consumers to reading and comprehending the information presented on disclosure forms and critiqued these forms on the basis of how well they are able to overcome these barriers. The 14 psychological phenomena they considered are described in more detail below and include: 1) consumers’ inability to process user-unfriendly features of disclosure forms, 2) consumers’ lack of contractual schemas or knowledge structures, 3) inaccurate default assumptions of how contractual provisions are likely to be structured and whether the contract is negotiable, 4) availability heuristics, 5) reason-based decision making, 6) biases in attribute estimation and evaluation, 7) confirmation biases, 8) consumers’ acceptance of senseless explanations, 9) argument immunization, 10) sunk cost effects, 11) endowment effects, 12) temporal and uncertainty discounting, 13) strong motivations to trust, and 14) social norms and signals. The underlying psychological reason why many of these phenomena impede consumers’ abilities to read and comprehend disclosure forms is that there is a limit to how much information consumers can process and so they are vulnerable to information overload. At the same time, there is a lot of information that consumers need to know to make sound home-loan decisions, and so consumers rely upon heuristics, cognitive shortcuts, to make these decisions. Our aim in this section is to analyze how well the Revised ESIS is able to overcome the barriers to reading and comprehending presented by these 14 psychological phenomena.

In our judgment, the information presented on the Revised ESIS is overall easier for consumers to understand than the information presented in the U.S. Housing and Urban Development’s HUD-1 disclosure form, Good Faith Estimate of Closing Costs form (“GFE”) and Federal Reserve’s Truth-In-Lending-Act (TILA) form that are currently used in the United States<sup>26</sup> and more comparable with the U.S. Federal Trade

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<sup>24</sup> The Commission noted that this low level of confidence is due in part to the different levels of consumer protection laws in effect among the Member States—hence the need for more uniform consumer protection laws relating to pre-contractual information to be provided to consumers.

<sup>25</sup> Stark, Debra Pogrud & Choplin, Jessica, *A Cognitive and Social Psychological Analysis of Disclosure Laws and Call for Mortgage Counseling to Prevent Predatory Lending*, 16 PSYCHOL. PUB. POL’Y & L. 85 (2010) (hereafter, “Psychological Analysis of U.S. Disclosures”)

<sup>26</sup> The Department of Housing and Urban Development revised the HUD-1 and GFE forms in 2008 to try to make them more user friendly and our comparisons are based on these revised forms. The GFE (a three form) and the TILA (usually a one page document—it is not on a proscribed form yet but must contain certain information and is generally presented in a consistent fashion by lenders) must now be presented to borrowers before they incur any substantial loan costs when applying for a loan and the HUD-1 (a three

Commission's (FTC) proposed form because the Revised ESIS includes short explanations of many line items for consumers who are less sophisticated such as "Loan Description" and "Early Repayment."<sup>27</sup> It therefore does better than its American counterparts on the first psychological phenomenon, consumers' inability to process user-unfriendly features of disclosure forms. Consistent with our assessment, the vast majority of the former and prospective consumers who participated in the qualitative testing of the Revised ESIS form<sup>28</sup> thought that the amount of information presented on the form was not overwhelming<sup>29</sup>, that consumers would not suffer from too much information overload, and that it was largely written in plain language.<sup>30</sup> By contrast, the HUD-1 has language on it that financially less sophisticated consumers may not understand (e.g., origination charge, balloon payment, prepayment penalty) that it does not define. The Revised ESIS form, by contrast, defines much of the language that financially less sophisticated consumers may not understand (such as "repayment home loan" and "recurrent" and "non-recurrent" costs), although it does leave other vitally important terms undefined (such as "nominal interest rate" and "APRC") and it is critical that these terms should also be clearly defined and explained in the Revised ESIS form. We recommend that the costs to be included in the APRC calculation (a matter the Commission is seeking feedback on how to proceed) should be broad based—it should include all costs to obtain the loan—rather than narrowly—based only on direct lender

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page form) is presented to the borrower at the time of the loan closing and includes not only a listing of every charge and fee from any source payable to obtain the loan but also required deposits with the lender for the payment of taxes and insurance and a comparison of the estimated fees and charges with the actual ones at closing (with regulatory limits on the degree to which the actual costs/fees can exceed the estimated figures).

<sup>27</sup> See Psychological Analysis of U.S. Disclosures, *supra* note 25, for a discussion of why the proposed FTC form is easier for financially less sophisticated consumers to follow than HUD-1 and TILA.

<sup>28</sup> The ESIS form, like that GFE and HUD-1 forms used in the United States, was tested using qualitative methods wherein researchers interviewed former and prospective consumers. While this type of testing was useful in exploring some of the weaknesses of the form. There are, however, some problems with this research methodology. For example, the conversational interactions that these researchers had were very different from the conversational interactions that lenders and credit intermediaries have with consumers and these conversational interactions will affect how consumers process the presented information. Eye-tracking technology which allows researchers to follow participants' eye movements as they look over disclosure forms can be used to address these concerns and explore whether consumers look at the right things when they review and when they are led through disclosure forms, whether they spend the most time on important or problematic things, and the degree to which their eyes dilate when they look at problematic terms.

<sup>29</sup> The participants from Belgium were the only exception, see European Commission Directorate-General for Internal Market and Services (2008). Consumer Testing of Possible New Format and Content for the ESIS on Home Loans Final Report, p. 34.

<sup>30</sup> Qualitative testing can be very useful for exploratory purposes in generating hypotheses, but the questions interviewers ask and how they ask them are very different from how lenders or intermediaries typically lead consumers through these forms. To understand how consumers process the information presented in disclosure forms, it will be necessary to understand how intermediaries can facilitate or undermine the ability of consumers to glean information and understand how the loan works. Research in our laboratory is using eye-tracking technology to investigate whether consumers look at the right things on disclosure forms, whether they spend the most time looking at important or problematic things, whether their eyes dilate when they look at problematic terms, and how being led through a disclosure form by an intermediary affects participants' eye movements when they look over a form.



charges, as the lending industry desires, so that consumers can use this figure to better be able to compare the total price of two or more loans.<sup>31</sup>

One important example of how the Revised ESIS is more user-friendly than the American disclosure forms relates to the consumer's right to prepay the loan and what charges, if any, the lender will impose in that circumstance, a critical and often not well understood loan term. The Revised ESIS does a much better job in covering this than the American counterparts. In the Revised ESIS' section on Early Repayment consumers are told in plain language that they have the possibility to repay the loan early and provides an enumeration of the exit charges that the borrower must pay to the lender for an early repayment under a variety of repayment amounts. Although well done, this section of the Revised ESIS could be improved even more to help address psychological phenomenon number 4 (availability heuristics; discussed in more detail below) by presenting in plain language all the conditions that would trigger a non-voluntary early repayment of the loan such as default or the sale of the home (although this has to be balanced with the goal of avoiding information overload). It should be pointed out that although some of the discussion group participants who pretested the Revised ESIS had difficulties with this section, it is much easier for financially less sophisticated consumers to understand than under the forms currently used in the United States. The HUD-1, for example, simply presents the question "Does your loan have a prepayment penalty?" and presents checkboxes for "No" and "Yes" and if "Yes" is checked, it further presents the maximum prepayment penalty. There are several problems with this American approach starting with the fact that financially less sophisticated consumers may not know what a "prepayment penalty" is. They could even confuse it with a penalty for turning in a monthly payment early. Furthermore, presenting the maximum penalty, although valuable in that it disallows lenders from hiding this fee, does not give consumers a sense of the conditions under which prepayment penalties or early repayment fees can be charged as the Revised ESIS form does. The Revised ESIS form does well on this score, although some of the focus group participants who reviewed the ESIS were still confused by this section.

In defense of the Revised ESIS on its disclosure of early repayment charges, it might be pointed out that it is not surprising that consumers have difficulties thinking about all of the scenarios under which early repayment might be possible for them, because they judge the likelihood of events based upon the ease of recalling or imagining such scenarios (a phenomenon called the "availability heuristic," psychological phenomenon number 4, discussed in more detail below) and they might not be able to recall or imagine all of the relevant scenarios. Furthermore, it might turn out that no disclosure form will be able to educate financially less sophisticated consumers about everything they need to know, which is why in Section III we advocate mortgage counseling by independent third parties for financially less sophisticated consumers before they take on very risky loans.

Although in general the Revised ESIS is more user-friendly and helpful to consumers than the American disclosure forms, the Revised ESIS needs to be revised to better alert consumers to how high their monthly payments can rise under an adjustable rate loan as the revised American disclosure forms now do. The Illustrative Repayment

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<sup>31</sup> The Commission has not yet taken a position on whether to calculate the APRC on a broad or a narrow basis.

Table in ESIS is particularly problematic because with only that information consumers have no idea how the actual repayment schedule might differ from the illustrative one and consumers will be unable to determine whether they can afford the loan in the long run. By contrast, the HUD-1 used in the United States specifies the maximum rate and maximum monthly payment amount that the loan can adjust to. The Revised ESIS should be revised to do so as well. Other than this fatal flaw, the demonstration amortization schedule format can be useful for the period before interest rates start to adjust and presenting whether or not the loan is an adjustable rate loan in plain language as ESIS does, rather than checkbox format as the HUD-1 does, might also be a helpful feature.

A strength of the Revised ESIS, that it does not lead to information overload, may, however, be due to the fact that the Revised ESIS form does not include an itemization of all of the costs and charges incident to obtaining the loan and omits certain other information previously noted.<sup>32</sup> The Revised ESIS like the GFE, HUD-1 and TILA forms currently used in the United States presents: the loan amount, the interest rate and the APRC, the duration of the home loan agreement, and the number and frequency of payments. The Revised ESIS does not, however, list a number of fees that are included in the American forms that reflect charges payable to third parties such as: government recording or registration fees for filing the deed and mortgage, real estate broker fees if the loan is for a purchase rather than a refinance, appraisal fees to appraise the value of the home, and flood certification fees to certify that the home is not in a flood plain (perhaps because some or all of these fees do not apply as they do in the U.S.) or charges/fees due to the lender or credit intermediary (such as origination charges or a tax service fee<sup>33</sup> or any fees to a credit intermediary or any other form of compensation they receive for making or arranging the loan beyond the interest rate the lender is charging). Fortunately, there is a location on the Revised ESIS where all additional costs are to be listed and we presume that all of these charges will be included in this section, but this requirement should be made clear in any Directive relating to the imposition of the Revised ESIS so that there will be no hidden fees or charges in connection with obtaining the loan.<sup>34</sup>

While the American forms enumerate and disclose these sorts of commonly imposed lender charges, some of the lender/mortgage broker charges, are not well explained in the American forms. Stark and Choplin (2010) criticized the HUD-1 used in the United States in that the revised forms did not adequately disclose and explain the presence of a “yield spread premium” (an amount that credit intermediaries, mortgage brokers in the United States, receive from lenders for inducing consumers to take out

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<sup>32</sup> The Revised ESIS, as previously noted, also fails to define or explain two key terms of the loan (APRC and nominal interest rate) and fails to adequately disclose the specific impact an adjustable rate loan can have on the borrower’s ability to repay the debt. Perhaps with the inclusion of all of these omitted items the form might lead to information overload. When ESIS was tested, the two places for additional costs (recurrent and non-recurrent) included only two items: insurance and property valuation costs.

<sup>33</sup> It is surprising that there was no mention in the form of origination charges. One possible explanation might be that lenders do not charge them in Europe or it is included in the interest charges or otherwise included in some other charge.

<sup>34</sup> A tax service fee could apply if the lender requires the borrower to deposit with the lender in escrow monies to pay real estate taxes and the lender then charges a fee to make periodic real estate tax payments on the mortgaged property.

higher priced loans than they otherwise would have qualified for)<sup>35</sup> —an especially problematic hidden charge as they create a situation wherein the financial interests of credit intermediaries are contrary to the financial interests of consumers. The lack of transparent disclosure of these charges in the GFE and HUD-1 forms fails to alert consumers to the fact that they are receiving a higher priced loan than they qualified for and fails to clearly depict to what extent, if any, this payment to the mortgage broker was applied by the broker to the borrower's closing costs to reduce such costs.<sup>36</sup> Based upon information in the White Paper it appears that yield spread premiums are not currently used in the European Union Member States as they are in the United States (except in countries like Great Britain which at one time had a sub-prime market), so they are not currently an issue for European consumers who would be relying upon the Revised ESIS for protection. However, if yield spread premiums ever started to be used in the European Union, it should be required that those charges would be listed and explained as evidence of taking on a loan at a higher price than the consumer qualifies for, in the section where all additional costs and fees are to be listed. Such a requirement could cause European consumers to seek out lower cost loans. The counterargument is that yield spread premiums are not a fee or charge that is paid by the borrower, rather they are payments from the lender to the credit intermediary. Consumers nevertheless need to be made aware if any such payments are being made so that they will be better positioned to judge what is in their interests and distinguish between their interests and the credit intermediaries' interests.

In addition, although it does not directly affect the price of a loan, consumers should be made aware in advance whether or not a lender is requiring money to be deposited with the lender in advance for any of the costs of home ownership such as home owner's insurance or property taxes, but there is no place in the Revised ESIS calling for information to be disclosed on "required deposits." Consumers should be made aware of these issues in advance in the Revised ESIS since they might want to shop around for a loan from a lender that will not require the consumer to make these deposits and instead rely on the consumer to make these payments as they become due.<sup>37</sup> Another issue that is a problem at times in the European Union, but is legally prohibited in the United States, is tie-ins wherein lenders require borrowers to accept other services from the lender (e.g., keep a bank account with the lender) which could at times be a hidden cost of taking out a home loan. The requirement for any tie-ins (if still lawful) should be

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<sup>35</sup> It is raised in line 800 of the HUD-1 as part of the "origination charge" and then deducted as a credit in line 801, which is thus no real credit against other closing costs.

<sup>36</sup> See, note 9, *supra*, which indicated that only 7 cents per dollar of YSP was applied to the borrower's closing costs according to one study.

<sup>37</sup> The required deposits tie up the consumer's money without the consumer receiving interest on the funds deposited and if the lender fails to make payment of taxes and insurance the consumer will have to expend time and effort to correct this. While required deposits should be noted in the Revised ESIS, we do not recommend that it be included in the calculation of total closing charges as in the HUD-1 since we believe that the HUD-1's treatment makes it difficult to easily compare true closing charges among more than one loan when some lenders require deposits and others do not. The deposits are not true closing charges to obtain a loan because the consumer will need to pay real estate taxes or insurance (two typical deposit requirements) as an owner of real estate even if the lender does not seek a deposit for this. It is an expense either way.

included and detailed in the Revised ESIS since the costs of these services should be factored into the price of the home loan and used for comparison shopping purposes.

In summary, the Revised ESIS is a critical first step to empowering consumers to make sound home loan decisions because it creates a relatively well-designed mandatory uniform information statement which would include a standardized annual percentage rate charge (“APRC”) calculated in a uniform fashion among the Member States and would be provided before the consumer enters into the loan. It is a necessary condition *and* essential to the Commission’s goal of enhancing consumer confidence to take out a cross-border home loan so that comparison-shopping can take place. Assuming that the Revised ESIS is filled in and revised as recommended in this Section II, it will allow consumers (at least those with a minimum level of prior financial literacy) to have the essential information necessary to compare a loan from a lender in one Member State with a loan from a lender in another Member State in a side-by-side fashion. The Revised ESIS with the changes we recommend would create a physical schema (psychological phenomenon number 2 discussed below) for the loan terms that will enhance consumer financial literacy and better enable EU consumers to compare loans from across the entire EU.

Although the Revised ESIS disclosure form does a good job of balancing the goal of providing all of the information the borrower needs with the goal of being user-friendly and not information overload, there are a number of psychological barriers to sound home loan decision making even with the best of forms. The remainder of this Section II will focus on these psychological barriers.

Even the best of information forms leave financially less sophisticated consumers who have not yet learned essential home-loan contract schemas vulnerable. Some unsophisticated consumers will still lack the background knowledge they need to comprehend how loans work (psychological phenomenon number 2) and might need to be further educated about how home loans work before they can make sound decisions when taking out such a loan.<sup>38</sup> Furthermore, some consumers will have inaccurate assumptions of how loans are structured (psychological phenomenon number 3), perhaps because they have successfully taken out loans in the past and assume that the current loan is structured the same as previous loans. These false default assumptions may cause consumers to pay less attention to the disclosure form. Other consumers may incorrectly

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<sup>38</sup> While financial literacy programs during elementary and secondary school are helpful and necessary, financial educators have noted that individuals are most receptive to learning when they are most in need of the information provided. Consequently, consumers can potentially learn the most if they receive important background information at the time they are in the process of seeking a home loan through such information in the disclosure forms themselves or through a one-on-one session with a mortgage counselor. See, Barbara O’Neill, The John Marshall Law School Symposium, *Avoiding Predatory Loans: Is Financial Education the Solution?* (May 18, 2003) (outline on file with author) (emphasizing that the best learning is not in the classroom but at “teachable moments,” such as when a person is in financial distress, through “active” learning [learning by doing], learning from experience, and one on one learning).

assume that mortgage loans are contracts of adhesion and cannot be negotiated<sup>39</sup> leaving them with no reason to comparison shop to find the best loan.<sup>40</sup>

As mentioned above in the discussion of the Early Repayment section, consumers may also misjudge the likelihood of events related to the loan (e.g., that they will need to sell the house or otherwise be in a position to repay the loan early, that the loan payments will adjust, or that they will encounter financial difficulties), because people judge how likely events are based upon how easily such circumstances come to mind (a phenomenon called the “availability heuristic”<sup>41</sup>; psychological phenomenon number 4). Even though the ESIS may indicate that the loan is an adjustable rate loan, for example, the consumer may not accurately evaluate the likelihood of a large adjustment upward.

Because the amount of information that consumers need to process when they review disclosure forms exceeds their working memory capacity, people often try to simplify their decision by finding a single reason or justification for making a choice at the expense of all other features of the home loan.<sup>42</sup> This phenomenon is called reason-based decision-making (psychological phenomenon number 5). In the case of home loans, the single reason or justification is often that the initial monthly payment was affordable.<sup>43</sup> They then ignore or give relatively little weight to the other features of the loan. This strategy for making a choice can cause consumers to neglect problematic features of the loan even if they are listed on the disclosure form.

Just because a value is presented on a disclosure form does not mean that people will understand what that value means.<sup>44</sup> In fact, cognitive psychologists have identified many factors that can bias people’s evaluation, comprehension, and estimation of attribute values (psychological phenomenon number 6). One such factor is the status quo or default value bias under which consumers may accept disadvantageous terms if they have gotten used to them (such as a prior high interest rate loan).<sup>45</sup> Another factor is framing effects under which the way a term is described will affect how people evaluate it. For example, if a lender or credit intermediary were to say “in the first few years of your loan, the proportion of your monthly payment paying for interest is higher than it will be later on,” doing so would present the early proportion paying for interest as a loss to the consumer notwithstanding any tax benefits. By contrast, saying “after the first few years of your loan, the proportion of your monthly payment paying for interest is lower

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<sup>39</sup> See, e.g., James P. Nehf, *European Fair Trading Law: The Unfair Commercial Practices Directive*, 35 Int’l J. Legal Info. 305 (2007) (book review). (author noted “Most consumer transactions result in contracts of adhesion where all but the most basic terms are neither read by the consumer nor negotiable” after discussing the widely criticized “consent model” of contracts as not reflecting what happens in a typical merchant-consumer transaction).

<sup>40</sup> H. Beales, M.B. Mazis, S.C. Salop, & R. Staelin, *Consumer Search and Public Policy*, 8 J. CONSUMER RES., 11-22. (1981).

<sup>41</sup> A. Tversky & D. Kahneman, *Availability: A Heuristic for Judging Frequency and Probability*, 4 COGNITIVE PSYCHOL. 207-232 (1980).

<sup>42</sup> Eldar Shafir, Itamar Simonson, & Amos Tversky, *Reason-Based Choice*, 49 COGNITION 11-36 (1993).

<sup>43</sup> Lauren E. Willis, *Decision-Making and the Limits of Disclosure: The Problem of Predatory Lending*, 65 MD. L. REV. 707, 780-81 (2006).

<sup>44</sup> Hsee, C.K., *The Evaluability Hypothesis: An Explanation For Preference Reversals Between Joint and Separate Evaluation of Alternatives*, 67 Organizational Behavior and Human Decision Processes 247-257 (1996).

<sup>45</sup> H. Helson, *Adaptation-Level Theory*, N.Y. HARPER & ROW (1964); D. Kahneman & A. Tversky, *Prospect Theory: An Analysis of Decision Under Risk*. 47 ECONOMETRICA 263-291 (1979).

than at the start,” doing so would present the later portion as a gain to the consumer.<sup>46</sup> Yet another factor is range effects under which an unreasonable term will look less unreasonable, if even more unreasonable terms have been offered (such as the mortgage broker or lender telling the consumer that another lender would require six months of interest for early repayment but this lender is only requiring five).<sup>47</sup> The range effect can be enhanced by frequency effects under which presenting numerous decoy values above or below the to-be-evaluated term will make an unreasonable term look even less unreasonable<sup>48</sup> (such as the preceding example but where the lender or credit intermediary gives examples of what several other banks would charge which are all higher than what this bank will charge). Still another factor is verbal comparisons under which language-based comparisons (such as “the interest rate we are offering you is better than the interest rate other lenders would offer you”) to other terms can affect how reasonable the to-be-evaluated term is judged (that is, make the interest rate they are offering seem more reasonable).<sup>49</sup> Finally, anchoring effects can affect estimates of unknown values. Under these effects, a person hears an arbitrary number and the consumer’s estimate of the number they are estimating will be biased towards the arbitrary number. For example, if they hear that the average probability of needing to repay a loan early is 2%, their estimate of their own probability will be biased toward this number even if in actuality it is much higher than this<sup>50</sup>. These biases may prevent consumers from understanding how problematic home-loan terms are even if they see those terms presented on the disclosure form and succeed in reading the form.

One problem that the Commission, like their American counterparts, failed to take into account is how the manner in which the Revised ESIS is presented to consumers by lenders or credit intermediaries can impede its usefulness. This issue is particularly relevant for psychological phenomena 7 (confirmation bias), 8 (acceptance of senseless explanations), and 9 (argument immunization). The tendency to test whether lenders and credit intermediaries are telling the truth by looking for information that would confirm what they say, rather than looking for information that would disconfirm what they say is called a confirmation bias (psychological phenomenon number 7). This phenomenon has been demonstrated in many cognitive psychological studies.<sup>51</sup> Consumers may, therefore, look over the ESIS looking for information that confirms what lenders and credit intermediaries told them about the loan, rather than look over the ESIS form looking for information that would disconfirm what the intermediaries told them. They might look at

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<sup>46</sup> Amos Tversky and Daniel Kahneman, *The Framing of Decisions and the Psychology of Choice*, 211 SCIENCE, 453–58 (Jan. 1981).

<sup>47</sup> The range is the highest and lowest values that the consumer has seen. Volkmann, J. (1951). Scales of judgment and their implications for social psychology. In J. H. Roherer & M. Sherif (Eds.), *Social Psychology at the Crossroads*, New York: Harper & Row, 279-294; A. Parducci, *Category Judgments: A Range-Frequency Model*, 72 PSYCHOL. REV. 407–418 (1965).

<sup>48</sup> A. Parducci, *Category Judgments: A Range-Frequency Model*, 72 PSYCHOL. REV. 407–418 (1965).

<sup>49</sup> Choplin, J. M. & Hummel, J. E. *Magnitude Comparisons Distort Mental Representations of Magnitude*, 131 J. EXPERIMENTAL PSYCHOL.: GEN. 270-286 (2002); Choplin, J. M. & Hummel, J. E. *Comparison-Induced Decoy Effects*, 33 Memory & Cognition 332-343 (2005).

<sup>50</sup> A. Tversky & D. Kahneman, *Judgment Under Uncertainty: Heuristics and Biases*, 185 SCIENCE 1124–1130 (1974).

<sup>51</sup> P.C. Wason, *On the Failure to Eliminate Hypotheses in a Conceptual Task*, 12 Q.J. OF EXPERIMENTAL PSYCHOL. 129–140 (1960); J. Klayman and Y.W. Ha, *Confirmation, Disconfirmation, and Information in Hypothesis Testing*, 94 PSYCHOL. REV. 211–228 (1987).

the repayment schedule presented in Section 7 to confirm that the initial monthly payment quoted to them by the intermediary is accurate, but fail to look to see the degree to which the loan adjusts and the maximum to which it could adjust even if the ESIS form repeatedly says that it does, indeed adjust.

Consumers will often accept senseless explanations—even if these explanations have no bearing on reality—as long as the syntax of an explanation is provided (psychological phenomenon number 8)<sup>52</sup>, so even if a consumer discovers a problematic term in the ESIS unscrupulous lenders or intermediaries may be able to explain it away and make it appear as if it is not problematic when it really is. For example, if a consumer was told previously that the loan would be at a fixed rate, but then discovers on the ESIS form that it will adjust after 5 years, an unscrupulous lender or intermediary might explain the consumer's concern away by saying something senseless such as, "Five years at a fixed rate is a 'fixed rate loan,' it has to adjust after that point because market interest rates will be sure to adjust by that time likely downward." Consumers have been shown to be vulnerable not only to plausible explanations but even implausible responses to questions that take on the syntax of an explanation.<sup>53</sup>

Likewise, unscrupulous intermediaries may be able to preempt the discovery of a problematic term using a phenomenon called argument immunization (psychological phenomenon number 9)<sup>54</sup> under which they might give consumers a sense that something could be 'misinterpreted' and then immediately demonstrate that such an interpretation would be inaccurate. After that, consumers will be less likely to believe the so-called 'misinterpretation' even if that interpretation would have been the accurate one and the ESIS makes it patently obvious. For example, an unscrupulous intermediary might immunize consumers against discovering how problematic early repayment fees are when they read the EISIS form by telling them before they ever see the form that there are certain provisions in the form that only apply to rich people such as the early repayment section. A consumer might then skip over this section when they read over the ESIS form on the assumption that it does not apply to them.

Because even the best loan information forms can not prevent many consumers from being induced to make unwise home loan decisions when lenders and intermediaries take advantage of these three psychological phenomena—number 7 (confirmation bias), 8 (acceptance of senseless explanations), and 9 (argument immunization)—we argue in Section III that additional protections should be provided to consumers such as imposing duties of suitability on the mortgage lender and intermediary or requiring advice from an independent third party, especially when the borrower is entering into a non-standard

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<sup>52</sup> E. J. Langer, A. Blank & B. Chanowitz (1978). *The Mindlessness of Ostensibly Thoughtful Action: The Role of "Placebic" Information in Interpersonal Interaction*. 36 J. PERSONALITY & SOC. PSYCHOL. 635-642. Investigated the effectiveness of explanations in getting people to comply to requests in an experiment in which the experimenter asked to butt in line to make photocopies. They found that even senseless explanations (*i.e.*, "May I use the Xerox machine, because I have to make copies?") was effective in getting compliance.

<sup>53</sup> See, Choplin and Stark (2010) (on file with authors). "An Empirical Investigation of Consumer Deception Through Explanation Scripts: Legal & Policy Implications"

<sup>54</sup> W.J. McGuire, *Resistance to Persuasion Conferred by Active and Passive Prior Refutation of the Same and Alternative Counterarguments*, 63 J. OF ABNORMAL & SOCIAL PSYCHOL. 326-332 (1961); W.J. McGuire & D. Papageorgias, *The Relative Efficacy of Various Types of Prior Belief-Defense in Producing Immunity Against Persuasion*. 62 J. ABNORMAL & SOC. PSYCHOL. 327-337 (1961).

loan product or a risky loan product.<sup>55</sup> These recommendations would also help consumers overcome the instances of information overload represented by the first 6 psychological phenomena.

Due to the influence of a phenomenon called “sunk costs” (psychological phenomenon number 10; under which consumers are willing to sink more resources toward attaining a goal after they have already spent some resources toward attaining that goal than they would have originally been willing to spend)<sup>56</sup>, one key feature in determining how effective the Revised ESIS form is likely to be is the timing of when the form is required to be presented to the consumer. The Commission has failed to specify precisely when the Revised ESIS should be provided to the consumer but did indicate that the consumer should receive the Revised ESIS so the consumer can do comparison shopping of the loan and often refers to the disclosure form as “pre-contractual information,” leading one to conclude that the form would be required to be delivered to the borrower some time before the consumer has committed to the loan.<sup>57</sup> The “sunk costs” phenomenon suggests that the form should be presented to consumers early, certainly before consumers sink financial resources into pursuing the loan and preferably before they sink time and effort.<sup>58</sup>

However, even that might not be early enough due to the influence of a phenomenon called “endowment effects” (psychological phenomenon number 11) under which consumers will start overvaluing things—such as a home—that they have started to think of as their own and will then be willing to spend much more than they would have originally been willing to spend so as to avoid losing what they consider to be theirs).<sup>59</sup> This phenomenon will make consumers over value the home and under value the costs and risks associated with the loan to purchase the home. These effects can start to kick in as soon as consumers have started to think about the house as if it belongs to them and started to imagine what their daily lives will be like when they live in the house. Once consumers feel as if the house belongs to them, then owning the house will seem the status quo, losing it will seem as if it is a loss, and consumers will over value the home and under value the costs and risks associated with the loan to purchase the home.

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<sup>55</sup> Among the additional measures we recommend in Section III is for the Commission to create, after consultation with the mortgage lending industry, consumer representatives, and other stakeholders, a risk based classification of loan products and a standard form of prudent home loan.

<sup>56</sup> H.R. Arkes & C. Blumer, *The Psychology of Sunk Cost*, 35 *ORG. BEHAV. AND HUM. DECISION PROCESSES* 124–140 (1985); H.R. Arkes & L. Hutzler, *The Role of Probability of Success Estimates in the Sunk Cost Effect*, 13 *ORG. BEHAV. AND HUM. DECISION PROCESSES* 295–306 (2000).

<sup>57</sup> See White Paper, *supra* note 2, at 6. The Commission also stated, however, that the information should be provided “sufficiently before the conclusion of the contract” which is a bit confusing since it would make more sense to say before “entering into the contract.”

<sup>58</sup> In the United States, there are two stages in the process of applying for and obtaining home loans at which lenders are required to disclose loan terms. The first stage is early in the application process, at which time lenders are required to give consumers two disclosure forms: the Good Faith Estimate (GFE) and the TILA disclosure form. At the time that the loan is funded, consumers receive the HUD-1 disclosure form showing actual closing costs—which now include comparisons with the estimated charges in the GFE and laws that prohibit increases in these figures beyond certain tolerances. It appears that there is not a second stage disclosure contemplated for the EU and just the Revised ESIS at the front end of the home loan process which we assume—but the Directive should clarify—will not change at the time of the funding of the loan.

<sup>59</sup> D. Kahneman, J.L. Knetsch & R.H. Thaler, *Experimental Tests of the Endowment Effect and the Cause Theorem*, 98 *J. POLIT. ECON.* 1325–1348 (1990).



Therefore we recommend that consumers should receive the ESIS Statement as early in the process of purchasing the home as possible.

Consumers also have a tendency to ignore or discount delayed and uncertain charges (called temporal and uncertainty discounting; psychological phenomenon number 12)<sup>60</sup>, so consumers will not be dissuaded by costs and fees that they will not have to pay for a while even if those costs and fees are problematic. They might not worry about a loan that has a fixed rate for the first 5 years, but then adjusts afterwards, for example, because 5 years seems like it is so distant in the future. They, likewise, might not worry about early repayment fees, because the probability of early repayment seems low and would be in the distant future anyway.

Consumers also have a tendency to trust lenders and credit intermediaries on whom they are dependent (psychological phenomenon number 13).<sup>61</sup> The reason for this misplaced trust seems to stem from a reciprocity effect.<sup>62</sup> Consumers trust the lenders and credit intermediaries who are “giving” them loans, because these lenders and credit intermediaries give the consumers the impression that they “trust” the consumers to pay back the loans. The framing of loans as “gifts” may be partially responsible for this effect. Lenders and credit intermediaries are not “selling” loans or “putting loans on the market” and consumers are not “buying” loans; rather lenders and credit intermediaries are “giving” loans and consumers are “taking” loans. Since the lenders and credit intermediaries are being so kind as to give a loan and trust the consumer, it is incumbent upon consumers to trust those lenders and credit intermediaries who trust them by trusting them back in return. This reciprocity rule may be particularly strong among consumers who are given lower status in society (i.e., people with low socio-economic status, ethnic minorities, young people, and women) who are likely to distrust only if they fear an unequal outcome.<sup>63</sup> A simple form such as the ESIS cannot correct this false framing of a reciprocal relationship.

Furthermore, no matter how good a disclosure form may be, consumers will be vulnerable to social norms and signals that communicate that it is not necessary to carefully read the ESIS form (psychological phenomenon number 14). Consumers commonly sign documents when prompted to do so. The representative presenting the form simply tells them, “sign here,” pointing to the line where they are to sign, and they sign.<sup>64</sup> They do so, in part, in response to the social signal that they are expected to sign. Other examples of how the social situation can signal that people are expected to sign include the fact that title companies in the United States usually only schedule 1-2 hours for a home loan closing (much of that time devoted to simply waiting for the lender to authorize funding), yet it would take many more hours to actually read through the combined acquisition and loan documents.<sup>65</sup> Similarly, European consumers may accept

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<sup>60</sup> S.J. Estle, L. Green, J. Myerson, D.D. Holt, *Differential Effects of Amount on Temporal and Probability Discounting of Gains and Losses*, 34 MEMORY & COGNITION 914–928 (2006).

<sup>61</sup> Weber, J.M., Malhotra, D., Murnighan, J.K., *Normal Acts of Irrational Trust: Motivated Attributions and the Trust Development Process*, Research in Organizational Behavior, 26, 75-101 (2005).

<sup>62</sup> See R.B. CIALDINI, INFLUENCE: THE PSYCHOLOGY OF PERSUASION, ch. 2 (HarperCollins 1984) (2007).

<sup>63</sup> See Hong, K. & Bohnet, I., *Status and Distrust: The Relevance of Inequality and Betrayal Aversion*, J. ECON. PSYCHOL., 28, 197-213 (2007).

<sup>64</sup> Debra Pogrund Stark, & Jessica M. Choplin, *A License to Deceive: Enforcing Contractual Myths Despite Consumer Psychological Realities*, 5 N.Y.U. J. L. & BUS. 617-744 (2009).

<sup>65</sup> It took a research assistant of one co-author, who happened to be a mortgage broker, over two hours just

the terms of home loans without reading the ESIS carefully simply because social norms and signals communicate that they are expected to do so. Stark and Choplin (2009) found this affect among study participants in the U.S. but we have not yet studied how participants among the various Member States may behave.

While psychological barriers 10 and 11 relating to sunk costs and the endowment effect are very difficult to overcome, the additional reforms we propose in Section III should help to some extent and the proposed reforms should be highly effective in addressing barriers 12-14 (temporal and certainty discounting, misplaced trust, and social norms not to carefully read before signing) as well as the information overload type barriers 1-9. We discuss how the reforms proposed can address all fourteen psychological barriers in Section III.

Thus while mandating the revised ESIS including a uniformly calculated APRC is a critical first step to empowering consumers, the 14 psychological barriers presented above suggest that doing so is inadequate and needs to be supplemented with other consumer protection measures. One additional measure that the Commission did appear to endorse further action on related to whether the borrower has the ability to repay the debt (i.e. whether the borrower was “creditworthy”). The Commission indicated that it favored mandating that lenders (and possibly intermediaries as well) determine the creditworthiness of a borrower before offering the loan to the borrower) and the creation of advice standards that have to be met if advice is given.<sup>66</sup> However, the Commission did not embrace other measures (the first three of which they noted as possible reforms): (i) creating risk guidelines for home loans, (ii) imposing a duty on lenders and mortgage brokers to ensure that the loan was suitable, (iv) requiring mandatory advice on home loans, and (iv) creating a standard form of home loan product. These reform ideas, modified to address some of the concerns about them noted by the Commission and modified to take into account the psychological phenomena noted in Section II, are discussed in detail in Section III.

### III. Consumer Protection Measures that the Commission Should Reconsider and Include in its Directive

Due to the cognitive and social psychological barriers discussed in Section II, we recommend the Commission endorse and begin the process of developing four additional reform measures for a future Directive on the residential mortgage market in the EU.

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to speed-read through the loan documents that included terms even he did not understand nor did he pause to ponder in that time frame. *See* Psychological Analysis of U.S. Disclosures, *supra* note 25 at \_\_\_\_\_. *See*, also, *Castellana v. Conyers Toyota, Inc.*, 407 S.E.2d 64, 64 (Ga. App. 1991) (noting that it took the consumer two hours and forty-five minutes to read the acquisition and finance documents in the context of the purchase of an automobile).

<sup>66</sup> *See*, Impact Assessment Annex 3, *supra* note 11, at 36 and 44 where it is stated under objectives: “it should be ensured that: mortgage lenders, and intermediaries where appropriate, sufficiently assess the creditworthiness of a borrower; consumers have access to objective advice which is based on the profile of the customer and commensurate with the complexity of the products and the risks involved.” And then identified legislation obliging mortgage lenders to assess consumer creditworthiness (option 4) along with developing high level standards for the provision of advice obliging Member States to ensure that if advice is provided it is done so according to those standards. (option 4.3) as the best option to meet those objectives. Impact Assessment Annex 3, *supra* note 11, at 54.

The first such measure would be mandating the creation of a “risk-based classification” (from the borrower’s perspective) of the loan products being offered in the EU market.<sup>67</sup> The Commission had sought feedback on, among other things, the creation of “risk guidelines” and on encouraging responsible borrowing. The Financial sector trade unions suggested establishing a risk classification of credit products to help guide the borrowing decision,<sup>68</sup> which would, in our minds, be more helpful to consumers than would the creation only of “risk guidelines.” Presenting consumers with a set of guidelines on the riskiness of different loan features could very well lead to information overload as some consumer advocates asserted.<sup>69</sup> However, the creation of a risk-based classification of loan products is different; the consumer would receive a simple “rating” of how safe or risky is the loan being offered to them through the following types of classifications: “1. Very Safe”, “2. Safe”, “3. Risky” and “4. Very Risky”). This rating system should be highly useful to consumers to overcome the various cognitive barriers to decision making previously discussed. It would help overcome psychological phenomenon number 1, consumers’ inability to process user-unfriendly features of disclosure forms, in that this single classification would summarize other features and thereby lessen cognitive overload. It would help overcome psychological phenomenon number 2, consumers’ lack of contractual schemas or knowledge structures, in that even if consumers are unable to make a judgment regarding how risky a loan is due to lack of knowledge on their part, they will nevertheless, understand these classifications. It might help to overcome psychological phenomenon number 5, reason-based decision making, if this feature would receive enough weight so that monthly payment is not the only feature of the loan that they consider. It would most likely also help psychological phenomenon number 6, biases in attribute estimation and evaluation, since this classification would summarize a variety of other features, which then would not require separate evaluations of each one to come to a judgment about the loan as a whole. The main psychological phenomenon it would help overcome, however, is number 4, availability heuristics, this classification would allow a judgment of probability without requiring consumers to imagine possible scenarios of which they are not aware. Unfortunately, this classification system would still leave consumers vulnerable to psychological phenomenon number 8, acceptance of senseless explanations, and number 9, argument immunization, as long as lenders and credit intermediaries could find a way to explain away the classification.

Although a loan product that is rated “Risky” or “Very Risky” might make sense for some consumers in light of their particular circumstances, it puts every consumer on notice that for many consumers this loan product would not be appropriate and the consumer should obtain independent advice from a trained mortgage counselor before entering into this loan product. For example, if a loan accrues interest at a floating rate with no cap on how high the rate can rise, this would be a very risky home loan for most consumers because rates could rise above what the borrower can afford. However, if the borrower is very wealthy, and large increases in the interest rate will not make the loan unaffordable to this borrower, this consumer may desire to take on this risk and gamble that rates will stay low and she will benefit from having taken on a lower adjustable rate

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<sup>67</sup> This possibility was raised in the Summary of Responses to the Public Consultation on Responsible Lending and Borrowing in the EU issued on November 30, 2009 (the “Summary of Responses”) at 13.

<sup>68</sup> Summary of Responses, *supra* note 67, at 13.

<sup>69</sup> Summary of Responses, *supra* note 67, at 6.

loan compared with the interest rate she would pay under a fixed rate loan. A second example of a loan that would be risky for a typical homeowner, but not all consumers, is one where very little or no amount of principal is being paid during the term of the loan (i.e. an interest only loan) and when the loan matures there is a large balloon payment of principal due. This is risky if at the time the loan matures the mortgage market has changed and become more difficult to obtain a loan. If the borrower does not qualify for a new loan to pay off the old one, the borrower will have to sell the home to be able to repay the debt, unless the borrower is wealthy and has other assets/income to use to pay off this debt. A more prudent loan would be a “fully-amortizing” loan where enough principal is being paid each month with the accrued interest so that when the loan matures and becomes due, there is no additional principal owed at that time.

If creation of risk-based classifications of the loan products being offered in the EU market is adopted as part of the Directive, then once the list and classifications are created, the ESIS should conspicuously disclose this information on the offered loan product with a recommendation to obtain independent advice when the loan offered is a high risk home loan product. The existence of this risk based classification would also further the Commission’s goal of creating a more integrated EU market offering more diverse loan products, because consumers will feel more confident to take on a home loan from a cross-border lender if that loan is rated with a low level of risk by an independent body such as the Commission. In addition, by learning about the different types of home loan products being offered among the Member States, the Commission can better gauge the risks to consumers based on the types of home loans being marketed to them and can then better assess whether to impose a suitability duty on mortgage brokers and whether and under what circumstances borrowers should be mandated to receive advice before taking on certain home loans.

The main disadvantage to creating a risk based classification of home loan products and the disclosure in the ESIS of the offered loan’s classification relates to the costs and difficulties of creating it which will require: (i) identifying the different home loan products available among the Member States and periodically updating that list, and (ii) determining the risk-classifications to be awarded to the different types of home loan products being offered (we recommend that the Commission take on this task after consultation with the stakeholders involved). The Commission should engage in a detailed estimate of costs to create this classification reform measure. While we have not undertaken this detailed cost analysis, we do foresee long term benefits from the creation of this classification system in terms of the Commission’s articulated goals of enhancing consumer protection and consumer confidence in taking on home loan products offered by cross-border lenders and the Commission should take these long term benefits fully into account when engaging in a cost-benefit analysis in light of their articulated goals.

It should also be noted that there is a second possible disadvantage of creating a risk classification for home loans but this potential problem can be addressed. A loan might be rated as risky and dissuade some consumers from taking on the loan even though under a particular borrower’s circumstances the loan would not be so risky. Indeed some members of the non-financial services industry who commented on the creation of risk guidelines pointed out that risks depend on the financial circumstances of the individual so guidelines are not so useful and could overstate or understate risks.<sup>70</sup> To mitigate this

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<sup>70</sup> Summary of Responses, *supra* note 67, at 7.

possibility, the disclosure in the ESIS can note this possibility and indicate that the consumer should receive advice from an independent<sup>71</sup> mortgage counselor to see if the loan product offered to them would be too risky or would be appropriate for the specific consumer. Some of the members of the non-financial services industry also raised the possibility that in reaction to the risk based guidelines lenders could make their products to fit the risk guidelines. This would actually be a good thing, though, since only low cost loans that are prudent would be able to fit in the lowest rated risk based classification.

The financial services industry federations were skeptical about the idea of risk guidelines and the possibility of establishing a set of harmonised guidelines and generally stated that there was no need for additional risk warnings when the other pre-contractual information is clear and comprehensible, when there are already obligations under the Consumer Credit Directive to provide “adequate explanations” and when most Member States already have a self-regulatory system in place to mention risks to consumers.<sup>72</sup> Thus, in their view, the costs of creating the guidelines exceeded the benefits. However, the points raised by those in the financial services industry are not very persuasive. First, based on data reported by the Commission, many consumers complain that the current pre-contractual information is not clear and comprehensible<sup>73</sup> hence there is a need for this information. Second, providing this additional information would assist consumers to overcome some of the cognitive limitations with which they struggle. It would provide an important benefit to consumers who typically suffer from information asymmetries where they know much less about loan terms, available alternatives, and risks that different terms pose than those who are selling them the loans. The consumers would not have to wade through long and detailed guidelines, but instead, under our proposal, the consumer would be given a rating of the loan product offered to them in terms of how risky it is on a number scale. Third, the Consumer Credit Directive the lenders wish to rely upon does not apply to home loans and even if it did it is highly unlikely that the easy to comprehend information from a risk-based classification would provide to consumers would already be provided under the concept of “adequate information” under that Directive. Fourth, if self-regulation has not even worked in the context of providing the voluntary ESIS, it is highly unlikely it will be effective in this context where mortgage lenders and intermediaries would be asked to voluntarily explain the risks of a home loan product they are offering which might be against their self-interest in terms of adding time to the loan process or causing a consumer to reject the product being offered to them.

While Member States who responded to the reform idea of creating risk guidelines viewed the risk guidelines in a positive light, they also mentioned the difficulties involved in imposing them on the industry and questioned who should develop these guidelines.<sup>74</sup> As previously explained, the risk based classifications of loan products we

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<sup>71</sup> It is very important that the advisor not be the lender, the mortgage broker or anyone else with an interest in the consumer taking out the loan proposed to avoid the problem of the advice being influenced by this interest. This issue is discussed in greater detail in the section discussing the fourth additional measure proposed in this article.

<sup>72</sup> Summary of Responses, *supra* note 67, at 6.

<sup>73</sup> See, Impact Assessment Annex 3, *supra* note 11, at 15: “According to a Eurobarometer survey from 2005, 59% of EU citizens surveyed felt that it was difficult to understand the information given by financial institutions about the way their mortgages work and the risks involved.”

<sup>74</sup> *Id.* at 7.

propose are an important supplement to the revised ESIS and should be less difficult to impose on the industry than mandating the ESIS itself since there is no heightened burden on lenders and credit intermediaries with the creation by the Commission of the classification system. To avoid conflicts of interest, the Commission itself (rather than the entities in the financial services market) should, with input from the various stakeholders, create the list of home loan products being offered in the EU market and then classify each of these products in terms of level of risk based on criteria similar to the features discussed below for an “approved standard form of prudent home loan product.”

The second measure that we recommend is strongly connected to the first measure. We recommend that the Commission create an “approved standard form of prudent home loan product” that consumers could feel confident taking because in order to qualify for this designation the loan must be a highly prudent and low cost loan. The Commission should consult with the various stakeholders as to the features that would make the loan qualify for this status (it would receive the lowest risk ranking) with the final decision on these features to be determined by the Commission.<sup>75</sup> The advantage of creating a Commission approved standard form of prudent home loan product is that if a loan complies and fits within the definition this would be conspicuously noted on the ESIS and a consumer could feel very confident that they have taken on a prudent and low cost home loan. Conversely, if not on the approved standard form of home loan product, this should also be conspicuously noted on the ESIS with a warning that the consumer should seek independent advice on if the loan being offered is truly in the borrower’s best interests. Doing so would help address psychological phenomenon number 2, consumers’ lack of contractual schemas or knowledge structures, since having a standard form of prudent home loan product would facilitate learning of home-loan schemas and all alternative loans that differ from the standard could more easily be compared to the standard. It would also help overcome psychological phenomenon number 3, inaccurate default assumptions of how contractual provisions are likely to be structured, since the new standard would create a default and differences from this default would be noticeable. The standards for a loan to qualify as an approved standard form of home loan should be set high in terms of protection to consumers since there is no prohibition to lenders making loans not on the standard form and the extent of the variation from the standard form can be noted in the risk classification. By creating an “approved standard form of prudent home loan product” and a risk classification designation for each loan offered, consumers are more likely to take on a prudent home loan from a source outside of their borders, thus promoting the Commission goals of integrating the EU home mortgage market and enhancing consumer protection.<sup>76</sup>

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<sup>75</sup> Based on the inability of the representatives from the lending industry and consumer representatives to come to agreement on matters like how the APRC should be calculated it is highly unlikely those groups will be able to come to agreement on the features of the approved standard form of home loan that is prudent and low cost.

<sup>76</sup> The existence of the proposed standard form of approved home loan product is also likely to induce many lenders and credit intermediaries to offer this type of low cost and highly prudent loan to the benefit of consumers in light of the proposed interaction of this form of loan with the third (imposing a duty to only offer suitable home loan products for the consumer and fourth reform (mandating independent financial advice for loans rates as “very risky”) measures proposed later in this section since if on the approved standard form of prudent home loan suitability is presumed and advice is not required. Another

In determining the features that would make a home loan product prudent from the borrower's perspective, we recommend that the "approved standard form of prudent home loan product" should include the following seven factors. First, the loan would either be at an "affordable"<sup>77</sup> fixed interest rate for the entire term of the loan or an adjustable rate loan with a cap on the interest rate increases to a level that the borrower could afford based on the debt to income ratio at the time the loan is being made.<sup>78</sup> Second, the loan would be a fully amortizing loan as discussed above so that if the mortgage market has tightened or interest rates have risen significantly and the borrower could not qualify for a new loan when the loan matured the borrower would not be in default and lose her home. Third, the interest rate of the loan would not exceed the average interest rate charged by lenders for a comparably risky home loan to ensure that one of the key components of the price of the loan is at the market level.<sup>79</sup> Fourth, the fees to the lender or credit intermediary (including any fees associated with paying off the loan prior to its maturity date—a "repayment" or "prepayment charge") shall not exceed a specified percentage of the loan amount and the closing costs shall not exceed a specified percentage of the loan amount<sup>80</sup> (with a flat dollar amount for very small principle loans) in order for the loan to qualify, these being the key remaining factors for a low-priced loan. Fifth, the loan would permit prepayments and not include as events of default matters beyond what are customarily considered an event of default (such as failure to make payment of the monthly installments, insurance and real estate taxes, and acts of waste or failing to maintain the home such that the mortgage lien is impaired) and the loan must provide adequate cure periods in light of the nature of the default. Sixth, in the case of a refinance, the loan must provide a "net economic benefit" to the borrower. Just because a borrower pays off a loan accruing interest at say 6% with a new loan accruing interest at 5.5% does not necessarily mean that the borrower will reap a net economic benefit from the refinance. For there to be a net economic benefit, the borrower needs to hold onto the new lower interest rate loan long enough so that the reduced interest rate payments on the new loan exceed the costs the borrower paid to obtain the new loan. So the issue of a net economic benefit from a refinance needs to take into account the anticipated period of time before the borrower takes on a new refinance or plans to sell the home when the borrower incurs costs to obtain the new home loan (versus a "no closing costs" home loan which were sometimes offered in the U.S. where the interest rate charged is a bit higher to take into account those closing costs). Finally, the loan should meet any other factors that the Commission deems to be evidence of a prudent and low cost home loan (this could include factors relating to whether the lender

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approach is to require lenders to first offer the approved standard form of prudent home loan to the consumer but allowing the consumer to opt out and obtain a different home loan product.

<sup>77</sup> Affordable based on a highly prudent debt to income ratio set by the Commission.

<sup>78</sup> The fixed interest rate and monthly amortization of the principle of the loan would need to equal an amount that under a debt to income ratio is considered "affordable" (that percentage to be determined by the Commission).

<sup>79</sup> See, Impact Assessment Annex 3, *supra* note 11, at 139 noting that in France a loan is deemed usurious if the APR rate is more than one-third of the average percentage rate applied by credit institutions during the previous quarter for loans of a similar type presenting similar risk factors. Currently it appears that there is no sub-prime home loan market in the EU, but if that were to develop, then the average interest rate could take into account what is average for a comparable home borrower.

<sup>80</sup> This would be set by the Commission based on what would be considered a low cost loan in terms of such fees in light of historical averages for such fees and charges.

is making a loan to a “creditworthy” borrower such as loan to value ratios, the credit history of the borrower, and the source of the borrower’s income—but since in the White Paper the Commission seemed to indicate that they intended to impose a duty on lenders to make sure the borrower is creditworthy we have not included those factors in the approved standard form of home loan which is more focused from the borrower’s perspective). We presume that the laws relating to collection and foreclosure applicable to a cross-border loan would still be the laws in the jurisdiction where the home is located and so this would not be a factor.<sup>81</sup>

The main disadvantage of creating a Commission approved standard form of prudent home loan product is the difficulty and costs in creating it and updating it to take into account changes in the marketplace. Borrowers can still select loans that do not comply with the “approved standard form of home loan product” but they will first be made aware that the loan they are selecting contains certain features that may be more risky or unfavorable and should seek advice from independent mortgage counselors before doing so. Like the risk based classification of loans, this information, whether the loan offered to them complies with the approved standard form of loan, serves as an easy heuristic for consumers to rely upon when deciding among a myriad of home loan products.

The Commission sought and received comments from the various stakeholders on whether they would “welcome a set of standardized or certified products to be offered to consumers.”<sup>82</sup> The chambers of commerce and some consumer advocates expressed support for creating standard forms of home loan products so that consumers could have access to basic products that are the same in all Member States that should reduce the costs of these products.<sup>83</sup> Other consumer advocates commented that all loan products should be fair and suitable to the individual needs of the consumer, not only standardized ones (we address this point in our third and fourth proposed reform measures).<sup>84</sup> Consumer advocates also cautioned that the standardized products should be accessible to low-income households or persons and that the standardized products should be created alongside developing innovative and creative financing solutions by the industry. We agree, except to the extent this means to offer what appears to be an affordable loan to those with lower incomes when in fact the loan will not remain affordable.<sup>85</sup> Some consumer advocates also noted that with the creation of “certified” home loan products could facilitate the offer to consumers of certain products without the need to obtain independent financial advice on the product.<sup>86</sup> This point is correct and would add efficiency into the system for consumers since under the proposed “approved standard form of prudent home loan” they could be assured they were obtaining a prudent and low cost loan. Some consumer representatives indicated that lenders should be forced to present these certified standard form of home loan products to consumers but consumers

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<sup>81</sup> White Paper, *supra* note 2, at 7, citing to the “Rome I” Regulation recently agreed by the Council and the European Parliament.

<sup>82</sup> Summary of Responses, *supra* note 67, at 7.

<sup>83</sup> Summary of Responses, *supra* note 67, at 7.

<sup>84</sup> *Id.*

<sup>85</sup> Such as offering loans with initial low teaser rates that after a few years automatically rises to rates that are not affordable or offering loans that are interest only with a huge balloon payment when the loan becomes due so the lower income borrower can afford the monthly payments and then might lose the home.

<sup>86</sup> Summary of Responses, *supra* note 67, at 8.



should be able to opt out of taking the standard form and could take out a more sophisticated product that better suits the consumer's needs.<sup>87</sup> In our proposal we also agree that the ultimate decision is for the consumer to make and agree that perhaps the default position (psychological phenomenon number 6, biases in attribute estimation and evaluation, includes among other factors the status quo or default value bias)<sup>88</sup> should be the offering of the approved standard form of prudent home loan product (since this form of home loan product is one that is most likely to be the best home loan product for most consumers) with the consumer still empowered to then opt out of that and select a different home loan product.<sup>89</sup>

The financial services industry federations, providers, and financial sector trade unions commented strongly against standardized products saying they are not necessary and not fit for purpose.<sup>90</sup> The industry representatives viewed standardized products as stifling innovation, limiting choice and diversity and reducing competition and pleaded to leave the choice to the credit institutions to design and offer a range of products in response to customer needs.<sup>91</sup> Member States were also largely opposed to product standardization, with many arguing there were no inherently unsuitable products (although there was cautious support for product standardization from a small number of Member State authorities as long as this would not interfere with market autonomy).<sup>92</sup> The trade union representatives indicated they would welcome risk classification and certification indicating suitability for different consumers but not standardization.<sup>93</sup> Based upon this last comment and the comment among some Member States about market autonomy it appears that the industry and Member States misconstrued the creation of standardized home loan products to exclude the use of other home loan products. In our reform proposal, consumers would be offered the approved standard form of prudent home loan product, warned if a home loan was not such a loan, but the consumer would still be able to choose a different form of home loan product if the lender can show the consumer that there is a better loan product in the market to suit that consumer's needs. Thus, the creation of a standard form of prudent home loan product will not stifle innovation or limit choice or diversity and could increase competition (i.e. competition from cross-border loan providers whom consumers would now feel more confident to work with since they are offering the approved standard form of prudent home loan). While some consumers may be cautious before entering into a home loan product different from the approved standard form of home loan product, this caution is a good thing, and can still be overcome through explanation by the mortgage lender or credit

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<sup>87</sup> Id.

<sup>88</sup> See R.H. Thaler & C.R. Sunstein, *NUDGE: IMPROVING DECISIONS ABOUT HEALTH, WEALTH & HAPPINESS* 50 (2009).

<sup>89</sup> As protection to the consumer who chooses to opt out of the standard approved form of home loan under our reform proposals the consumer would receive the risk classification of the different loan product and if it is classified as "very risky", the consumer would then be required to receive independent advice on this first set forth in the fourth reform measure we propose.

<sup>90</sup> Summary of Responses, *supra* note 67, at 8.

<sup>91</sup> Id.

<sup>92</sup> Summary of Responses, *supra* note 67, at 9.

<sup>93</sup> Summary of Responses, *supra* note 67, at 8.

intermediary of why a different form of home loan product would make sense for the borrower.

The third reform measure that we recommend is that the EU mortgage credit Directive the Commission issues include a mandated duty on mortgage lenders and intermediaries to offer only “suitable” home loan products to the consumer (i.e., loans that meet the consumer’s basic needs and goals based on certain criteria developed by the Commission). Due to information asymmetry, with mortgage lenders and credit intermediaries knowing much more than the typical consumer relating to the home mortgage market, and the problem of moral hazard where a lender or intermediary has an incentive to market loans to consumers that are not in the consumer’s best interests,<sup>94</sup> imposing a duty of suitability on mortgage lenders and intermediaries is a way to level the playing field and induce mortgage lenders and mortgage intermediaries to only offer “suitable” home loans to consumers.<sup>95</sup> Although the Revised ESIS (if made mandatory and revised as we recommended in Section II) will provide consumers with the basic important information on the mortgage loan presented to them,<sup>96</sup> due to the various cognitive and social psychological barriers discussed in Section II<sup>97</sup>, many consumers will not be able to effectively use the ESIS as intended and imposing a duty of suitability can enhance consumer confidence and consumer protection by providing a strong incentive to mortgage lenders and intermediaries to only offer to consumers loans that satisfy the suitability standard.

Without this duty there is great potential for consumers to be offered home loans that do not meet their basic needs and goals and for consumers to fail to realize this. But with this reform consumers can be helped to overcome a variety of psychological phenomena discussed in this article including: psychological phenomena number, 2, consumers’ lack of contractual schemas or knowledge structures (without this duty such consumers might take on an unsuitable loan due to their lack of knowledge, but now will not), number 3, especially assumptions regarding whether the contract is negotiable (without this duty individuals who might have taken on an unsuitable loan because they mistakenly believed they could not negotiate for a better one, will now not be offered an unsuitable home loan) numbers 8, acceptance of senseless explanations and 9, argument immunization, since lenders and credit intermediaries would no longer be able to explain the unsuitable features away, number, 13, strong motivations to trust (without this duty consumers who

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<sup>94</sup> See, Impact Assessment, Annex 3, *supra* note 11, at 39-40. “Taking these factors into account [the asymmetric relationship where the interests of a mortgage lender and borrower are skewed because the lender can always look to the collateral to pay off the debt or if the lender plans to sell the loan to a third party, and a desire to avoid the time involved in determining if the loan is one the borrower can afford to repay] ...the consumer might be presented with a range of products that does not fully reflect his financial needs and circumstances. Consequently, there is a risk that the consumer chooses a product for which there is a chance that consumers may fail to meet their contractual obligations and thus may eventually loose [sic] their home.”

<sup>95</sup> To avoid potential liability to the consumer for the harm consumers suffer from being induced to take on an “unsuitable” home loan, lenders and credit intermediaries will be induced to offer loans that meet the suitability standard. Determining the enforcement measures for the reforms proposed is beyond the scope of this paper and a matter that the Commission would need to consider in a fashion similar to enforcement mechanisms used for other Directives.

<sup>96</sup> See, Section II for a discussion of additional loan terms that might require disclosure on the ESIS.

<sup>97</sup> See, Impact Assessment, Annex 3, *supra* note 11, at 35.

are insecure about obtaining a loan and then feel that the lender has conferred a great benefit to them by providing them with a loan, and consequently are less likely to question the loan terms, will now not take on an unsuitable loan) and number 14, social norms and signals, not to pay attention to material presented in forms (without this duty some consumers might not read the loan terms and realize the loan offered is unsuitable; but with the duty they will only be offered suitable home loans). Although it appears that little data has been collected on the extent to which consumers in the EU Member States are being offered “unsuitable” home loans,<sup>98</sup> the Commission noted that data collected in the UK reflects that in one-third of the files reviewed<sup>99</sup> “there was an inadequate assessment of consumers’ ability to afford the mortgage credit product sold; in almost half the files reviewed there was an inadequate assessment of customers’ suitability (e.g. needs and circumstances) for the mortgage.”<sup>100</sup>

What is considered a “suitable” home loan would be defined by the Commission after consultation with the various stakeholders but in our opinion should include initially at least the first two of the following three factors: (i) a loan that the borrower can afford to repay,<sup>101</sup> (ii) in the case of a refinance, a loan that provides a net economic benefit to the borrower in light of the anticipated period of time before the borrower takes on a new refinance or plans to sell the home, with an exception for a refinance for a different purpose, when clearly documented,<sup>102</sup> and (iii) a loan that is at the average current interest rate, fees and closing costs charged by lenders for loans within a specified geographic range<sup>103</sup> of the mortgaged property for a comparable loan to a comparable borrower (to avoid price disparities) or above those rates and costs by no more than a specified percentage set by the Commission.<sup>104</sup>

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<sup>98</sup> See, Impact Assessment, Annex 3, *supra* note 11, at 40.

<sup>99</sup> The loans reviewed were for borrowers with impaired credit histories who were being offered sub-prime loans.

<sup>100</sup> Impact Assessment, Annex 3, *supra* note 11, at 40.

<sup>101</sup> The affordability issue would be based on applying a debt to income ratio determined by the Commission after consulting with the stakeholders. One difficulty may be taking into account the fact that a ratio greater than say 33% may be imprudent in some countries but prudent in other countries in light of differing cost of living expenses in each country. The Commission would have to take this into account when establishing debt to income ratios and may want to consider different ratios based on different costs of living circumstances among the Member States. Also, consumer advocates noted that while a 30% loan to income ratio may be unaffordable to a low-income family, it might be affordable for higher-income individuals and that each case should be taken individually on the issue of affordability. Summary of Responses, *supra* note 67, at 9. Consumer and user representatives, a corporate representative, and financial sector trade unions noted that upper limits of loan to income ratios should be considered within the range of 33-40%, as currently apply in some national laws. Summary of Responses, *supra* note 67, at 10.

<sup>102</sup> The concept of “net economic benefit” was defined in the discussion of the standard form of approved home loan, but it is recognized that if the consumer needs to refinance the debt on her home due to an emergency or for any other purpose unrelated to reducing the costs of her loan, then the consumer is free to do so and the mortgage broker or lender will have no liability in this circumstance. The mortgage lender or broker would need to document this situation with the borrower filling out a form indicating that they realize they are not receiving a net economic benefit from the loan and are refinancing for other purposes.

<sup>103</sup> The region should be large enough in size to encompass many communities to avoid charging members of certain communities more than members of other communities but not so large as to encompass regions with varying circumstances that would explain price valid disparities.

<sup>104</sup> The interest rate, fees, and closing costs issue were already discussed regarding creating a standard form of approved home loan, here they could be even above those figures for comparably situated borrowers under comparable loans up to a cap set by the Commission.

The first factor of suitability, that the borrower can afford to repay the loan and consequently should not lose their home or any equity they have in their home from a default in repaying the debt, is the cornerstone of responsible lending. It relates to the “creditworthiness” of the borrower that the Member States and all of the stakeholders that commented on it indicated they believed lenders should always take it into account.<sup>105</sup> It is necessary to create a duty of only offering “affordable” home loans to consumers because both credit intermediaries and home lenders may have an incentive not to. Credit intermediaries and lenders will earn fees from making unaffordable home loans (perhaps even higher fees than with an affordable home loan) regardless as to whether the borrower makes payments on the loan throughout the term of the loan. If the borrower fails to make payments on an unaffordable loan there is no negative impact to credit intermediaries and there may even be no negative impact on lenders if the value of the home and costs to recover on this collateral in a foreclosure exceeds the mortgage debt on the home or if the lenders have sold the mortgage loans to the secondary market without retaining any exposure to such loan defaults.<sup>106</sup> In reaction to the large scale making of unaffordable home loans in the U.S before the financial meltdown in 2007, commentators have been advocating for a duty of suitability that focuses on the affordability of the loan and certain other reforms<sup>107</sup> which would apply to all home mortgage loans rather than just for very high cost home loans (a duty under HOEPA but which affects a very small percentage of the home loan market due to the very high cost and APR triggers).<sup>108</sup> Although there is not a large sub-prime mortgage market among the EU Member States as there was in the U.S. there is still great potential among the EU Member States for credit intermediaries and even lenders to offer loans to consumers that the consumers are in risk of not being able to repay.<sup>109</sup> Consequently, it is important to create a duty on lenders and credit intermediaries in the EU Member States to only offer home loans to consumers that meet the “affordability” standard established by the Commission at the

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<sup>105</sup> Summary of Responses, *supra* note 67, at 11. “Member States stated that the burden of proof should be on the lenders to demonstrate how they have fulfilled the creditworthiness assessment requirements, without stipulating exactly how this should be done.”

<sup>106</sup> Although the EU Member States do not have a secondary mortgage market to the same level as in the U.S., creating a stronger secondary mortgage market for home loans was one of the articulated goals of the Commission in the Green Paper.

<sup>107</sup> See, e.g., Kathleen C. Engel & Patricia A. McCoy, *A Tale of Three Markets: The Law and Economics of Predatory Lending*, 80 TEX. L. REV. 1255, 1343-44 (2005) (in addition to raising under the duty of suitability the affordability concept they also raised as reforms prohibiting yield spread premiums, lump sum insurance payments, and requiring an economic rational for a refinance). Engel and McCoy advocated a duty of suitability to be imposed on mortgage lenders and credit intermediaries applying the Coase theory that the person who can prevent a harm at the lowest cost should have the burden of doing so and this would be the home mortgage lender and credit intermediary rather than the borrower since financial literacy efforts for consumers are costly and unlikely to succeed and the problems posed with sales tactics of mortgage lenders and mortgage brokers. *Id.* at 1336. They argued that disclosures are inadequate and that consumers rely on intermediaries.

<sup>108</sup> See, Federal Reserve Board Amendment to Regulation Z, 73 Fed. Reg. 44522 (July 30, 2008) (four new protections to “high priced loans” are: (a) prohibit “unaffordable loans”, (b) prohibit certain prepayment charges, (c) require escrows for taxes and insurance, and (d) prohibit evasions of these protections with spurious open end loans.

<sup>109</sup> In particular, the use of floating rate loans is common and lenders should be required to make sure that the maximum potential rate of the loan is one that the borrower can afford to pay.

time the loan is made.<sup>110</sup> Because credit intermediaries and lenders should already be considering affordability issues in the context of the “creditworthiness” assessment, imposing this duty should not create any additional significant burden on lenders and credit intermediaries. We recommend that the standard of affordability established by the Commission should be a “floor” (i.e. a minimum standard based at least on the creation of a prudent debt to income ratios)<sup>111</sup> but permits lenders to apply any additional factors for borrowers to meet in order to preserve the lender’s autonomy to best determine the affordability issue once the minimum duty has been satisfied.

The second suitability factor proposed would only apply to a “refinance” of a home loan mortgage. Under the duty of suitability, if a borrower is taking out a new home loan to pay off an existing home loan to take advantage of prevailing lower interest rates, then there must be a net economic benefit from the refinance.<sup>112</sup> However, as discussed in the section on features of an approved standard form of prudent home loan, just because the interest rate is lower does not necessarily mean that the refinance provides a net economic benefit to the borrower, a point many borrowers fail to realize. Consequently, for a refinance loan to be suitable, it must provide a net economic benefit (as defined earlier) to the consumer, or the consumer must sign a document indicating that the purpose of the refinance is not for a net economic benefit (the document should explain what a “net economic benefit” is and how it does not exist under the contemplated refinance) but for another purpose (for example a refinance that increases the loan amount because the additional amount will be used by the consumer for personal reasons<sup>113</sup>). The U.S. Congress enacted a law that required a net economic benefit, at least in the context of very high cost home loans<sup>114</sup> in reaction to the problem that many U.S. mortgage brokers and lenders would induce borrowers to repeatedly refinance their homes over a short period of time at lower interest rates from the prior loan but with high costs associated in obtaining the new loans which caused borrowers not to enjoy a net economic benefit from each refinance (a predatory loan feature referred to as “loan flipping”). The harmful practice of loan flipping, which typically arises in an

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<sup>110</sup> If the borrower falls on hard times after the loan is made due to illness, divorce or unemployment (three key causes of default) this does not make a loan unaffordable or subject the lender to a claim of breach of duty, a concern raised by the financial services industry federations. Summary of Responses, *supra* note 67, at 10. On the other hand, marketing a loan to someone with an initial low teaser rate that can then rise to levels beyond what the consumer can afford at the time the loan is made would be a breach of the duty.

<sup>111</sup> For example, many stakeholders noted that upper limits of a loan to income ratio should be considered within the 33-40% range “as currently apply in some national laws.” Summary of Responses, *supra* note 67, at 10.

<sup>112</sup> Typically the essential reason for a consumer to refinance a prior home loan debt is for the expected net economic benefit of paying a lower amount of interest under the new loan, but if the closing costs are not recouped from this lower amount of interest there is no net economic benefit from entering into the new loan.

<sup>113</sup> For example, the borrower may wish to use the additional funds to purchase a luxury item or to pay off other, non-secured debts that might be accruing interest at a higher interest rate than the interest rate on the home loan. In the U.S. many may seek out a refinance to pay off health care expenses or educational expenses, but these uses are less likely in the EU market where the government is more likely to cover these types of expenses than in the U.S.

<sup>114</sup> 15 U.S.C. § 1639 (h). This section provides in pertinent part “A creditor shall not engage in a pattern or practice of extending credit to consumers under mortgages referred to in section 103(aa) [[15 USCS § 1602\(aa\)](#)] based on the consumers’ collateral without regard to the consumers’ repayment ability, including the consumers’ current and expected income, current obligations, and employment.”

environment of declining interest rates, can be greatly discouraged by imposing a duty on home lenders and credit intermediaries that when they offer a refinance of a home loan the refinance must create a net economic benefit to the borrower or for the refinance to be clearly documented to the consumer as being for a different purpose. Although determining if there is a “net economic benefit,” as defined by the Commission, will impose a small additional administrative burden on lenders and credit intermediaries<sup>115</sup>, imposing this duty will provide an important protection to consumers who think they are making a wise home loan decision to replace a higher interest loan with a lower interest loan, when in fact they are not likely to receive the benefit from the refinance they think they are getting due to their schema deficit regarding financial literacy.

The third potential suitability factor, that the consumer is being offered a loan at an interest rate, fees and costs no higher (beyond a specified permitted percentage) than the average interest rates, fees or closing costs for a similarly situated consumer<sup>116</sup> currently charged by lenders,<sup>117</sup> is a way to discourage mortgage lenders and credit intermediaries from engaging in significant price disparities to the detriment of some consumers.<sup>118</sup> This is not the same as a usury law since there is no cap on the interest rate or closing costs charged, but instead a restriction that would prohibit lenders from treating similarly situated borrowers to differently priced home loans. Due to the large administrative burdens from imposing this as a duty,<sup>119</sup> we propose that this third factor not necessarily become a part of the suitability factors until data is collected to determine if price disparities are a significant problem in the EU. In the U.S. there is evidence that African-Americans, Hispanics, and the elderly disproportionately targeted for higher interest rate and higher closing cost loans even after taking into account the creditworthiness of the borrowers.<sup>120</sup>

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<sup>115</sup> Lenders or credit intermediaries will need to inquire of the borrower on the likely period of time the borrower will hold onto the proposed new loan (keeping in mind possibilities of sale of the home or a future refinance of the debt for various reasons besides a drop in interest rates) and then check if the reduced interest payments over that period of time of holding the new loan exceeds the fees and costs to obtain the new home loan.

<sup>116</sup> Similarly situated consumers would mean similar in terms of debt to income ratios, credit histories, and loan to value ratios.

<sup>117</sup> As previously discussed, the lender would look at the average interest rate, fees, and costs charged by lenders within a specified geographic range of the home serving as collateral for the loan.

<sup>118</sup> Green Paper, *supra* note 3, at 3 (goal of enhancing price convergence articulated).

<sup>119</sup> Lenders should already be calculating debt to income ratios and loan to value ratios, but unless there is a reliable credit score for the consumer it will be difficult to compare one consumer's credit history against another's. Although consumers in the U.S. are routinely rated by various credit report companies, this does not appear to be the case to the same level among the EU Member States. White Paper, *supra* note 2, at 7 (the Commission noted that an Expert Group on Credit Histories was established to help the Commission prepare adequate measures to improve the accessibility, comparability and completeness of credit data in the E.U.).

<sup>120</sup> See, e.g., Debbie Gruenstein Bocian, Keith S. Ernst, & Wei Li, *The Effect of Race and Ethnicity on the Price of Subprime Mortgages*, 10 (Center for Responsible Lending, May 2006); and Michael S. Barr, Jane K. Dokko & Benjamin J. Keys, *Who Gets Lost in the Sub-prime Mortgage Fallout? Homeowners in Low and Moderate Income Neighborhoods* at 2 (2008), available at <http://ssrn.com/abstract=1121215> (suggesting that even in similar low income neighborhoods, African-American homeowners are significantly more likely to have a loan with a prepayment charge even after controlling for age, income, gender, and creditworthiness); see also Symposium, *The Middle-Class Crunch: The Life and Debt Cycle: The Growing*

Because all three of the factors that would impose a duty of suitability on the mortgage broker or lender would be satisfied under the approved standard form of home loan, there should be a presumption that the duty of suitability has been satisfied when a mortgage lender or mortgage broker has offered to the consumer a loan that is an approved standard form of prudent home loan product. This should encourage mortgage lenders and intermediaries to propose the approved standard form of prudent home loan product and to only offer alternative forms of home loans when they can still meet the three criteria articulated above.

The duty of suitability proposed is based upon a similar foundation as the duty most governments already impose on mortgage lenders and credit intermediaries not to engage in fraudulent or deceptive conduct. Such conduct taints the agreement that the consumer enters into because the consumer is not getting what she thought she bargained for and is inconsistent with the reasonable expectations of the consumer regarding the transaction. Similarly, consumers reasonably expect that the complicated home loan being offered to them by an expert in home loans will meet certain basic needs and goals they have regarding the loan and may be relying upon these experts not to offer them loans that do not meet these basic needs and goals. Indeed, some Member States already impose duties on mortgage lenders that are similar to aspects of the suitability duty proposed. For example, in Belgium, mortgage lenders are obliged to inform themselves of the consumer's situation and to "look, amongst the credit contracts they usually offer or for which they usually intervene, for the type and amount of credit best adapted, owing to the financial situation of the consumer at the time the contract is concluded (and to the aim of the credit)." <sup>121</sup> In Ireland, mortgage lenders must collect sufficient information from the consumer to enable them to provide a recommendation for a product or service appropriate to that consumer. <sup>122</sup> In the UK, mortgage lenders need to have a written responsible lending policy in place setting out the factors that they will take into account in assessing a customer's ability to repay and keep an adequate record to demonstrate they have taken account of the customer's ability to repay. <sup>123</sup> Recognizing the need for better consumer protection in the home loan market, several states in the United States have enacted legislation imposing duties of affordability and net economic benefit on mortgage brokers or lenders when offering home loans to consumers. <sup>124</sup>

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*Debt Burdens of Older Consumers and Related Policy Recommendations*, 44 HARV. J. LEGIS. 167, 180-81 (2007) (maintaining that "subprime and predatory lending disproportionately impact seniors").

<sup>121</sup> Impact Assessment Annex 3, *supra* note 11, at 36.

<sup>122</sup> *Id.*

<sup>123</sup> *Id.*

<sup>124</sup> Many states have enacted legislation imposing various duties on brokers relating to the suitability of the home loan for the borrower. Many of these statutes only apply to the situation of a high cost home loan, but some apply more broadly. See, e.g., ALASKA STAT. § 06.60.350 (b) (2008). (Licensees are required to consider various factors in determining net benefit to the borrower); ARK. CODE ANN. § 23-39-510 (4) (2010). (Licensees shall make reasonable efforts to secure a loan that is reasonably advantageous to the borrower. Licensees should consider rates, repayment terms, and charges; 205 ILL. COMP. STAT. ANN. 635/5-7 (1) (LexisNexis 1987) (Duty to act in the borrower's best interest); 205 ILL. COMP. STAT. ANN. 635/5-6 (LexisNexis 1987); (Borrower must have reasonable ability to repay the real estate taxes, homeowner's insurance, assessments, principal and interest); ME. REV. STAT. ANN. 9 §10-303-A (1)(F) (2009). (Licensees must make a reasonable effort to obtain a loan reasonably advantageous to the borrower regarding rates, charges, and repayment terms); MD. CODE REGS. 09.03.06.20 (2010). (Duty to recommend mortgage loans that have a net tangible benefit to the borrower); 940 MASS. CODE. REGS

However, it appears that no Member States currently impose a duty on home lenders and credit intermediaries to only offer a “suitable” home loan as proposed in this article.<sup>125</sup> Mortgage lenders and credit intermediaries are likely to object to the burden this duty would impose on them in order to comply. They would need to check to ensure not only that the consumer can afford the loan but also to determine that if there was a net economic benefit to the loan if a refinance. This would take up their time and could cause them to lose business if it turns out that the loan offered is not affordable under the standards set up by the Commission or if there is no net economic benefit from the refinance and the borrower was seeking that. Although representatives of the financial services industry federations agreed that creditworthiness should always be assessed, they were even against the establishment of mandatory criteria or mandatory tools for the assessment of creditworthiness. They cited as their reason that they wanted to retain their freedom to make this determination and to “preserve competition” in the banking business.<sup>126</sup> In addition they objected to EU wide harmonisation of credit-worthiness assessments “since specific criteria have to be reviewed on a case-by-case basis and there are national specificities to take into account.”<sup>127</sup> To accommodate these points (and also because our reform proposal is centered on the goal of enhancing consumer protection), our proposal focuses only on the affordability aspect of the creditworthiness assessment,<sup>128</sup> establishing a minimum level of affordability standard and allowing

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8.06 (2010). (Duty to ensure borrower’s ability to repay); MASS. CODE REGS. 8.06 (2010). (It is unfair practice for mortgage brokers to make a loan that is not in the best interests of the borrower); MINN. STAT. § 58.161 (2009). (Duty to ensure mortgage loan is in the best interest of the borrower); MINN. STAT. § 58.13 (2009). (Licensees must verify the consumer’s reasonable ability to pay before making a mortgage loan; i.e. licensee must verify ability to pay real estate taxes, interest, homeowner’s insurance, assessments, mortgage insurance premiums, and principal); N.H. REV. STAT. ANN. § 397-A:15 (LexisNexis 2010). (Licensees are prohibited from arranging a loan in which the licensee does not have a reasonable belief that the borrower will be able to make the scheduled payments); N.M. STAT. ANN. § 52-21B-20 (LexisNexis 2010). (Mortgage loan originators shall “direct, recommend and make reasonable efforts to secure a residential mortgage loan that is reasonably advantageous to the borrower, considering all of the circumstances, and has a net tangible benefit to the borrower”); N.M. STAT. ANN. § 58-21-8 (LexisNexis 2010). (A licensee shall not arrange a mortgage without documentation of the borrower’s reasonable ability to repay); N.M. STAT. ANN. § 52-21B-20 (LexisNexis 2010) (Mortgage loan originator shall disclose to applicants more favorable loans for which the applicant qualifies that were not offered by the originator); N.Y. [banking ] LAW § 590-b (Consol. 2010). (Brokers are to provide borrowers with a range of loan products that are appropriate to the borrower’s circumstances and that which the borrower qualifies); OHIO REV. CODE ANN. § 1322.081(A)(5) (LexisNexis 2010). (Mortgage brokers and originators must use reasonable efforts to secure a loan with repayment terms that are advantageous to the borrower); 10 PA. CODE § 46.2, (g)(1) (2010). (Licensees must determine that the borrower will have a reasonable ability to repay the loan before securing the loan); W. VA. CODE ANN. § 31-17-12, (7) (LexisNexis 2010) (Licensees shall ensure, in making loans, that the consumer has sufficient sources of income to timely repay the debt).

<sup>125</sup> Member States that commented on whether there should be a duty of suitability stated that while lenders should have a duty to take into account creditworthiness of the borrower, lenders should not have a duty to take into account the “suitability” of the loan for the borrower’s particular circumstances and that borrowers should do this themselves. Summary of Responses, *supra* note 67, at 11.

<sup>126</sup> Summary of Responses, *supra* note 67, at 10.

<sup>127</sup> *Id.*

<sup>128</sup> To the extent that the lending industry wishes to make loans to individuals who strongly appear not to be able to afford paying the loan back (e.g., to a borrower who would have a debt service ratio of 50% or higher) under the concept of freedom of contract and “preserving competition”—i.e. the right to operate in



lenders discretion to require more on affordability and discretion on how to otherwise determine a borrower's creditworthiness (subject of course to local fair lending/anti-discrimination laws). The second aspect of the suitability duty we proposed, a net economic benefit from a refinance, would be based upon a fairly simple calculation after inquiring of the borrower's specific situation and would take into account the borrower's articulated plans and goals regarding the proposed refinance.

The Commission did not raise the possibility of the third potential suitability factor considered in this article, that the interest rate, fees and closing costs do not exceed beyond a specified percentage the averages for comparable loans to comparable borrowers, and so there is no feedback from the stakeholders on this. We anticipate, however, that for a variety of reasons, the financial industry will be strongly opposed to this proposed reform. First, it will create a higher new administrative burden for lenders compared with the first two recommended elements. Furthermore, this third aspect of the duty of suitability will cut into the profits that the mortgage lender or credit intermediary would otherwise be able to make on the home loan depending on the cap that is set by the Commission which will also be objectionable to the lending industry. In addition, imposing any duty of suitability will be objectionable to mortgage lenders and credit intermediaries due to their concern that if it is argued that they breached the duty of suitability for the loan they offered to the borrower they may be exposed to liability for the borrower's damages. For these reasons, unless collected data reflects a problem with price disparities in the home mortgage markets among a majority of the EU Member States, we do not propose that this third aspect should currently be included in the Directive for the suitability duty, but that data on this question be collected.

To address the desire of lenders to avoid the additional burdens that the duty of suitability would impose and to address their concern that if they breach the proposed duty of suitability they will be exposed to liability for the consumer's damages, the Directive can provide that not only will the duty of suitability be presumed to be met if the loan offered to the borrower is on the standard form of approved home loan products, but that the duty will also be presumed to have been met if the consumer receives independent advice on a non-approved home loan from a certified as trained mortgage counselor when the mortgage broker or lender pays for this advice. As detailed below, the charge for this advice can be regulated and kept to reasonable amounts. This would be a way for home lenders and credit intermediaries to avoid the liability issue and burden of checking suitability, yet the consumer will be protected through receiving either an approved form of standard prudent home loan or advice from an independent and trained counselor for a non-approved home loan who can then check to make sure the three suitability factors are met for the non-standard home loan. Creating a duty of suitability that the mortgage lender and credit intermediary can opt out of by providing a loan on the standard form of approved home loan product or by paying for the consumer to receive independent advice on the offered loan creates a "sticky" default rule.<sup>129</sup> Lenders and

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a very high risk market—the recent sub-prime crisis in the U.S. provides a good example of how this can be very harmful to the public generally and should be regulated.

<sup>129</sup> When a default rule is not against the interest of a service provider then it should operate as intended to lead consumers through inaction to "choose" the default choice (for example having a certain percentage of one's income going into a 401K type retirement fund). But when the default rule is not in the interest of the service provider then something must be done to cause the service provider not to have as strong an incentive to steer the consumer away from the default choice. So, creating a duty of suitability which can

credit intermediaries now have a strong incentive to encourage borrowers to take a loan that meets the standards of the approved form of prudent home loan or to pay for counseling for the borrower if the borrower chooses a more risky home loan. Without the suitability duty, the lenders and credit intermediaries are far more likely to encourage the consumer to take on a home loan product that provides the best financial return to the lender and credit intermediary even when the loan is not suitable for the consumer's need and goals.

Due to the complexity of the decision-making process among the numerous forms of home loan options available, and the potential, as explained in Section II, for consumers to be misled by a mortgage lender or broker into a non-prudent and/or overpriced home loan, the fourth reform measure we recommend is a Directive that requires the consumer to receive advice from an independent, certified as trained, mortgage counselor when the loan being offered to the consumer is at the "very risky" level of risk classification. According to a Eurobarometer survey from 2005, 72% of consumers surveyed expect financial institutions to give them advice,<sup>130</sup> but only 46% of the consumers surveyed said they actually trusted the advice provided by financial institutions.<sup>131</sup> These two facts suggest that many consumers desire receiving advice on the home loan products offered to them but would prefer that this advice come from independent sources rather than individuals with a financial interest in the loan being offered. Done properly, this reform proposal could help overcome all 14 of the psychological barriers to wise home-loan decision-making outlined in Section II.<sup>132</sup> The Commission staff noted the many benefits of providing objective advice to consumers.<sup>133</sup>

"In an integrated market, the provision of objective advice plays a particularly significant role. In such a market, mortgage lenders can enter markets and offer their own range of products and, at the same time, consumers can, if they wish, shop cross-border for a progressively wider variety of products. As a consequence, consumers will be faced with choosing from a wider range of unfamiliar and even more complex products. Being able to receive advice will therefore be increasingly vital in terms of consumer confidence. Given the high value of a mortgage credit together with its social and economic importance, consumers need to be confident that they are taking out the best product for their needs. From a mortgage lender or investor perspective, there is risk of problems arising from moral hazard in that the adviser may have

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be presumed satisfied if the mortgage lender or credit intermediary offers and the borrower takes out the standard form of prudent home loan would be a way of creating a "sticky" default rule regarding offering the standard form of prudent home loan. See, Michael S. Barr, Sendhil Mullainathan & Eldar Shafir, *Behaviorally Informed Financial Service Regulation*, New America Foundation (2008) available at [www.newamerica.net/files/naf\\_behavioral\\_v5.pdf](http://www.newamerica.net/files/naf_behavioral_v5.pdf) "Where firms' incentives misalign with regulatory intent, changing the rules alone may not work well since firms may have the ability to work creatively around those rule changes." Id. at 6.

<sup>130</sup> Public Opinion in Europe: Financial Services, Special Eurobarometer 230 (August 2005), cited in Impact Assessment, Annex 3, *supra* note 11, at 37

<sup>131</sup> Id. at 38.

<sup>132</sup> See, Abdighani Hirad and Peter Zorn, *A Little Knowledge Is a Good Thing: Empirical Evidence of the Effectiveness of Pre-Purchase Homeownership Counseling*, Joint Center for Housing Studies of Harvard University at 2 (August 2001) (homeowners counseled in individual counseling under Freddie Mac's Affordable Gold program were 41% less likely to become 60 day delinquent on their home loans than equivalent borrowers in the study who were not counseled).

<sup>133</sup> Impact Assessment, Annex 3, *supra* note 11, at 41

incentives to recommend a product other than the one which is best suited for the consumer.”<sup>134</sup>

The Commission identified as an objective that “consumers have access to objective advice which is based on the profile of the customer and commensurate with the complexity of the products and the risks involved.”<sup>135</sup> Although the Commission noted that mandatory advice “would ensure that a consumer receives a clear recommendation for one or more products...would ensure that these products meet a consumer’s individual needs,” the Commission also noted that more experienced consumers may not need or even want advice due to the time this would take or because it may increase the costs for the loan.<sup>136</sup> Consequently, although the Commission endorsed the reform of creating advice standards once a party elects to provide advice to a borrower about a home loan, the Commission decided that the advice should not be made mandatory but instead only offered upon request of the borrower.<sup>137</sup> Mortgage Lenders also disfavored imposing mandatory mortgage advice and also raised the point that not all consumers necessarily need or require advice and that an obligation to provide advice would increase the cost of all mortgage loans.<sup>138</sup> Member States were reported as divided on whether the provision of advice should be compulsory with a majority opposed to introduction of mandatory advice, but did favor introduction of standards for the provision of advice.<sup>139</sup> The reform proposal relating to mandatory mortgage counseling outlined below addresses the valid objection that mandatory counseling could potentially cause some consumers to pay for a service that they neither need nor desire.

When asked whether providing advice should be compulsory, 50% of the consumers and users who provided feedback on the Green Paper indicated that they desired the advice to be compulsory and 50% did not favor this.<sup>140</sup> To address the fact that some consumers may not desire advice before entering into a home loan because the loan being offered to them is prudent and not risky, advice would only be mandated when the loan is not on the approved standard form of home loan and is rated as “very risky.” When the loan product being offered is classified as “very risky,” then consumers will typically benefit from the mandatory receipt of advice since there is a strong chance that the home loan being offered to them in fact is not a loan that the borrower should be taking yet the borrower might not otherwise be aware of this. An example of such a high-risk loan would be an “equity release” loan (commonly called a “reverse mortgage” in the U.S.). Due to the high cost of reverse mortgages and special risks of losing the home when a senior takes out this type of loan,<sup>141</sup> many seniors would be making a serious mistake in

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<sup>134</sup> Id.

<sup>135</sup> Impact Assessment Annex 3, *supra* note 11, at 44.

<sup>136</sup> Id. at 50. The Commission also noted the problems with advice coming from the lenders including the risk that mandatory advice will cause companies that already provide this advice to lose their business. But the mandatory advice proposed would not come from lenders or credit intermediaries compensated for arranging the loan but instead come from an independent source. The market for advice would remain open to all under our proposal except to lenders and mortgage brokers who would profit from inducing the consumer to take out the proposed loan.

<sup>137</sup> Id. at 54

<sup>138</sup> Impact Assessment, Annex 3, *supra* note 11, at 43.

<sup>139</sup> Impact Assessment, Annex 3, *supra* note 11, at 43.

<sup>140</sup> Impact Assessment, Annex 3, *supra* note 11, at 42.

<sup>141</sup> For example, if a senior becomes ill or injured and is being cared for at a hospital or nursing home for more than one year, under the loan documents for a reverse mortgage the senior will be in default under the

entering into this type of loan but might be induced to do so by lenders and intermediaries who seek the higher origination fees associated with this complicated loan product.<sup>142</sup>

However, there are several other reasons some consumers might not want to be mandated to receive advice prior to taking out a home loan, even a loan classified as “high risk.” For example, if the consumer considers herself to be highly sophisticated and knowledgeable about the particular home loan product being offered to her and alternatives she may think that it is a waste of time and of her money to be forced to receive advice on this high risk loan. If the Commission wishes to address this situation, they could create at the time they create the risk classifications a summary of the benefits and detriments to each loan product reviewed and what characteristics should exist for the loan to be appropriate for different consumers. This summary could be offered to consumers in an interactive computer program including self-tests to determine if the consumer has absorbed this information. After the consumer has successfully navigated this program if the consumer still desires to waive receipt of advice, she can.

Another reason some consumers might object to mandatory advice is to avoid the time delays and costs in obtaining this advice. To address the costs issue, the training session could be at an affordable, regulated charge (probably comparable to the charge for an appraisal of the property) that cannot be exceeded, and may in fact be paid by the mortgage lender or mortgage intermediary.<sup>143</sup> Furthermore, if an adequate number of companies are licensed to train mortgage counselors, then the counseling requirement should not add significant delays to the closing of the loan.<sup>144</sup>

Finally, some consumers may not desire mandatory counseling advice because they trust the mortgage intermediary or mortgage lender they are working with would not offer them a higher priced loan than they could qualify for or would not offer them a loan

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loan and can lose their home. See e.g. Christopher T. Robertson, Richard Egelhof, & Michael Hoke, *Get Sick, Get Out: The Medical Causes of Home Foreclosures*, Health Matrix 18, 65-105 (2008).

<sup>142</sup> These loans tend to be very high cost and only suitable for seniors who lack the necessary income to make ends meet and cannot afford a less costly means of paying their bill, but have enough equity in their home so that under the reverse mortgage the senior will receive adequate funds during their lifetime to pay for some of the senior’s everyday expenses and also more substantial expenses such as real estate taxes. See, e.g. Symposium, *Reverse Mortgages: An Innovative Tool for Elder Law Attorneys*, 26 Stetson L. REV. 617, 620-21 (1996). If the borrower fails to budget in real estate taxes and insurance and later the borrower lacks money for those items then the lender can claim the borrower is in default of the loan and re-take the home. Note, *Mortgage Foreclosures for Secondary Breaches: A Practitioner’s Guide to Defining “Security Impairment”*, 26 CARDOZO L. REV. 2563, 2563-64 (2005); Jim Flynn, *Consequences High for Unpaid Property Taxes*, The Gazette (Mar. 11, 2007), available at <http://www.gazette.com/articles/tax-20061-taxes-property.html>.

<sup>143</sup> Under an Illinois law that mandates mortgage counseling for certain “high risk home loans” the mortgage broker or lender must pay for the counseling, which is by statute limited to no more than \$300 (less than the cost of a typical home appraisal report). 765 ILCS 77/70 ( c )-(d). This approach could be adopted by the EU as well. Indeed, if a duty of suitability is already in place, many mortgage lenders and mortgage brokers who offer loans that are not on the standard form of approved loan product would probably not find paying for this counseling to be so objectionable since through it they will gain the presumption that the duty of suitability was met.

<sup>144</sup> According to data from ANTI-PREDATORY LENDING DATABASE SUMMARY REORT OF THE ILLINOIS DEPARTMENT OF FINANCIAL AND PROFESSIONAL REGULATION (May 1, 2009) it takes approximately 5 days to schedule and hold a counseling session. Part of the reason why the counseling requirement so far has not led to long delays is that many lenders have reformatted their loans so that they no longer are classified as “high risk” and are no longer subject to the counseling requirement. A similar reaction may occur among mortgage lenders in the EU Member States.

that contains risky or otherwise unsuitable features. Unfortunately, this trust may be misplaced. The mortgage intermediary has a conflict of interest with the borrower. Mortgage brokers are typically compensated based on a commission earned only when the loan is funded so even if the loan poses risks to the borrower, does not meet the borrower's needs or goals, or is overpriced, it is still in the mortgage broker's interest to push that loan, especially if the loan amount is high and the commission is based on the amount of the loan.<sup>145</sup> There is also a conflict of interest with the lender in that the lender's profit is also based on the funding of the loan and the higher the origination charges, the higher the lender's profits to the detriment of the borrower. Consequently, prudent consumers should not trust the mortgage broker or mortgage lender to find them the most suitable and low cost loan possible (unless such a duty is already imposed on them) but should seek independent advice when being offered a high cost or otherwise risky loan. Indeed, as detailed in Section II, unscrupulous mortgage lenders or credit intermediaries could lead consumers through the ESIS in a way that impedes the ability of the consumer to glean the information they need from the form to determine whether the loan terms are consistent with what they had been promised, whether the loan is on the approved standard form of home loan product, the risk classification of the loan and whether the loan terms are suitable for the consumer. For this reason, it is critical that before a borrower can enter into a very risky home loan that they first be required to receive independent advice on it from a certified as trained mortgage counselor who complies with the advice standards that the Commission establishes.

## Conclusion

The European Union Commission, as noted, seems poised to create a Directive that would mandate the disclosure of key loan terms and expenses be made to consumers among the EU Member States before they enter into a home loan. Providing this disclosure, in the form of the Revised ESIS with the modifications to it we detailed, including a standard and broad based method of calculating the APRC, would provide consumers with a very necessary and useful tool to shop for the most suitable loan and enhance the efficiency of the home loan market. Having said that, due to various cognitive and social psychological phenomena described in Section II, the revised mandatory ESIS alone will not adequately protect consumers from entering into risky or otherwise unsuitable home loans. In this article, we proposed four additional measures to be included in the Directive to address these psychological phenomena: (i) the creation of an approved standard form of prudent home loan product, and a disclosure in the revised ESIS of whether the product offered complies, (ii) the creation of a risk based classification system for the home loan products being offered among the EU Member States and a disclosure of the classification of the home loan product being offered in the revised ESIS, (iii) the creation of a duty of "suitability" to be imposed on mortgage lenders and credit intermediaries that the loans they are offering are affordable, provide a net economic benefit and do not reflect great price disparities, and (iv) the imposition of

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<sup>145</sup> See note 12 supra.

mandatory counseling advice from an independent, certified-as-trained mortgage counselor if the consumer is entering into a “very risky” home loan product.

The four reforms were designed to provide necessary protections to consumers at minimal added costs and minimal loss of autonomy to consumers and to the providers of loans. Indeed, the first two proposed reform measures do not mandate that the lender offer or that the borrower accepts any specific type of loan or loan term and instead, like the revised ESIS, provides important information to the consumer (whether the offered loan qualifies as meeting the requirements of a standard form of prudent home loan and the risk classification level of the loan product offered). While the third reform measure—imposing a duty of suitability on the mortgage lender or credit intermediary—would impede what type of loan terms and loan products lenders can offer to borrowers, the duty should be set at a level where a rational borrower *ex ante* would not choose to enter into a loan with such terms or features. The fourth reform measure, mandating counseling by an independent, trained mortgage counselor before entering into certain home loans, does in fact impede the borrower’s autonomy (being forced to receive some advice on the loan from an independent source), but we have reserved this reform for only home loans with features that would cause the loan to be classified as “very risky”—one that only a minority of rational borrowers would *ex ante* choose to take. Furthermore, the costs for the counseling should be kept at a low statutorily set maximum as Illinois has enacted for its high-risk home loans.

Creating, implementing, and monitoring compliance with the four proposed reforms will create costs primarily imposed on the EU Member States rather than on consumers or lenders. In order for the Commission to engage in a cost-benefit analysis of these reform measures for the Member States, the Commission will need to obtain not only estimates of these costs, but also better data on how well the home loan market is currently functioning without these reforms (including obtaining statistics on price disparities and loan default rates) and the economic benefits these reforms are likely to create for Member States. These benefits include improvements to the economies of the Member States through enhanced integration of the EU mortgage market<sup>146</sup> and benefits to consumers who will through these reforms be empowered to enter into lower cost and less risky loans, leading to fewer loan defaults. It is also in the interest of members of the financial industry to at least embrace the first two reform measures we propose (creating a standard form of prudent home loan and a risk based classification system of loans) since implementation of these two measures may be a necessary precondition to lenders being successful at marketing home loans to consumers cross-border. These two reforms can significantly raise the confidence level of consumers to feel protected when they are presented with a cross-border home loan when that loan is certified in the ESIS as being in compliance with the standard form of prudent home loan or when the loan offered reflects a low level of risk rating in the ESIS.

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<sup>146</sup> The Commission projected a substantial positive impact on the economies of the Member States from enhanced integration of the EU mortgage market. Green Paper, *supra* note 2, at 1.

