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### Consumer Protection Initiatives in the EU Mortgage Market: A Behavioral Economics Based Critique and Proposal, 25 Temp. Int'l & Comp. L.J. 1 (2011)

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# CONSUMER PROTECTION INITIATIVES IN THE EU MORTGAGE MARKET: A BEHAVIORAL ECONOMICS BASED CRITIQUE AND PROPOSAL

*Debra Pogrund Stark\* & Jessica M. Choplin†*

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## I. INTRODUCTION

In 2005, the Commission of the European Communities (Commission) issued the Green Paper “Mortgage Credit in the EU” (Green Paper). The Green Paper initiated the process of assessing the merits of Commission intervention in the EU residential mortgage credit markets. This assessment involved: (i) examining the current condition of the mortgage market in the EU, (ii) soliciting feedback from the Member States and stakeholders regarding 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” (White Paper) which included a useful summary of the feedback received and additional data collected; it also proposed certain changes to the credit markets that the Commission is considering for a Directive.<sup>1</sup>

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1. A “Directive” is a legislative act of the EU initiated by the Commission and approved by

This article initially analyzes and critiques the goals articulated by the Commission in the White Paper, as well as certain of the consumer protection initiatives they have proposed. As will be discussed, some of the goals the Commission articulated are likely to work against each other. Moreover, many may be unobtainable under the initiatives as currently proposed, in light of certain cognitive phenomena that affect consumers when taking out home loans. With these points in mind, this article employs a behavioral economics analysis which indicates that the key consumer protection initiatives tentatively embraced by the Commission represent a step in the right direction. However, there are additional measures that any Directive the Commission issues must incorporate in order to achieve the stated goal of enhancing consumer confidence and protection. These additional measures are detailed and discussed in this article alongside the measures the Commission tentatively endorsed.<sup>2</sup>

## II. A CRITIQUE OF THE GOALS ARTICULATED BY THE COMMISSION

In the Green Paper, the Commission first focused on the current condition of the EU mortgage credit market in order to determine what goals the Commission should pursue with respect to this market.<sup>3</sup> The Commission noted that the EU mortgage credit markets, despite sharing some common trends, remain very diverse in terms of size, growth, product variety, borrower profiles, distribution structures, loan durations, home ownership rates and funding mechanisms. Accordingly, the level of direct cross-border sales is less than 1% of the overall residential mortgage credit activity.<sup>4</sup> The Commission also noted that, of the markets in which consumers participate, the mortgage credit markets are among the most complex.<sup>5</sup> Consequently, this debt is likely to be the most significant ongoing 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>6</sup> In light of this, the Commission's key goal was to increase the efficiency and competitiveness of mortgage markets; doing so results in an integration of markets, which ensures that mortgage credit can be demanded and

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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. See Consolidated Version of the Treaty on the Functioning of the European Union art. 115, Mar. 30, 2010, 2010 O.J. (C 83) 114, <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2010:083:0047:0200:EN:PDF> [hereinafter TFEU].

2. 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 White Paper on Financial Services Policy 2005-2010*, at 5, COM (2005) 619 final (Dec. 1, 2005), [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) [hereinafter White Paper].

3. *Commission Green Paper on Mortgage Credit in the EU*, at 5, COM (2005) 327 final (July 19, 2005) [hereinafter *Green Paper*].

4. *Green Paper*, *supra* note 3, at 5.

5. *Id.* at 4.

6. *Id.*

offered with limited hindrance throughout the EU.<sup>7</sup> In 2005, the Commission expressed an intent to: (i) decrease the costs of a mortgage loan; (ii) enhance market completeness, product diversity, and price convergence; and (iii) create a more liquid funding market based on modern and flexible funding techniques and products that serve more borrowers (including those with poor and incomplete credit ratings) through increased use of the capital markets and insurance.<sup>8</sup> However, by the time the White Paper was issued in 2007, the goal of providing funds to borrowers with poor credit ratings was de-emphasized in favor of prudent lending standards, apparently due to the sub-prime mortgage crisis in the United States.<sup>9</sup>

In analyzing the Commission's goals, it is interesting to note that "consumer protection" is not identified as the key goal; instead it is listed as an area to work on in order to achieve an integrated and efficient EU mortgage market.<sup>10</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. It was this sub-prime market, coupled with a lack of consumer protection, that improperly directed some consumers into a higher priced loan than for which they qualified.<sup>11</sup> Another reason may be that the EU generally required higher creditworthiness standards<sup>12</sup> than lenders in the United States for loans where the originating lenders primarily sold off their mortgage loan pools after originating them, which had the effect of protecting consumers.<sup>13</sup>

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7. *Id.* at 3.

8. *Id.* at 3-6.

9. *White Paper, supra* note 2, at 3-4.

10. *Green Paper, supra* note 3, at 6.

11. See ELIZABETH WARREN & AMELIA WARREN TYAGI, *THE TWO INCOME TRAP: WHY MIDDLE CLASS MOTHERS AND FATHERS ARE GOING BROKE* 135 (2003). Also heavily contributing to home loans in the United States being overpriced was the fact that mortgage brokers there 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 applied to the borrower's closing costs. Real Estate Settlement Procedures Act (RESPA), 73 Fed. Reg. 68,268 (Nov. 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). In contrast, mortgage broker compensation among the EU Member States tends to be based on a fixed fee or percentage of the loan amount commission. EUROPE ECONOMICS, *DG INTERNAL MARKET AND SERVICES STUDY ON CREDIT INTERMEDIARIES IN THE INTERNAL MARKET* 108 (2009).

12. Creditworthiness is a determination that borrowers have the means to afford making the loan payments. See *Credit Worthiness*, INVESTOPEDIA, <http://www.investopedia.com/terms/c/Credit-Worthiness.asp> (last visited Mar. 20, 2011).

13. As of 2005, about 34% of Americans owned their homes free and clear of any mortgages. Todd J. Zywicki & Joseph D. Adamson, *The Law and Economics of Subprime Lending*, 80 U. COLO. L. REV. 1, 3 (2009). "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)." *Id.* "Most subprime loans were adjustable rate mortgages, thus subprime loans comprise some subset of this 16% of all homeowners." *Id.*; *Preserving the American Dream: Predatory Lending Practices and Home Foreclosures: Hearing Before the S. Comm. on Banking, Housing and Urban Affairs*, 110th Cong. 5 (2007) (written

Nevertheless, it is troubling that consumer protection is identified only as a sub-goal to the Commission's primary objective of removing barriers to a more integrated and efficient EU mortgage-market. The Commission's White Paper did note some important consumer protection problems in the EU mortgage-market, such as: (i) a lack of uniform pre-contractual information (in the form of a European Standardized Information Sheet [ESIS]), which limited comparison shopping by consumers;<sup>14</sup> (ii) a lack of transparency with regard to both the compensation of mortgage credit intermediaries<sup>15</sup> and whether these intermediaries are tied to a specific lender;<sup>16</sup> (iii) restricted consumer mobility and decreased competition resulting from tying the loan in with other products;<sup>17</sup> (iv) a failure by lenders to verify the borrower's creditworthiness (which may lead to a loss of their homes);<sup>18</sup> (v) borrowers taking on "unsuitable" loans;<sup>19</sup> and (vi) a lack of adequate

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statement of Douglas G. Duncan, Chief Economist, Mortgage Bankers Association) [hereinafter *Hearing Before the S. Comm.*].

14. *Green Paper, supra* note 3, at 6; see also *Accompanying the White Paper on the Integration of EU Mortgage Credit Markets: Impact Assessment*, at 13, SEC (2007) 1683 (Dec. 18, 2007), [http://ec.europa.eu/governance/impact/ia\\_carried\\_out/docs/ia\\_2007/sec\\_2007\\_1683\\_en.pdf](http://ec.europa.eu/governance/impact/ia_carried_out/docs/ia_2007/sec_2007_1683_en.pdf) [hereinafter *Impact Assessment Annex 3*] (noting that, for example, at the end of 2005, institutions representing only 40% of the French mortgage market had subscribed to the voluntary Code of Conduct that included a form of ESIS to be delivered to borrowers before they entered into the home loan, with even fewer actually implementing it).

15. Mortgage credit intermediaries are independent mortgage brokers or agents of the lender who assist borrowers in obtaining home loans. *Impact Assessment Annex 3, supra* note 14, at 82.

16. *Id.*; *Summary of Responses to the Public Consultation on Responsible Lending and Borrowing in the EU*, at 17 (Nov. 30, 2009), available at [http://ec.europa.eu/internal\\_market/finservices-retail/docs/credit/resp\\_lending/feedback\\_summary\\_en.pdf](http://ec.europa.eu/internal_market/finservices-retail/docs/credit/resp_lending/feedback_summary_en.pdf) [hereinafter *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).

17. *Impact Assessment Annex 3, supra* note 14, 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 selling two or more products together in a package, when at least one of these products is not sold separately. *Id.* at 81; see also *White Paper, supra* note 2, at 5.

18. *Impact Assessment Annex 3, supra* note 14, at 36, 39-40. 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 lenders assess the creditworthiness of a borrower. *Id.* The report also noted that when lenders transfer their risks by 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. *Id.* Eventually the consumers may fail to meet their contractual obligations and lose their home. *Id.*

19. Unsuitable loans are those that a borrower may be able to afford to pay back, but are sub-optimal in light of the borrower's needs and goals. EUROPE ECONOMICS, *supra* note 11, at 126. See also *id.* at iv (noting that "[t]he 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. *Id.* The intermediaries putatively give expert advice but have an incentive to provide advice that causes the borrower to take the loan so the

financial literacy among EU consumers<sup>20</sup> or information asymmetries that fail to provide borrowers with adequate advice on the best loan for their purposes among the variety of loan products being offered to them.<sup>21</sup> In light of these problems,<sup>22</sup> the Commission should have recognized consumer protection as a goal equivalent in importance to its stated aim of creating a more integrated and efficient EU market. The priority of goals is important here because it will direct the Commission's decision making when it engages in a cost-benefit analysis of different reform options, including consumer protection measures.

Furthermore, in the White Paper and its accompanying impact assessments, the Commission articulated potentially inconsistent goals in aiming to "explore ways through which greater product diversity can be combined with strong consumer protection and adequate financial stability."<sup>23</sup> Problematically, increasing the diversity of available loan products makes it more difficult for consumers to understand and evaluate a particular product and select one that best fits their circumstances.<sup>24</sup> In order to pursue both goals, it may be necessary to impose a "suitability" duty on mortgage lenders and intermediaries or a duty to provide mandatory, independent advice (two measures the Commission has considered but not 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 the need for further measures than those currently endorsed by the Commission are discussed in Section III.

In the next section, this article analyzes the most fundamental reform measure embraced by the Commission:<sup>25</sup> *mandating* that mortgage lenders (and possibly

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intermediary can earn her commission. *Id.* at vi-v.

20. Impact Assessment Annex 3, *supra* note 14, 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.")

21. *Id.* at 37 (noting 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.)

22. 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.

23. *White Paper*, *supra* note 2, at 4.

24. See D.A. Lussier & R.W. Olshavsky, *Task Complexity and Contingent Processing in Brand Choice*, 6 J. CONSUMER RES. 154, 164-165 (1979) (finding that the choices consumers make depend upon the difficulty of deciding between options such that when there are too many options consumers make decisions based upon fewer product attributes); Lauren E. Willis, *Decision-Making and the Limits of Disclosure: The Problem of Predatory Lending*, 65 MD. L. REV. 707, 780-81 (2006) (arguing that consumers primarily concentrate on monthly payment when they make home loan decisions and often ignore other important product attributes).

25. See Impact Assessment Annex 3, *supra* note 14, at 28. The Commission compared the various options and concluded that binding legislation mandating the disclosure of certain key

credit intermediaries<sup>26</sup>) present borrowers with certain standardized, pre-contractual information that outlines the basic terms of the loan, allowing the borrower to compare this offer with other available options. Theoretically, this information would empower consumers to take out loans that were the most suitable for them (ones 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 they need to make sound home loan decisions and to feel confident in their decision-making.<sup>27</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.

### III. A BEHAVIORAL ECONOMIC ANALYSIS OF THE COMMISSION'S REVISED MANDATORY ESIS

#### A. *The Revised ESIS*

The Commission's White Paper is aimed at enhancing consumer confidence in taking out a home loan from a cross-border lender.<sup>28</sup> The most fundamental

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pre-contractual information would best provide consumers with accurate and timely information and, in particular, was the only solution to ensure the comparability of the Annual Percentage Rate of Charge. *Id.* 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. *Id.*; see also *Green Paper*, *supra* note 3 (noting that the Commission was not 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. See Impact Assessment Annex 3, *supra* note 14, at 23 (A majority of the Member States voiced support for the introduction of binding legislation to supply consumers with ESIS and 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)).

26. See Impact Assessment Annex 3, *supra* note 14, at 24 (stating that “[i]n 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 resulting from commission based compensation, one would imagine that the Commission would take this into account and apply the binding information requirement to them as well. See *id.*

27. See D.P. Stark & 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. 85, 90-96 (2010) (highlighting that 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, but failed to use the forms to effectively shop for the best loan they could qualify for). This was due, in part, to being steered into overpriced loans by mortgage brokers seeking yield spread premiums, and who took advantage of consumer cognitive and social psychological vulnerabilities. *Id.*

28. See *Green Paper*, *supra* note 3, at 5 (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).

measure the Commission preliminarily recommended was the creation of a Directive mandating the use of a revised standardized form that provided home loan borrowers with certain pre-contractual information. The mandatory pre-contractual information recommended by the EU Commission is a revised version of the currently voluntary European Standardized Information Sheet (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 (Psychological Analysis of U.S. Disclosures).<sup>29</sup>

The Psychological Analysis of U.S. Disclosures considered fourteen psychological phenomena that can create barriers to a consumer's reading and comprehension of the information presented on disclosure forms.<sup>30</sup> It also critiqued these forms on the basis of how well they are able to overcome these barriers.<sup>31</sup> The fourteen psychological phenomena, described in more detail below, are: (1) the 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 reason why many of these phenomena impede consumers' abilities to read and comprehend disclosure forms is a psychological phenomenon known as information overload; that is, there is a limit to how much information consumers can process.<sup>32</sup> At the same time, there is a lot of information that consumers need to know in order to make sound home-loan decisions, and so they rely upon heuristics, or cognitive shortcuts, to make these decisions.<sup>33</sup> Our aim in this section is to analyze how well the Revised ESIS is able to overcome the barriers presented by these fourteen psychological phenomena.

In our judgment, the information presented on the Revised ESIS is generally easier for consumers to understand than the information presented in the U.S. Housing and Urban Development's HUD-1 disclosure form, the Good Faith Estimate of Closing Costs form (GFE), or the Federal Reserve's Truth-In-Lending-Act (TILA) form, all of which are currently used in the United States.<sup>34</sup> The

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29. See generally Stark & Choplin, *supra* note 27.

30. *Id.* at 97-105.

31. *Id.* at 105-113.

32. See generally Naresh K. Malhortra, *Reflections on the Information Overload Paradigm in Consumer Decision Making*, 10 J. CONSUMER RES. 436 (1984).

33. See generally *id.*

34. See U.S. DEP'T OF HOUSING AND URBAN DEVELOPMENT: SETTLEMENT STATEMENT (2008), <http://archives.hud.gov/news/2008/hud-1.pdf> [hereinafter HUD-1 Form]; U.S. DEP'T OF HOUSING AND URBAN DEVELOPMENT: GOOD FAITH ESTIMATE (GFE) (2008), <http://www.hud.gov/offices/hsg/rmra/res/gfestimate.pdf>; Truth in Lending Act (TILA), 75 Fed.



Revised ESIS is more comparable with the U.S. Federal Trade Commission's (FTC) proposed form because the Revised ESIS includes short explanations of many line items, such as "Loan Description" and "Early Repayment," for less sophisticated consumers.<sup>35</sup> It therefore surpasses its American counterparts with regard to the first psychological phenomenon, which is a consumer's inability to process user-unfriendly features of disclosure forms.

Consistent with our assessment, the majority of consumers who participated in qualitative testing of the Revised ESIS form<sup>36</sup> did not feel overwhelmed by the amount of information presented on the form, did not suffer from information overload, and felt that the form was largely written in plain language.<sup>37</sup> The Revised ESIS form also defines much of the language that financially less sophisticated consumers may not understand (such as "repayment home loan" and "recurrent" and "non-recurrent" costs).<sup>38</sup> By contrast, the HUD-1 form does not define financially sophisticated terms like "origination charge," "balloon payment," and "prepayment penalty."<sup>39</sup>

However, the Revised ESIS does leave other vitally important terms undefined (such as "nominal interest rate" and "APRC"). It is critical that these terms should also be clearly defined and explained. In particular, we recommend that the costs to be included in the APRC calculation (a matter about which the Commission is seeking feedback) should be broadly based, including all costs to obtain the loan, rather than narrowly based. This should include only direct lender charges, as the lending industry desires, so that consumers will be able to compare the total price of two or more loans.<sup>40</sup>

One important example of how the Revised ESIS is more user-friendly than American disclosure forms concerns the consumer's right to prepay the loan and what charges, if any, the lender will impose in that circumstance. This is a critical and often misunderstood loan term. In the Revised ESIS' section on Early Repayment, consumers are told in plain language that they may repay the loan early, and all the potential exit charges triggered by early repayment are clearly enumerated.<sup>41</sup> Although well done, this section of the Revised ESIS could be

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Reg. 7794 (2010).

35. For a discussion of why the proposed FTC form is easier for less financially sophisticated consumers to follow than HUD-1 and TILA, see Stark & Choplin, *supra* note 27, at 112.

36. European Standardized Information Sheet, in EUROPEAN AGREEMENT ON A VOLUNTARY CODE OF CONDUCT ON PRE-CONTRACTUAL INFORMATION FOR HOME LOANS 7, [http://ec.europa.eu/internal\\_market/finservices-retail/docs/home-loans/agreement\\_en.pdf](http://ec.europa.eu/internal_market/finservices-retail/docs/home-loans/agreement_en.pdf) [hereinafter Revised ESIS Form].

37. EUROPEAN COMMISSION, CONSUMER TESTING OF POSSIBLE NEW FORMAT AND CONTENT FOR THE ESIS ON HOME LOANS, PHASE 1 (2009) (hereinafter ESIS CONSUMER TESTING), [http://ec.europa.eu/internal\\_market/finservices-retail/docs/credit/esis\\_presentation-2009\\_05\\_13\\_en.pdf](http://ec.europa.eu/internal_market/finservices-retail/docs/credit/esis_presentation-2009_05_13_en.pdf).

38. Revised ESIS Form, *supra* note 36, at 5-7.

39. HUD-1 Form, *supra* note 34, at 3.

40. The Commission has yet to take a position on whether to calculate the APRC on a broad or a narrow basis.

41. See Revised ESIS Form, *supra* note 36, at 5-7.

further improved to address psychological phenomenon number four (the availability heuristics,<sup>42</sup> 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. However, this must be balanced with the goal of avoiding information overload. Although some discussion group participants who pre-tested the Revised ESIS had difficulties with this section, it is nevertheless easier for financially less sophisticated consumers to understand than the forms currently used in the United States.<sup>43</sup>

The HUD-1, for example, simply asks “Does your loan have a prepayment penalty?” and presents checkboxes for “No” and “Yes.”<sup>44</sup> If “Yes” is checked, it then presents the maximum prepayment penalty.<sup>45</sup> 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. Prepayment charges are any fees associated with paying off the loan prior to its maturity date.<sup>46</sup> They could potentially misconstrue it as a penalty for turning in a monthly payment early. Furthermore, presenting the maximum penalty, although important in preventing lenders from hiding it, fails to provide consumers a clear understanding of the conditions under which prepayment penalties or early repayment fees can be charged, as does the Revised ESIS form.

The Revised ESIS form does well on this score, despite the fact that some of the focus group participants who reviewed the ESIS were still confused by this section.<sup>47</sup> In fact, it is unsurprising that, despite the plain language of the Revised ESIS, some consumers will continue to have difficulties considering all of the scenarios under which early repayment might be possible for them. Consumers judge the likelihood of events based upon the ease of recalling or imagining such scenarios, (the “availability heuristic”) and might not be able to recall or imagine all relevant scenarios. Furthermore, it is also possible that no disclosure form will be able to fully educate financially less sophisticated consumers about everything they need to know. For this reason, in Section III we advocate mortgage counseling by independent third parties for financially less sophisticated consumers before they take on very risky loans.

While the Revised ESIS is generally more user-friendly and helpful to consumers than the American disclosure forms, there remains room for improvement. The form should alert consumers to how high their monthly payments could rise under an adjustable rate loan, which the revised American

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42. A. Tversky & D. Kahneman, *Availability: A Heuristic for Judging Frequency and Probability*, 4 COGNITIVE PSYCHOL. 163, 207-32 (1980).

43. ESIS CONSUMER TESTING, *supra* note 37.

44. HUD-1 Form, *supra* note 34, at 3.

45. *Id.*

46. *Prepayment Penalty*, INVESTOPEDIA, <http://www.investopedia.com/terms/p/prepaymentpenalty.asp> (last visited Mar. 28, 2011).

47. ESIS CONSUMER TESTING, *supra* note 37, at 34.

disclosure forms already do.<sup>48</sup> The Illustrative Repayment Table in ESIS is particularly problematic because, with only that information, consumers have no idea how their actual repayment schedule might differ from the illustrative one. As a result, consumers may be unable to determine whether they can truly afford a loan in the long run. By contrast, the HUD-1 used in the United States specifies the maximum rate and maximum monthly payment amount to which a loan can adjust.<sup>49</sup> The Revised ESIS should do so as well. Other than this flaw, the demonstration amortization schedule format used by the Revised ESIS can be useful for calculations during the period before interest rates start to adjust.<sup>50</sup> The plain language used by the ESIS to explain whether or not a loan has an adjustable rate, rather than the checkbox format used by the HUD-1, is also a helpful feature for consumers.

It must be noted that one of the strengths of the Revised ESIS may also have potential downsides. As described above, consumers do not report that it leads to information overload. However, this may be because the Revised ESIS form does not include an itemization of all costs and charges incident to obtaining the loan, nor does it contain certain other information previously noted.<sup>51</sup> Just like the GFE, HUD-1, and TILA forms currently used in the United States, the Revised ESIS presents the loan amount, the interest rate and the APRC, the duration of the home loan agreement, and the number and frequency of payments.<sup>52</sup> The Revised ESIS does not, however, list a number of fees that are included in the American forms, which reflect charges payable to third parties. These fees include 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 United States).<sup>53</sup> Moreover, fees resulting from a lender or credit intermediary (such as origination charges, tax service fees,<sup>54</sup> fees to a credit intermediary, or any other form of compensation an intermediary receives beyond the lender's interest rate) are also listed on the Revised ESIS form.<sup>55</sup> Fortunately, the Revised ESIS reserves a section for the listing of all additional costs; we presume this section will include all of these charges. However, this requirement should be made clear in any Directive relating to the imposition of the Revised ESIS, so there will be no hidden fees or charges in connection with obtaining the loan.<sup>56</sup>

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48. HUD-1 Form, *supra* note 34, at 3.

49. *Id.*

50. Revised ESIS Form, *supra* note 36, at 5-7.

51. *Id.*

52. *Id.* at 5-6.

53. HUD-1 Form, *supra* note 34, at 2-3.

54. 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.

55. Revised ESIS Form, *supra* note 36, at 6.

56. A tax service fee could apply if the lender requires the borrower to deposit with the

While the American forms enumerate and disclose these types of commonly imposed lender charges, certain lender/mortgage broker charges are not well explained. Some have criticized the United States' HUD-1 for failing to adequately disclose and explain the presence of a "yield spread premium" (an amount that credit intermediaries receive from lenders for inducing consumers to select higher priced loans than they otherwise would have qualified for).<sup>57</sup> This is an especially problematic hidden charge, as it places credit intermediaries' financial interests in conflict with those of consumers. This lack of transparent disclosure of these charges in the GFE and HUD-1 forms fails to inform consumers that they may be receiving a higher priced loan than they are qualified for. It also fails to clearly depict to what extent, if any, this payment to the mortgage broker was applied by the broker to reduce the borrower's closing costs.<sup>58</sup>

Based upon information in the White Paper, it appears that yield spread premiums are not currently an issue for European consumers, because they are not used in the European Union as frequently as they are in the United States (except in countries like Great Britain, which at one time had a sub-prime market).<sup>59</sup> However, if yield spread premiums gain popularity in the European Union, those charges should be required to be listed and explained, which might cause European consumers to seek out lower cost loans. Some may argue that yield spread premiums are not a fee or charge paid by the borrower, but rather payments from the lender to the credit intermediary; nevertheless, consumers must be made aware of such payments so that they will be better positioned to distinguish between their own interests and those of credit intermediaries.

Additionally, although it does not directly affect the price of a loan, consumers should be notified of any deposits required to be given to the lender in advance of any home ownership costs, such as home owner's insurance or property taxes. There is currently no place in the Revised ESIS calling for information on required deposits to be disclosed in advance. Consumers should be made aware of these issues in the Revised ESIS, as they might want to shop for a loan that would allow them to make these payments as they become due, rather than in advance.<sup>60</sup>

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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.

57. See Stark & Choplin, *supra* note 27, at 97.

58. *Id.* at 92 n. 21 (indicating that according to one study, only seven cents per dollar of YSP was applied to the borrower's closing costs).

59. *White Paper*, *supra* note 2, at 10.

60. The required deposits tie up the consumer's money without the consumer receiving interest on the funds deposited; 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 they be included in the calculation of total closing charges as in the HUD-1. The HUD-1's treatment makes it difficult to easily compare true closing charges among more than one loan because some lenders require deposits and others do not. See generally HUD-1 Form, *supra* note 34. 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

Another problematic issue in the European Union concerns “tie-ins,” a mechanism through which lenders require borrowers to accept other services from the lender, such as keeping a bank account with the lender, as a condition of the mortgage. This practice, which is prohibited in the United States, may amount to a hidden cost of taking out a loan. Such tie-ins (if still lawful) should be included and detailed in the Revised ESIS so their cost may be factored into the price of the loan and thus, allow for consumer comparison.

In summary, the Revised ESIS is a critical first step in empowering consumers to make sound home loan decisions because it creates a relatively well-designed mandatory uniform information statement. This statement would include a standardized annual percentage rate charge (APRC), calculated uniformly among Member States, and would be provided before the consumer enters into the loan. Inclusion of this charge enables comparison shopping, making it both necessary and essential to the Commission’s goal of enhancing consumer confidence among those who take out cross-border home loans.

Assuming the Revised ESIS is modified as recommended in this Section, it will enable consumers with only a minimum level of prior financial literacy to make a side-by-side comparison of a loan from a lender in one Member State with a loan from a lender in another Member State. The Revised ESIS, with the changes we recommend, would create a physical schema<sup>61</sup> for the loan terms that would 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 goals of providing borrowers with all necessary information, being user-friendly, and avoiding information overload, a number of psychological barriers remain. The remainder of Section II will focus on these.

### ***B. Psychological Barriers Affecting Consumers’ Comprehension of Mortgage Instruments***

Even the best information forms leave financially less-sophisticated consumers vulnerable to home loan contract schemes. Inevitably, certain unsophisticated consumers will still lack the requisite background knowledge to comprehend how loans work (psychological phenomenon number two). As such, they might need further education about the process before they can make sound loan decisions.<sup>62</sup> Furthermore, some consumers will have inaccurate assumptions

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this. It is an expense either way.

61. This addresses psychological phenomenon number two, which is discussed *supra* Part III.A, para. 2 and *infra* text accompanying notes 115, 130.

62. 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. See Barbara O’Neill, *Avoiding Predatory Loans: Is Financial Education the Solution?*, Speech at the John Marshall Law School Symposium (May 18, 2003) (outline of the speech on file with the author). Consequently, consumers can potentially learn the most by receiving important background information while in the process of seeking a home loan, through such information in disclosure forms themselves or through a one-on-one session with a mortgage counselor. *Id.* (emphasizing that the best learning

of how loans are structured (psychological phenomenon number three), perhaps because they have successfully taken out loans in the past and assume the structure of their current loan mirrors their previous ones. These false default assumptions may cause consumers to pay less attention to disclosure forms or incorrectly assume that mortgage loans are contracts of adhesion and cannot be negotiated,<sup>63</sup> leaving them with no incentive to comparison shop.<sup>64</sup>

As mentioned above in the Early Repayment section, consumers may also misjudge the likelihood of events related to the loan (for example, 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).<sup>65</sup> This is because people judge the likelihood of an event based on how easily certain circumstances come to mind (called the “availability heuristic,” psychological phenomenon number four). Although the ESIS may indicate that a loan is adjustable, for example, the consumer may not accurately evaluate the likelihood of a large upward adjustment.

Because the large amount of information consumers must process in reviewing disclosure forms exceeds their working memory capacity, consumers often try to simplify decisions by myopically justifying a choice at the expense of all other features of the home loan.<sup>66</sup> This phenomenon is called “reason-based decision-making” (psychological phenomenon number five).<sup>67</sup> In the case of home loans, consumers’ justification is often that the initial monthly payment was affordable.<sup>68</sup> Many consumers then ignore or give relatively little weight to other features of the loan. This decision making strategy may cause consumers to neglect problematic features of the loan, even if they are listed on the disclosure form. As such, merely presenting a value on a disclosure form does not necessarily ensure that consumers will understand what it means.<sup>69</sup>

In fact, cognitive psychologists have identified many factors that can influence consumers’ evaluation, comprehension, and estimation of attribute

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occurs 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).

63. See, e.g., James P. Nehf, *European Fair Trading Law: The Unfair Commercial Practices Directive*, 35 INT’L J. LEGAL INFO. 305, 305 (2007) (noting that “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).

64. H. Beales, et al., *Consumer Search and Public Policy*, 8 J. CONSUMER RES. 11, 14 (1981).

65. See text accompanying notes 40-43.

66. See generally Eldar Shafir, et al., *Reason-Based Choice*, 49 COGNITION 11 (1993).

67. *Id.*

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

69. C.K. Hsee, *The Evaluability Hypothesis: An Explanation for Preference Reversals Between Joint and Separate Evaluation of Alternatives*, 67 ORG. BEHAV. & HUM. DECISION PROCESSES 247, 255 (1996).

values (psychological phenomenon number six). One such factor is the “status quo” or “default value” bias, under which consumers may accept disadvantageous terms to which they have become accustomed, such as a prior high interest rate loan.<sup>70</sup> Another factor is framing effects, under which the description of a term affects an individual’s evaluation of it. For example, if a lender or credit intermediary said, “in the first few years of your loan, the proportion of your monthly payment of interest will be higher than in later years,” it frames the early proportion of 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 than at the start,” frames the later portion as a gain to the consumer.<sup>71</sup>

Another factor is “range effects,” under which an unreasonable term appears more reasonable if even more unreasonable terms have been offered (such as a mortgage broker telling the consumer that some other lender would require six months of interest for early repayment, whereas he only requires five).<sup>72</sup> The range effect can be enhanced by presenting numerous decoy values designed to make the unreasonable term look more reasonable.<sup>73</sup> For example, the lender in the preceding example might list examples of several other banks’ charges, all higher than his banks 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 consumer judges the to-be-evaluated term (that is, making the interest rate the lender is offering seem more reasonable).<sup>74</sup> Finally, anchoring effects can affect estimates of unknown values. Under these effects, when a person hears an arbitrary number, his estimate of the number will be biased towards the arbitrary number. For example, if the consumer hears that the average probability of needing to repay a loan early is two percent, his estimate of his own probability will be biased toward this number, even if in actuality it is much higher.<sup>75</sup> These biases may prevent consumers from recognizing how problematic home-loan terms are, even if they see those terms presented on the disclosure form and succeed in reading the form.

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70. H. HELSON, ADAPTATION-LEVEL THEORY (1964); D. Kahneman & A. Tversky, *Prospect Theory: An Analysis of Decision Under Risk*, 47 *ECONOMETRICA* 263, 286 (1979).

71. Amos Tversky & Daniel Kahneman, *The Framing of Decisions and the Psychology of Choice*, 211 *SCIENCE* 453, 454 (1981).

72. The range is the highest and lowest values seen by the consumer. J. Volkmann, *Scales of Judgment and Their Implications for Social Psychology*, in *SOC. PSYCH. AT THE CROSSROADS 279-94* (J. H. Roherer & M. Sherif eds., 1951); A. Parducci, *Category Judgments: A Range-Frequency Model*, 72 *PSYCHOL. REV.* 407 (1965).

73. Parducci, *supra* note 72.

74. J. M. Choplin & J. E. Hummel, *Magnitude Comparisons Distort Mental Representations of Magnitude*, 131 *J. EXPERIMENTAL PSYCHOL.* 270, 286 (2002); J. M. Choplin & J. E. Hummel, *Comparison-Induced Decoy Effects*, 33 *MEMORY & COGNITION* 332, 343 (2005).

75. A. Tversky & D. Kahneman, *Judgment Under Uncertainty: Heuristics and Biases*, 185 *SCIENCE* 1124, 1126 (1974).

The Commission, like its American counterparts, failed to consider that the manner in which lenders or credit intermediaries present the Revised ESIS to consumers impedes its usefulness. This issue is particularly relevant for psychological phenomena seven (“confirmation bias”), eight (“acceptance of senseless explanations”), and nine (“argument immunization”). A confirmation bias is a tendency to test whether lenders are telling the truth by seeking information that would confirm what they say, rather than seeking information that would disconfirm what they say. This phenomenon has been demonstrated in many cognitive psychological studies.<sup>76</sup> Consumers may, therefore, examine the ESIS for information confirming, rather than disconfirming what lenders and credit intermediaries told them about the loan. For example, one might look at the repayment schedule presented in Section 7 to confirm that the intermediary quoted them an accurate initial monthly payment, but fail to see the degree to which the loan adjusts and the maximum to which it could rise, despite the fact that the ESIS form repeatedly states this information.

Consumers will often accept irrational explanations, as long as the syntax of the explanation is provided (psychological phenomenon number eight).<sup>77</sup> As a result, unscrupulous lenders or intermediaries may be able to conceal problematic terms in the ESIS. For example, if a consumer is told that a loan has a fixed rate, but then discovers on the ESIS form that it will adjust after five 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 downward by that time.” Consumers have been shown to be vulnerable to such implausible responses when they take on the syntax of an explanation.<sup>78</sup>

Likewise, unscrupulous intermediaries may be able to preempt the discovery of a problematic term using a phenomenon called “argument immunization” (psychological phenomenon number nine)<sup>79</sup> under which they give consumers a sense that something could be “misinterpreted,” and then immediately demonstrate that such an interpretation would be inaccurate.<sup>80</sup> After that, consumers will be less

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76. P.C. Wason, *On the Failure to Eliminate Hypotheses in a Conceptual Task*, 12 Q.J. EXPERIMENTAL PSYCHOL. 129 (1960); J. Klayman & Y.W. Ha, *Confirmation, Disconfirmation, and Information in Hypothesis Testing*, 94 PSYCHOL. REV. 211, 216 (1987).

77. E. J. Langer, et al., *The Mindlessness of Ostensibly Thoughtful Action: The Role of "Placebic" Information in Interpersonal Interaction*, 36 J. PERSONALITY & SOC. PSYCHOL. 635, 637-38 (1978). The study investigated the effectiveness of explanations in convincing people to comply with requests in an experiment where the experimenter asked to butt in line to make photocopies. They found that even senseless explanations (e.g., “May I use the Xerox machine, because I have to make copies?”) were effective in getting compliance. *Id.*

78. See Choplin & Stark, *An Empirical Investigation of Consumer Deception Through Explanation Scripts: Legal & Policy Implications* (2010) (on file with authors).

79. Stark & Choplin, *supra* note 27, at 97.

80. William 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, 329-31 (1961); William J. McGuire & Demetrious Papageorgias, *The Relative Efficacy of Various Types of Prior Belief-Defense in Producing Immunity Against Persuasion*. 62



likely to believe the so-called “misinterpretation,” even if the ESIS makes it patently obvious that this interpretation is the correct one.<sup>81</sup> For example, an unscrupulous intermediary might immunize consumers against discovering how problematic early repayment fees are by telling them, before they ever see the ESIS 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.

Even the best loan information forms cannot prevent many consumers from being induced to make unwise home loan decisions when lenders and intermediaries take advantage of these three psychological phenomena – number seven (confirmation bias), number eight (acceptance of senseless explanations), and number 9 (argument immunization); for this reason, additional protections should be provided to consumers.<sup>82</sup>

We suggest imposing duties of suitability on the mortgage lender and intermediary and/or requiring advice from an independent third party, especially when the borrower is entering into a non-standard loan product or a risky loan product.<sup>83</sup> These recommendations would also help consumers overcome the instances of information overload represented by the first six psychological phenomena.

One key feature that must be considered when assessing the potential effectiveness of the Revised ESIS form is the time at which the form is required to be presented to the consumer. This is due to the influence of a phenomenon called “sunk costs” (psychological phenomenon number ten), where consumers are willing to sink more resources toward attaining a goal than they initially anticipated because they have already spent resources to attain that goal.<sup>84</sup> The Commission has failed to specify precisely when the Revised ESIS should be provided to the consumer. However, it did indicate that the consumer should receive the Revised ESIS in time to do comparison shopping of the loan and often referred to the disclosure form as “pre-contractual information.”<sup>85</sup> Thus, the form would need to be delivered to the borrower some time before the consumer has committed to the loan.<sup>86</sup> The “sunk costs” phenomenon suggests that the form

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J. ABNORMAL & SOC. PSYCHOL. 327, 332-35 (1961).

81. McGuire & Papageorgias, *supra* note 80, at 332-35.

82. Stark & Choplin, *supra* note 27, at 97; *see also infra* Part III.

83. 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. *See infra* Part III.

84. Stark & Choplin, *supra* note 27, at 97; Hal R. Arkes & Catherine Blumer, *The Psychology of Sunk Cost*, 35 ORG. BEHAV. AND HUM. DECISION PROCESSES 124, 124-25 (1985); Hal R. Arkes & Laura Hutzler, *The Role of Probability of Success Estimates in the Sunk Cost Effect*, 13 ORG. BEHAV. AND HUM. DECISION PROCESSES 295, 295 (2000).

85. *See White Paper*, *supra* note 2, at 6.

86. *Id.* The Commission also stated, somewhat confusingly, that the information should be provided “sufficiently before the conclusion of the contract.” *Id.* It would be clearer to state:

should be presented to consumers early, certainly before consumers invest financial resources into pursuing the loan and, preferably, before they invest time and effort.<sup>87</sup>

However, even that might not be early enough due to the influence of a phenomenon called “endowment effects” (psychological phenomenon number eleven) where consumers overvalue objects—such as a home—that they have started to think of as their own.<sup>88</sup> This makes consumers willing to spend much more money than they initially anticipated in order to avoid losing what they consider to be theirs.<sup>89</sup> This phenomenon makes consumers overvalue the home and undervalue the costs and risks associated with the loan.<sup>90</sup> These effects can begin as soon as consumers think of the house as their possession and imagine their daily lives in the house.<sup>91</sup> Once consumers feel that the house belongs to them, then owning the house will seem the status quo and losing it will seem a loss. 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; this is called “temporal discounting” (psychological phenomenon number twelve).<sup>92</sup> Consequently, consumers will not be dissuaded by problematic costs and fees if such fees can be paid at a later date.<sup>93</sup> For example, consumers might be concerned about a loan that has a fixed rate for the first five years, but then afterwards adjusts, because they perceive five years to be in the distant future. Likewise, they might not be concerned about early repayment fees, because the probability of early repayment seems low and is also in the distant future.

Consumers also have a tendency to trust lenders and credit intermediaries on

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“before entering into the contract.” *Id.*

87. 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. *More Information about RESPA*, HUD.GOV, <http://hud.gov/offices/hsg/ramh/res/respamor.cfm> (last visited Feb. 4, 2011). 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 Mortgage Servicing Disclosure Statement. *Id.* At the second stage, when the loan is funded, consumers receive the HUD-1 disclosure form showing actual closing costs. *Id.* The HUD-1 statement includes 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. *Id.*

88. *Id.*

89. Daniel Kahneman, et al., *Experimental Tests of the Endowment Effect and the Cause Theorem*, 98 J. POLIT. ECON. 1325, 1326-29 (1990).

90. Daniel Kahneman et al., *Anomalies: The Endowment Effect, Loss Aversion, and Status Quo Bias*, 51 J. ECON. PERSP. 193, 194 (1991) (discussing asymmetrical valuing generally).

91. *Id.*

92. Sara J. Estle et al., *Differential Effects of Amount on Temporal and Probability Discounting of Gains and Losses*, 34 MEMORY & COGNITION 914, 914 (2006).

93. *Id.*

whom they are dependent (psychological phenomenon number thirteen).<sup>94</sup> The reason for this misplaced trust stems from a reciprocity effect.<sup>95</sup> Consumers may trust the lenders and credit intermediaries who “give” them loans because the consumers perceive that the lenders and credit intermediaries “trust” the consumers to pay back the loans. The framing of loans as “gifts” may be partially responsible for this effect.<sup>96</sup> 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. Consumers perceive that, because the lenders and credit intermediaries are kindly giving a loan and trusting the consumer, it is incumbent upon consumers to also trust those lenders and credit intermediaries.<sup>97</sup> This reciprocity rule may be particularly strong among consumers who were historically considered to have a lower status (i.e., people with low socio-economic status, ethnic minorities, young people, and women), and who are only likely to distrust when they fear an unequal outcome.<sup>98</sup> A simple form such as the ESIS cannot correct this false framing of a reciprocal relationship. Furthermore, no matter how thorough 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 fourteen).<sup>99</sup> Consumers commonly sign documents without scrutiny when prompted to do so.<sup>100</sup> The representative presenting the form simply tells consumers, “sign here,” pointing to the line where they are to sign, and they sign.<sup>101</sup> They do so partly in response to the social signal that they are expected to sign immediately.<sup>102</sup>

An example of how the social situation can signal that people are expected to sign documents without scrutiny is that title companies in the United States usually only schedule one or two hours for a home loan closing.<sup>103</sup> Much of that time is 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>104</sup> Similarly, European consumers may accept the terms of home loans

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94. J. Mark Weber et al., *Normal Acts of Irrational Trust: Motivated Attributions and the Trust Development Process*, in RESEARCH IN ORGANIZATIONAL BEHAVIOR 75, 80-81 (Barry Staw & Roger Kramer, eds., 2005).

95. See ROBERT B. CIALDINI, INFLUENCE: THE PSYCHOLOGY OF PERSUASION 31 (rev. ed. 2007).

96. *Id.* at 17-18.

97. CIALDINI, INFLUENCE, *supra* note 95, at 17-18.

98. See Kessely Hong & Iris Bohnet, *Status and Distrust: The Relevance of Inequality and Betrayal Aversion*, J. ECON. PSYCHOL. 197, 207 (2007) (stating that people with lower economic status have a strong aversion to loss).

99. Stark & Choplin, *supra* note 27, at 97.

100. D.P. Stark, & J.M. Choplin, *A License to Deceive: Enforcing Contractual Myths Despite Consumer Psychological Realities*, 5 N.Y.U. J. L. & BUS. 617, 707-8 (2009).

101. *Id.*

102. *Id.*

103. *Id.*

104. See Stark & Choplin, *supra* note 27, at 104-05; see also *Castellana v. Conyers Toyota, Inc.*, 407 S.E.2d 64, 68 (Ga. App. 1991) (stating that it took the consumer two hours and forty-

without reading the ESIS carefully simply because social norms and signals communicate that they are expected to do so. Stark and Choplin found this effect among study participants in the U.S., but we have not yet studied how participants among the various Member States may behave.<sup>105</sup>

While psychological barriers ten and eleven 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. These reforms should also be highly effective in addressing barriers twelve, thirteen, and fourteen (“temporal and certainty discounting,” “misplaced trust,” and “social norms not to carefully read before signing”)<sup>106</sup> as well as the information overload type barriers one through nine.<sup>107</sup> We discuss how the reforms proposed can address all fourteen psychological barriers in Section III.

Thus, while mandating the revised ESIS that includes a uniformly calculated APRC is a critical first step to empowering consumers, the 14 psychological barriers presented above suggest that doing so alone is inadequate and needs to be supplemented with other consumer protection measures. One additional measure that the Commission did appear to endorse is related to whether the borrower has the ability to repay the debt (i.e., whether the borrower was “creditworthy”).<sup>108</sup> 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 standards that have to be met if advice is given.<sup>109</sup> However, the Commission did not embrace other possible 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, (iii) 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 to take into account the psychological phenomena noted in Section II, are discussed in detail in Section III.

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five minutes to read the acquisition and finance documents in the context of the purchase of an automobile). It took a research assistance of one co-author of this article, who happened to be a mortgage broker, over two hours just 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.

105. Stark & Choplin, *A License to Deceive*, *supra* note 100, at 707-08.

106. Stark & Choplin, *supra* note 27, at 97.

107. *Id.*

108. See Impact Assessment Annex 3, *supra* note 14, at 36, 44.

109. See Impact Assessment Annex 3, *supra* note 14, at 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”). *Id.* Impact Assessment Annex 3 concludes that the best strategy for meeting the above is via legislation obliging mortgage lenders to assess consumer creditworthiness (option 4) and development of high level standards for the provision of advice obliging Member States to ensure that it is provided according to those standards (option 4.3). *Id.* at 54.

#### IV. CONSUMER PROTECTION MEASURES THAT THE COMMISSION SHOULD RECONSIDER AND INCLUDE IN ITS DIRECTIVE

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

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>110</sup> The Commission had sought feedback on such topics as creating “risk guidelines” and encouraging responsible borrowing.<sup>111</sup> The Financial sector trade unions recommended assisting consumers’ borrowing decisions via the establishment of risk classifications of credit products;<sup>112</sup> we believe such classifications would be more helpful to consumers than creating only risk guidelines. Simply 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 have asserted.<sup>113</sup> However, the creation of a risk-based classification of loan products is different; the consumer would receive a simple “rating” of the safety or risk of the loan being offered. This rating could take the form of 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 in overcoming the various cognitive barriers to decision-making previously discussed. It would mitigate the effects of psychological phenomenon number one, consumers’ inability to process user-unfriendly features of disclosure forms, because a single classification would summarize various features and thereby alleviate cognitive overload.<sup>114</sup> It would mitigate psychological phenomenon number two, consumers’ lack of contractual schemas or knowledge structures, because even if consumers are unable to judge the riskiness of a loan, they will understand the meaning of these classifications.<sup>115</sup> It might overcome psychological phenomenon number five, reason-based decision-making, if consumers considered this feature as seriously as they do their potential monthly payment.<sup>116</sup> It would very likely also help reduce psychological phenomenon number six, biases in attribute estimation and evaluation, since this classification summarizes 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.<sup>117</sup>

The main psychological phenomenon whose impacts the classification would

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110. Summary of Responses, *supra* note 16, at 13.

111. *Id.* at 13-14.

112. *Id.* at 13.

113. *Id.* at 6.

114. Stark & Choplin, *supra* note 27, at 97-98.

115. *Id.* at 98.

116. *Id.* at 100.

117. Stark & Choplin, *supra* note 27, at 100.

assuage, however, is number four, availability heuristics.<sup>118</sup> 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.<sup>119</sup>

Although a loan product that is rated “Risky” or “Very Risky” might make sense for some consumers given their circumstances, the rating puts consumers on notice that, for many, this loan is not appropriate and that consumers should obtain the independent advice of a trained mortgage counselor. For example, if a loan accrues interest at a floating rate with no cap on how high the rate can rise, it might warrant a “very risky” rating 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 the lower adjustable rate loan as compared to the higher fixed rate.

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). When such loans mature 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 it has become more difficult to obtain a loan. If the borrower does not qualify for a new loan to pay off the previous 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 or available income to pay off this debt. A more prudent loan would be a “fully-amortizing” loan, in which enough principal is being paid each month, in addition to the accrued interest, so that when the loan matures and becomes due, there is no additional principal owed.<sup>120</sup>

If comprehensive risk-based loan product classifications are adopted as part of a Directive, the ESIS should conspicuously disclose this information on an offered loan product, along with a recommendation to obtain independent advice when the offered loan is high risk. The existence of this risk-based classification would also further the Commission’s goal of creating a more integrated EU market that offers more diverse loan products. This will result because consumers will feel more confident in taking a home loan from a cross-border lender if that loan is rated with a low level of risk by an independent body like the Commission. In addition, by learning about the different types of home loan products being offered among the

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118. *See id.* at 99-100.

119. *See id.* at 101-02.

120. *Understanding Fair Lending*, UNITED STATES DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT, 41, [http://portal.hud.gov/hudportal/documents/huddoc?id=DOC\\_7386.pdf](http://portal.hud.gov/hudportal/documents/huddoc?id=DOC_7386.pdf). This loan is traditionally known as a fixed rate mortgage that is fully paid at the end of the loan period, and distinguished from a balloon payment mortgage that does not fully amortize. *Id.*

Member States, the Commission can better gauge the risks to consumers and can then better assess whether to impose a suitability duty on mortgage brokers. It will also be in a better position to determine the circumstances in which borrowers should be mandated to receive advice before taking on certain home loans.

The main disadvantage to creating a risk-based comprehensive classification of home loan products and the disclosure in the ESIS of the offered loan's classification is the creation costs and difficulties. These difficulties will be: (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.<sup>121</sup> 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 with respect to the Commission's articulated goals of enhancing consumer protection and consumer confidence. The Commission should take these long term benefits fully into account when engaging in a cost-benefit analysis in light of their articulated goals.

The second possible disadvantage of creating a risk classification for home loans is that a loan might receive a risky rating and dissuade some consumers from taking on the loan, even though the loan is not risky for every potential borrower. Indeed, some members of the non-financial services industry who commented on the creation of risk guidelines indicated that risks depend on the financial circumstances of the individual, so guidelines may not be useful and could overstate or understate risks.<sup>122</sup> To mitigate this possibility, the disclosure in the ESIS should note the possibility of overstating or understating risks and direct the consumer to seek advice from an independent<sup>123</sup> mortgage counselor. Some of the members of the non-financial services industry also raised the possibility that lenders might react to the risk based guidelines by tailoring their products to those guidelines.<sup>124</sup> This would actually be a positive reaction, since only low cost loans are categorized as the lowest rated risk based classification.

In contrast to our suggestion, the financial services industry federations doubt "the possibility of establishing a set of harmonized guidelines."<sup>125</sup> They opined that the additional risk warnings were redundant because the other pre-contractual information is clear and comprehensible, that there are already obligations under the Consumer Credit Directive to provide suitable explanations, and that most Member States already mandate informing consumers of the risks.<sup>126</sup> Thus, in their

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121. We recommend that the Commission take on this task after consultation with the stakeholders involved.

122. Summary of Responses, *supra* note 16, at 6-7.

123. To avoid a conflict of interest, it is very important that the advisor not be the lender, the mortgage broker or anyone else with an interest in the consumer acquiring the loan. *See infra* notes 196-213 (discussing, in greater detail, the fourth additional measure).

124. Summary of Responses, *supra* note 16, at 7.

125. *Id.* at 6.

126. *Id.*

view, the costs of creating the guidelines exceeded the benefits.

However, the arguments 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>127</sup> hence, there is a need for this information. Second, providing this additional information would allow consumers to overcome some of the cognitive limitations that they struggle with. It would provide an important benefit to consumers who typically suffer from information asymmetries created by their lack of knowledge about the loan terms, the available alternatives, and the risks that different terms pose compared to 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 risk rating for the loan product offered, based on a simple 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 an easily comprehensible risk-based classification would be matched by the simple concept of “adequate information” under that Directive. Fourth, if self-regulation has not spurred a voluntary ESIS, it is highly unlikely that it will be effective in a context where mortgage lenders and intermediaries might be asked to act against their self-interest and explain the risks of a home loan product they are offering.

Those Member States that were receptive to creating risk guidelines also mentioned the difficulty in imposing them on the industry and questioned who should develop these guidelines.<sup>128</sup> As previously explained, the risk based classifications of loan products we 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 if the Commission creates 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. It should then classify each of these products by risk, based on criteria similar to those used for an “approved standard form of prudent home loan product,” discussed directly below.

The second measure that we recommend is strongly connected to the first: the Commission should create an “approved standard form of prudent home loan product.” This loan would be highly prudent and low cost; therefore, consumers could feel confident in acquiring it. The Commission should consult with the various stakeholders to determine the mandatory features of such a loan, but the Commission should finalize these features.<sup>129</sup> The advantage of creating a

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127. Impact Assessment Annex 3, *supra* note 14, 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.” *Id.*

128. Summary of Responses, *supra* note 16, at 7.

129. Based on the inability of the representatives from the lending industry and consumer



Commission-approved standard form of prudent home loan product is that if a loan complies with the definition, this could be conspicuously noted on the ESIS. As a result, consumers could feel very confident that they have taken on a prudent and low cost home loan. Conversely, if the loan product was not given an approved standard form, this could also be conspicuously noted on the ESIS, along with a warning that the consumer should seek independent advice regarding the loan.

While the standard form of prudent home loan product indicates that the Commission has approved certain features of the loan product and thus may discourage independent analysis, it could also facilitate consumer education of home loan schemas in that it would provide a default type of loan product to which all alternative loans that differ from the standard could more easily be compared. The standard form of prudent home loan product may thereby partially assuage the effects of psychological phenomenon number two.<sup>130</sup> It would also help overcome psychological phenomenon number three, inaccurate default assumptions of how contractual provisions are likely to be structured, since the new standard would create a default and deviations from this default would be noticeable. The standards for a loan to qualify as an approved standard form of home loan include rigid protection of consumers because lenders are not prohibited from making non-standard loans; 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>131</sup>

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 should be either an “affordable,” fixed interest rate loan for the entire term, or an adjustable rate loan with the interest rate increases capped at a level that the borrower could afford, based on a debt to income ratio.<sup>132</sup> Second, the loan should be a fully amortizing loan. This means that if the mortgage market has tightened or interest rates have risen significantly, the borrower would not be in

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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.

130. Stark & Choplin, *supra* note 27, at 104-05.

131. *White Paper*, *supra* note 2, at 4. 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 for the benefit of consumers because lenders can comply with the third (imposing a duty to only offer suitable home loan products for the consumer) and fourth reforms (mandating independent financial advice for loans rates as “very risky”). Another approach is to require lenders to first offer the approved standard form of prudent home loan to the consumer but allow the consumer to opt out and obtain a different home loan product.

132. 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 the Commission considers “affordable.” *White Paper*, *supra* note 2, at 4.

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. This ensures that one of the key components of the price of the loan remains consistent with the market level.<sup>133</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 (with a flat dollar amount for very small principle loans).<sup>134</sup> This provision controls the key remaining factors for a low-priced loan. Fifth, the loan would permit prepayments and would recognize only customary events of default. Customary events include the failure to pay monthly installments or insurance and real estate taxes, as well as acts of waste or failing to maintain the home such that the mortgage lien is impaired. On a related matter, the loan must also 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, for example, six percent, with a new loan accruing interest at, for example, five and a half percent, 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 potential net economic benefit from a refinance must consider the anticipated period of time before the borrower takes on a new refinance in addition to plans to sell the home when the borrower incurs costs to obtain the new home loan (in contrast to 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, seventh, the loan should meet any other factors that the Commission deems to be evidence of a prudent and low cost home loan (these could include factors relating to whether the lender 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).<sup>135</sup> 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

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133. See Impact Assessment Annex 3, *supra* note 14, at 139 (noting that in France a loan is deemed usurious if the APR 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).

134. These should be set by the Commission based on a low cost loan in light of historical averages for such fees and charges.

135. We have not included these factors in the approved standard form of home loan because as the Commission’s White Paper indicates, they already intend to impose a duty on lenders to make sure the borrower is creditworthy. See *White Paper*, *supra* note 2, at 7. The factors here focus on the borrower’s perspective.

factor.<sup>136</sup>

The main disadvantages of creating a Commission approved standard form of prudent home loan product are the difficulty and costs in creating it and updating it to account for changes in the marketplace. Borrowers can still select loans that do not comply with the “approved standard form of home loan product.” However, when doing so, they would first be made aware that the loan they are selecting contains certain features that may be more risky or unfavorable. They would also be instructed to seek advice from independent mortgage counselors before selecting such loans. Like the risk based classification of loans, this information 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>137</sup> The chambers of commerce and some consumer advocates expressed support for creating standard forms of home loan products across Member States that would reduce costs.<sup>138</sup> Other consumer advocates commented that all loan products, and not just those which are standardized, should be fair and suitable to the individual needs of the consumer.<sup>139</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 that this would permit lenders to offer a loan product to those with lower incomes that appears affordable but that in fact does not remain so.<sup>140</sup> Some consumer advocates also noted that the creation of “certified” home loan products could allow certain products to be offered to consumers without the need to obtain independent financial advice on the product.<sup>141</sup> This point is correct and would add efficiency into the system for consumers because they would already be assured that they were obtaining a prudent and low cost loan. Some consumer representatives indicated that lenders should be obligated to present these certified standard form of home loan products to consumers.<sup>142</sup> Consumers could choose to accept the standard form or opt out of it and take out a more sophisticated product that better suits their needs.<sup>143</sup> We also agree that the ultimate decision is for the consumer to make and the default position should be to offer the approved standard form of prudent home loan

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136. *White Paper, supra* note 2, at 7.

137. Summary of Responses, *supra* note 16, at 7.

138. *Id.*

139. *Id.* We address this point in our third and fourth proposed reform measures. *See* text accompanying notes 153-214.

140. For example, lenders may offer loans with initially low teaser rates that automatically rise after a few years and become unaffordable or offer 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 for some time, but still risk losing the home when the loan comes due.

141. Summary of Responses, *supra* note 16, at 8.

142. *Id.*

143. *Id.*

product, yet still allow the consumer to opt out of that and select a different home loan product.<sup>144</sup> This may help overcome the biases in attribute estimation and evaluation, including the status quo or default value bias.<sup>145</sup>

The financial services industry federations, providers, and financial sector trade unions commented strongly against standardized products, claiming that they are not necessary and not fit for purpose.<sup>146</sup> The industry representatives viewed standardized products as stifling innovation, limiting choice and diversity, and reducing competition.<sup>147</sup> They argued that the choice to design and offer a range of products in response to customer needs should be left to the credit industry.<sup>148</sup> Member States were also largely opposed to product standardization, with many arguing there were no inherently unsuitable products.<sup>149</sup> A small number of Member State authorities did, however, show cautious support for product standardization, conditioned upon its not interfering with market autonomy.<sup>150</sup> The trade union representatives indicated they would welcome risk classification and certification indicating suitability for different consumers, but not standardization.<sup>151</sup> Based upon this last indication and the comment among some Member States about market autonomy, it appears that the industry and Member States mistakenly believed that the creation of standardized home loan products would 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 and 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 he or she believed that another product would better suit his or her needs. Thus, the creation of a standard form of prudent home loan product will not stifle innovation or limit choice or diversity. It could also actually increase competition among cross-border loan providers because consumers would potentially feel more confident accepting their loan products if 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, this caution is a good thing and can still be overcome by the mortgage lender or credit intermediary, who will have the opportunity to explain why a different form of home loan product would make sense for the borrower.

The third reform measure that we recommend is for the Commission's

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144. 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. If it is classified as "very risky," the consumer would then be required to receive independent advice on this first as set forth in the fourth reform measure we propose.

145. See R.H. THALER & C.R. SUNSTEIN, *NUDGE: IMPROVING DECISIONS ABOUT HEALTH, WEALTH & HAPPINESS* 50 (2009).

146. Summary of Responses, *supra* note 16, at 8.

147. *Id.*

148. *Id.*

149. *Id.*

150. *Id.* at 9.

151. *Id.* at 8.

Directive to include a mandated duty on mortgage lenders and intermediaries to offer only “suitable” home loan products to the consumer. Suitable here means loans that meet the consumer’s basic needs and goals based on certain criteria developed by the Commission. Due to information asymmetry and the problem of moral hazard,<sup>152</sup> imposing a duty of suitability on mortgage lenders and intermediaries is a way to level the playing field.<sup>153</sup> Although the Revised ESIS, if made mandatory and further revised as we recommended in Section II, would provide consumers with the basic important information on the mortgage loan presented to them,<sup>154</sup> the various cognitive and social psychological barriers discussed in Section II<sup>155</sup> may limit its effectiveness. 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 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. Moreover, consumers will often be unaware that this is occurring. But with this reform, consumers can overcome a variety of psychological phenomena discussed in this article including: lack of contractual schemas or knowledge structures,<sup>156</sup> assumptions regarding whether the contract is negotiable,<sup>157</sup> acceptance of senseless explanations and argument immunization,<sup>158</sup> strong motivations to trust,<sup>159</sup> and social norms and signals that

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152. The Commission of the European Communities has commented on the relationship between the interests of mortgage lenders and the interests of borrowers:

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 lose [sic] their home.

Impact Assessment Annex 3, supra note 14, at 41.

153. To avoid potential liability to the consumer for the harm consumers suffer as a result of 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.

154. See supra Part II.

155. See Impact Assessment Annex 3, supra note 14, at 35.

156. The proposed duty prevents offering fiscally unsophisticated consumers an unsuitable loan.

157. Individuals might have taken on an unsuitable loan because they mistakenly believed they could not negotiate for a better one, but with the suitability requirement in place they will not be offered an unsuitable home loan in the first place; R.P. Hill & J.C. Kozup, *Consumer Experiences with Predatory Lending Practices*, 41 J. OF CONSUMER AFFAIRS 29, 40 (2007).

158. This is because lenders and credit intermediaries would no longer be able to explain the unsuitable features away. J.C. Choplin, D.P. Stark & J. Ahmad, *A Psychological Investigation of Consumer Vulnerability to Fraud: Legal and Policy Implications*, L. & PSYCHOL. REV. 35 (forthcoming).

159. Consumers are often insecure about obtaining a loan and then feel that the lender has

encourage minimal attention to material presented in forms.<sup>160</sup> 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>161</sup> However, the Commission noted that data collected in the UK reflects that in one-third of the files reviewed<sup>162</sup> “there was an inadequate assessment of consumers’ ability to afford the mortgage credit product sold”<sup>163</sup> and that “in almost half the files reviewed there was an inadequate assessment of customers’ suitability (e.g., needs and circumstances) for the mortgage.”<sup>164</sup>

The term “suitable” with regard to home loans should be defined by the Commission after consultation with the various stakeholders. In our opinion, the definition should include, at a minimum, the first two of the following three factors. First, the loan must be one that the borrower can afford to repay.<sup>165</sup> Second, in the case of a refinance, the loan must be one 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>166</sup> Finally, the loan must either be at the average current interest rate, fees, and closing costs

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conferred a great benefit to them by providing them with a loan, and consequently are less likely to question the loan terms. Hill & Kozup, *supra* note 157, at 40. But the suitability requirement places the two parties on more even footing and helps avoid this misconception.

160. Since consumers should only be offered suitable home loans, there is less risk from their failure to read the terms of an unsuitable product.

161. See Impact Assessment Annex 3, *supra* note 14, at 40.

162. *Id.* at 41. The loans reviewed were for borrowers with impaired credit histories who were being offered sub-prime loans.

163. *Id.*

164. Impact Assessment Annex 3, *supra* note 14, at 40.

165. 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 16, 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. *Id.* at 10.

166. The concept of “net economic benefit” was defined in the discussion of the standard form of approved home loan. See text accompanying notes 135-137. However, 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.

charged for loans within a specified geographic range<sup>167</sup> of the mortgaged property and with a comparable loan to a comparable borrower (to avoid price disparities) or the loan must be one with higher rates and costs by no more than a specified percentage set by the Commission.<sup>168</sup>

The first factor of suitability, referred to here as affordability, is the cornerstone of responsible lending. It ensures that the borrower can afford to repay the loan and consequently would not lose their home or equity as a result of a default in repaying the debt. It relates to the “creditworthiness” of the borrower, a factor that all Member State and stakeholder comments indicate lenders should always take it into account.<sup>169</sup> It is necessary to create a duty to offer only “affordable” home loans to consumers because both credit intermediaries and home lenders may have an incentive not to do so. Credit intermediaries and lenders will earn fees from making unaffordable home loans (perhaps even higher fees than with an affordable home loan), regardless of 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. 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>170</sup>

In reaction to the large scale granting of unaffordable home loans in the U.S before the financial meltdown in 2007, commentators have advocated for a duty of suitability that focuses on the affordability of the loan and certain other reforms.<sup>171</sup>

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167. 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.

168. 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.

169. Summary of Responses, *supra* note 16, at 11 (noting that “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”).

170. 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. *See generally Green Paper, supra* note 3.

171. *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) (also raising, as reforms, prohibiting yield spread premiums, lump sum insurance payments, and requiring an economic rationale 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. *Id.* at 1335. In this scenario, the duty would be imposed on 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. Additionally, they argued that disclosures are inadequate and that consumers rely on intermediaries. *Id.* at 1280.

This duty would apply to all home mortgage loans, not just very high priced home loans.<sup>172</sup> Although there is no large sub-prime mortgage market among the EU Member States as there was in the United States, there is still great potential among the EU Member States for credit intermediaries and even lenders to offer loans that the consumers may not be able to repay.<sup>173</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 time the loan is made.<sup>174</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 significant additional 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>175</sup> Such a floor would still permit lenders to apply any additional factors for borrowers to meet in order to preserve the lender’s autonomy in determining affordability, 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 one in order to take advantage of prevailing lower interest rates, then there must be a net economic benefit from the refinance.<sup>176</sup> However, as discussed previously, a lower interest rate does not necessarily mean that the refinance provides a net economic benefit to the borrower. This is a point many borrowers fail to realize. Consequently, for a refinance loan to be suitable, it must provide a net economic benefit to the

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

173. 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 stays within a range that borrower can afford to pay. *Types of Bonds*, INVESTING IN BONDS EUROPE, <http://www.investinginbondseurope.org/Pages/LearnAboutBonds.aspx?id=6354> (Mar. 26, 2010).

174. Summary of Responses, *supra* note 16, at 9. 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. *Id.* 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. Aaron Smith, Note, *A Suitability Standard for Mortgage Brokers: Developing a Common Law Theory*, 17 GEO. J. POVERTY LAW & POL’Y 377, 386 (2010).

175. 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 16, at 9.

176. 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.



consumer, or the consumer must sign a document indicating that the purpose of the refinance is not for a net economic benefit,<sup>177</sup> but for another purpose. For example, a refinance that increases the loan amount may cause the consumer to use the additional amount for personal reasons.<sup>178</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>179</sup> This was done in reaction to the practice by U.S. mortgage brokers and lenders of inducing 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. These costs eliminated the borrower's net economic benefit from each refinance (a predatory loan feature referred to as "loan flipping").<sup>180</sup> This harmful practice, which typically arises in an environment of declining interest rates, can be greatly discouraged by imposing a duty on home lenders and credit intermediaries to either create a net economic benefit to the refinancing borrower or to clearly document that the consumer has accepted the refinance with a different purpose. 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>181</sup> However, imposing this duty will provide an important protection to consumers who think they are making a wise home loan decision by replacing a higher interest loan with a lower interest one, when in fact they are not likely to receive any benefit from the refinance due to their schema deficit regarding financial literacy.

The third potential suitability factor requires that the consumer is offered a

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177. The document should explain what a "net economic benefit" is and how it does not exist under the contemplated refinance.

178. 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. Kerry Cappel, *Is Europe's Health Care Better?*, BLOOMBERG BUSINESSWEEK (June 13, 2007), [http://www.businessweek.com/globalbiz/content/jun2007/gb20070613\\_921562.htm](http://www.businessweek.com/globalbiz/content/jun2007/gb20070613_921562.htm); Jim Sheng, *Comparison of Tuition Costs of Higher Education Around the World*, HUBPAGES, <http://hubpages.com/hub/Comparison-of-cost-of-higher-education-around-the-world> (last visited Mar. 12, 2011).

179. Section 1639(h) of Title 15 of the United States Code provides:

A creditor shall not engage in a pattern or practice of extending credit to consumers under mortgages referred to in section 103(aa) of this title based on the consumers' collateral without regard to the consumers' repayment ability, including the consumers' current and expected income, current obligations, and employment.

15 U.S.C. §1639 (h).

180. Debra P. Stark, *Unmasking the Predatory Loan in Sheep's Clothing: A Legislative Proposal*, 21 HARV. BLACKLETTER L.J. 129, 139 (2005); see also Hasa A. Kingo, Note, *Preying on the American Dream: The Argument for HOEPA Reform Amidst Predatory Lending's Dire Effects on the Elderly Poor*, 17 GEO. J. POVERTY L. & POL'Y 335, 351 (2010).

181. 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. They will then need to 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.

loan at an interest rate, fees, and costs no higher (beyond a specified permitted percentage) than the average interest rates, fees, or closing costs currently charged by lenders<sup>182</sup> to similarly situated consumers.<sup>183</sup> The effect of this provision will be to discourage mortgage lenders and credit intermediaries from engaging in significant price disparities to the detriment of some consumers.<sup>184</sup> This is not the same as a usury law, as 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>185</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 are disproportionately targeted for higher interest rate and higher closing cost loans even after taking into account the creditworthiness of the borrowers.<sup>186</sup> If data reveals that similar disproportionate targeting exists in the EU, then this last suitability factor will also need to be implemented.

Because all three of the factors impose a duty of suitability on the mortgage broker or lender that would already be satisfied under the approved standard form of home loan, there should be a presumption that the duty of suitability has been satisfied when the consumer is offered a loan that is an approved standard form of prudent home loan product. Thus, the duty of suitability will also encourage mortgage lenders and intermediaries to propose the approved standard form of

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182. 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. See *supra* notes 167-68 and accompanying text.

183. Similarly situated consumers would mean similar in terms of debt to income ratios, credit histories, and loan to value ratios.

184. *Green Paper, supra* note 3, at 3 (articulating the goal of enhancing price convergence).

185. 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 15 (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.).

186. See, e.g., DEBBIE GRUENSTEIN BOCIAN, ET AL., THE EFFECT OF RACE AND ETHNICITY ON THE PRICE OF SUBPRIME MORTGAGES 10 (2006), available at [http://www.responsiblelending.org/mortgage-lending/research-analysis/r011-Unfair\\_Lending-0506.pdf](http://www.responsiblelending.org/mortgage-lending/research-analysis/r011-Unfair_Lending-0506.pdf) (stating that Latinos and African-Americans are twenty-eight percent and thirty-seven percent more likely, respectively, to receive a higher-rate subprime loan than whites); Michael S. Barr, et al., *Who Gets Lost in the Subprime Mortgage Fallout? Homeowners in Low and Moderate Income Neighborhoods* 2-3 (2008), <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 Deanne Loonin & Elizabeth Renuart, *The Life and Debt Cycle: The Growing Debt Burdens of Older Consumers and Related Policy Recommendations*, 44 HARV. J. ON LEGIS. 167, 180-81 (2007) (maintaining that "subprime and predatory lending disproportionately impact seniors").

prudent home loan product and to only offer alternative forms of home loans when they can still meet the three criteria articulated above.

The proposed duty of suitability 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 bargained for; the result 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. They 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>187</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>188</sup> In the United Kingdom, 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, while keeping an adequate record to demonstrate they have taken account of the customer's ability to repay.<sup>189</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>190</sup>

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187. Impact Assessment Annex 3, *supra* note 14, at 36.

188. *Id.*

189. *Id.*

190. *See, e.g.*, ALASKA STAT. § 06.60.350(b) (2011) (requiring licensees to consider various factors in determining net benefit to the borrower); ARK. CODE ANN. § 23-39-510 (4) (2010) (requiring licensees to make reasonable efforts to secure a loan that is reasonably advantageous to the borrower considering rates, repayment terms, and charges); 205 ILL. COMP. STAT. ANN. 635/5-7 (1) (LexisNexis 2011) (imposing duty to act in the borrower's best interest); 205 ILL. COMP. STAT. ANN. 635/5-6 (LexisNexis 2011) (requiring verification of borrower's reasonable ability to repay real estate taxes, homeowner's insurance, assessments, principal and interest); ME. REV. STAT. ANN.tit. 9-A § 10-303-A (1)(F) (2011) (requiring licensee to make reasonable effort to obtain a loan reasonably advantageous to the borrower regarding rates, charges, and repayment terms); MD. CODE REGS. 09.03.06.20 (A)(1) (2011) (imposing duty to recommend mortgage loans that have a net tangible benefit to the borrower); 960 MASS. CODE REGS. 8.06 (LexisNexis 2010) (declaring it unfair practice for mortgage brokers to make a loan that is not in the best interests of the borrower); MINN. STAT § 58.161 (2010) (imposing duty to ensure mortgage loan is in the best interest of the borrower); MINN. STAT. § 58.13, (2010) (requiring licensees to 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(x)

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>191</sup> Mortgage lenders and credit intermediaries are likely to object to the burden this duty would impose on them. They would need to check to ensure not only that the consumer can afford the loan, but also to ensure that a net economic benefit accrues to the borrower in the case of a refinance. This could be time consuming. It may also result in the loss of business if it turns out that the loan offered is not affordable or if the refinance does not offer a net economic benefit. 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 that assessment. They cited a desire to retain their freedom to make this determination and to “preserve competition” in the banking business.<sup>192</sup> In addition, they objected to EU-wide harmonization 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>193</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>194</sup> This

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(LexisNexis 2011) (prohibiting lenders from arranging a loan unless reasonable lender would believe borrower will be able to make the scheduled payments); N.M. REV. 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. REV. STAT. ANN § 58-21B-20(5) (LexisNexis 2010) (requiring mortgage loan originators to “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. REV. STAT. ANN § 52-21B-20(7) (LexisNexis 2010) (requiring mortgage loan originator to disclose to applicants more favorable loans for which the applicant qualifies that were not offered by the originator); N.Y.BANKING LAW § 590-(f) (Consol. 2011) (requiring mortgage brokers 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 2011) (requiring mortgage brokers to make reasonable efforts to secure a loan with repayment terms that are advantageous to the borrower); 10 PA. CODE § 46.2 (g)(1) (2011) (requiring the licensee to determine that the borrower will have ability to repay the loan); W. VA. CODE ANN § 31-17-12(a)(7) (LexisNexis 2010) (providing for the suspension or revocation of a mortgage broker’s license if loan made to consumer who has insufficient sources of income to timely repay the debt).

191. Summary of Responses, *supra* note 16, at 11. 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. *Id.*

192. *Id.* at 10.

193. *Id.*

194. 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 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

establishes a minimum level of affordability standard, while still allowing lenders to require a higher level of affordability. It also leaves them the discretion to determine a borrower's creditworthiness (subject of course to local fair lending/anti-discrimination laws).

The second aspect of the suitability duty we proposed is a net economic benefit from a refinance. It would be based upon a fairly simple calculation after inquiring into the borrower's specific situation, and it would also 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 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 would create a higher administrative burden for lenders, compared with the first two recommended elements. Furthermore, this third aspect of the duty of suitability would cut into the profits that the mortgage lender or credit intermediary would otherwise be able to make on the home loan, due to the cap set by the Commission. In addition, imposing any duty of suitability will be objectionable to mortgage lenders and credit intermediaries due to the potential exposure to liability an alleged breach of this duty would cause. 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. Rather, data on this question should first be collected.

However, the Directive can address the lender's desire to avoid the additional burdens that the duty of suitability would impose. It can also address their concern that a breach of the proposed duty will expose them to liability for the consumer's damages. In order to do so, the Directive should 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 lender pays for the consumer to receive independent advice on a non-approved home loan from a certified, trained mortgage counselor. 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, while also protecting consumers.

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>195</sup> Lenders and credit intermediaries

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should be regulated. William F. Buckley Jr., *If Only we Could Regulate the Subprime Crisis Away*, HOUSTON CHRONICLE, Jan. 3, 2008, <http://www.chron.com/disp/story.mpl/editorial/outlook/5426356.html>.

195. See MICHAEL S. BARR ET AL., BEHAVIORALLY INFORMED FINANCIAL SERVICE REGULATION, NEW AM. FOUND. 1, 8-9 (2008), available at [http://www.newamerica.net/files/naf\\_behavioral\\_v5.pdf](http://www.newamerica.net/files/naf_behavioral_v5.pdf). When a default rule is not against the

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.

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. This is 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. According to a Eurobarometer survey from 2005, seventy-two percent of consumers surveyed expect financial institutions to give them advice,<sup>196</sup> but only forty-six percent of the consumers surveyed said they actually trusted the advice provided by financial institutions.<sup>197</sup> These two facts suggest that many consumers desire advice on the home loan products, 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 fourteen of the psychological barriers to wise home-loan decision-making outlined in Section II.<sup>198</sup> The Commission staff noted the many benefits of providing objective advice to consumers.<sup>199</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

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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). *Id.* at 10. 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. *Id.* at 9. Thus, creating a duty of suitability which can 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. *Id.* at 8-10. However, "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 3.

196. Impact Assessment Annex 3, *supra* note 14, at 36.

197. *Id.*

198. See Abdighani Hiran & Peter Zorn, *A Little Knowledge Is a Good Thing: Empirical Evidence of the Effectiveness of Pre-Purchase Homeownership Counseling*, in LOW-INCOME HOMEOWNERSHIP WORKING PAPER SERIES 2 (2001), available at <http://www.jchs.harvard.edu/publications/homeownership/liho01-4.pdf> (stating that homeowners who receive individual counseling under Freddie Mac's Affordable Gold program are forty-one percent less likely ever to become 60-day delinquent on their home loans than equivalent borrowers in the study who do not receive such counseling).

199. Impact Assessment Annex 3, *supra* note 14, at 41.

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 incentives to recommend a product other than the one which is best suited for the consumer.<sup>200</sup>

The Commission specifically required 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>201</sup> Although the Commission noted that mandatory advice “would ensure that a consumer receives a clear recommendation for one or more product” it would also “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>202</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>203</sup>

Mortgage lenders also disfavored imposing mandatory mortgage advice, arguing 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>204</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 favoring introduction of standards for the provision of advice.<sup>205</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, fifty percent of the consumers and users who provided feedback on the Green Paper indicated that

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200. Impact Assessment Annex 3, *supra* note 14, at 41.

201. *Id.* at 44.

202. *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. *Id.* However, 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.

203. *Id.* at 54-55.

204. Impact Assessment Annex 3, *supra* note 14, at 43.

205. *Id.*

they desired the advice to be compulsory, while the other half did not.<sup>206</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, as there is a stronger chance both that the home loan being offered to them is not a loan that the borrower should be taking and that 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 United States).<sup>207</sup> 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>208</sup> many seniors would be making a serious mistake in 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>209</sup>

However, there are several other reasons some consumers might not want to receive mandatory advice prior to taking out a home loan, even a loan classified as very risky. For example, if the consumer considers herself to be highly sophisticated and knowledgeable about the particular home loan product being offered, as well as the alternatives, she may think that it is a waste of time and of

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206. *Id.* at 42.

207. A reverse mortgage is a loan available to seniors aged 62 or older in the United States. A reverse mortgage releases the home equity in the property as one lump sum or multiple payments made from the lender to the homeowner. The homeowner's obligation to repay the loan is deferred until the owner dies, the home is sold, or the owner ceases to occupy the home. *About Reverse Mortgages*, REVERSEMORTGAGE.ORG, <http://www.reversemortgage.org/Default.aspx?tabid=230> (last visited Mar. 24, 2011).

208. Maya Jackson Randall, *Debate on Reverse-Mortgage Risks Heat Up*, WALL ST. J., Dec. 14, 2010; Jim Puzanghera, *Greater Oversight of Reverse Mortgages Urged*, L.A. TIMES, Dec. 8, 2010. Seniors' health concerns can compound the risk of foreclosure. 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 loan and can lose their home. One survey revealed that almost half of all respondents indicated that their foreclosure was partially caused by medical illness or injury. See Christopher T. Robertson, et al., *Get Sick, Get Out: The Medical Causes of Home Foreclosures*, 18 HEALTH MATRIX 65, 68 (2008).

209. 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. Carolyn H. Sawyer, *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. Michael Gusto, *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*, COLO. SPRINGS GAZETTE, Mar. 11, 2007, <http://www.gazette.com/articles/tax-20061-taxes-property.html>.



her money to be forced to receive advice on this high risk loan. If the Commission wishes to address this situation they could create a summary of the benefits and detriments of each loan product reviewed, as well as the characteristics that make the loan to be appropriate for different consumers. This summary could be offered to consumers in an interactive computer training session, including self-tests to determine if the consumer has absorbed this information. If the consumer still desires to waive receipt of advice after successfully completing the training session, 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>210</sup> Furthermore, if an adequate number of companies are licensed to train mortgage counselors, then a mandatory advice requirement should not add significant delays to the closing of the loan.<sup>211</sup>

Finally, some consumers may not desire mandatory counseling advice because they believe that the mortgage intermediary or 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 that contains risky or otherwise unsuitable features. Unfortunately, this trust may be misplaced because 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 when the loan amount is high and the commission is based on the amount of the loan.<sup>212</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; the higher the origination charges, the higher the lender's profits. 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 instead seek independent advice when being offered a high cost or otherwise risky loan. Indeed, as detailed in Section II, unscrupulous mortgage lenders or credit

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210. See e.g., 765 ILL. COMP. STAT. ANN. 77/70 (c)-(d) (LexisNexis 2011) (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, which is less than the cost of a typical home appraisal report). 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.

211. According to data from the Illinois Department of Financial and Professional Regulation's Anti-Predatory Lending Database Program, an average counseling session may last 2-3 hours. ANTI-PREDATORY LENDING DATABASE PROGRAM, <https://www.ilapld.com/default.aspx> (last visited Mar. 25, 2011).

212. *Hearing Before the S. Comm, supra* note 13, at 2-3.

intermediaries could lead consumers through the ESIS in a way that impedes the ability of the consumer to glean the information they need 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 products, 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 enters into a very risky home loan, he or she 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.

## V. CONCLUSION

The EU Commission, as noted, seems poised to create a Directive that would mandate the disclosure of key loan terms and expenses to EU consumers before they enter into a home loan. Providing this disclosure in the form of the Revised ESIS with the modifications we have detailed here, 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. However, 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 offered product complies with that standard; (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) imposing a duty of “suitability” on mortgage lenders and credit intermediaries to ensure that the loans they are offering are affordable, provide a net economic benefit, and do not reflect great price disparities; and (iv) requiring mandatory counseling advice from an independent, certified-as-trained mortgage counselor if the consumer is entering into a home loan product classified as very risky.

The four reforms were designed to provide necessary protections to consumers with minimal added costs and minimal loss of autonomy for both consumers and 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. Instead, like the revised ESIS, they simply provide 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 limit the 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 restrict 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, similar to what Illinois has enacted for its high-risk home loans.<sup>213</sup>

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), as well as the economic benefits these reforms are likely to create. Ultimately, these reforms will benefit consumers by ensuring that they 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 the very least, embrace the first two reform measures we propose, as implementation of these two measures may be a necessary precondition to successfully marketing cross-border home loans to consumers. These two reforms can significantly raise the confidence level of consumers, allowing them to feel protected when they are presented with a cross-border home loan that has been certified as being in compliance with the ESIS's standard form of prudent home loan or when the loan offered reflects a low level of risk rating in the ESIS. As these benefits will encourage both consumers and lenders to transact cross-border home loans, these reforms should be viewed as an essential step in achieving the Commission's primary goal of enhancing the integration of the EU mortgage market, which in turn should lead to improvements in the economies of all Member States.<sup>214</sup>

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213. See 765 ILL. COMP. STAT. ANN. 77/70.

214. 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 3, at 3.