

# RESPA

## Regulatory Impact Analysis and Initial Regulatory Flexibility Analysis FR-5180-F-02

### Final Rule to Improve the Process of Obtaining Mortgages and Reduce Consumer Costs



Office of Policy  
Development  
and Research

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## EXECUTIVE SUMMARY

### I. Introduction

This chapter of the Regulatory Impact Analysis is the Final Regulatory Flexibility Analysis (FRFA) of the final rule as described under Section 604 of the Regulatory Flexibility Act. The requirements of the FRFA are listed below along with references to where the requirements are covered in the FRFA and where more detailed discussion can be found in other chapters of the Regulatory Impact Analysis (RIA).

*A description of the reasons why action by the agency is being considered* can be found in Section III of this chapter, in Section II of Chapter 1 of the RIA, and in greater detail in the first sections of Chapters 3 and 4 of the RIA.

*A succinct statement of the objectives of, and legal basis for, the final rule* is provided in Section III of this chapter. This is also discussed in Section II of Chapter 1 of the RIA and in greater detail in the first sections of Chapters 3 and 4 of the RIA.

*A description and an estimate of the number of small entities to which the rule will apply or an explanation of why no such estimate is available.* Section V provides data on small businesses that may be affected by the rule. As explained in Section V, Chapter 5 of the RIA also provides extensive documentation of the characteristics of the industries directly affected by the rule, including various estimates of the numbers of small entities, reasons why various data elements are not reliable or unavailable, and descriptions of methodologies used to estimate (if possible) necessary data elements that were not readily available. The industries discussed in Chapter 5 of the RIA included the following (with section reference): mortgage brokers (Section II); lenders including commercial banks, thrifts, mortgage banks, credit unions (Section III); settlement and title services including direct title insurance carriers, title agents, escrow firms, and lawyers (Section IV); and other third-party settlement providers including appraisers, surveyors, pest inspectors, and credit bureaus (Section V); and real estate agents (Section VI). As explained in Section V of this chapter, Appendix A includes estimates of revenue impacts for the new Good Faith Estimate (GFE).

*A description of the projected reporting, record keeping, and other compliance requirements of the rule, including an estimate of the classes of small entities that will be subject to the requirement and the types of professional skills necessary for preparation of the report or record.* Compliance requirements and costs are discussed in Sections VII through IX of this chapter. In no case are any professional skills required for reporting, record keeping, and other compliance requirements of this rule that are not otherwise required in the ordinary course of business of firms affected by the rule. As noted above, Chapter 5 of the RIA includes estimates of the small entities that may be affected by the rule.

*An identification, to the extent practicable, of all relevant Federal rules which may duplicate, overlap or conflict with the final rule.* The final rule provisions for describing loan terms in the new GFE and the HUD-1 are similar to the Truth in Lending Act (TILA) regulations; however the differences in approach between the TILA regulations and HUD's RESPA rule make them more complementary than duplicative.. Overlaps are discussed further in this chapter.

In addition, this Chapter contains (c) *a description of any significant alternatives to the final rule which accomplish the stated objectives of applicable statutes and which minimize any significant impact of the final rule on small entities.* The FRFA also describes comments dealing with compliance and regulatory burden in the 2008 proposed rule. Some of the comments were on provisions of the 2008 proposed rule that have been dropped. Other comments were on impacts that the Department believes will be small or non-existent. Some of the compliance and regulatory burden comments concerned costs that are only felt during the start-up period and are one-time costs. These are discussed in Section VII.B, while comments on recurring costs of implementing the new GFE form are addressed in Section VII.C. Section VII.D discusses GFE-related changes in the final rule that reduce regulatory burden. Section VII.E discusses compliance issues related to GFE tolerances on settlement party costs, while Section VII.F discusses efficiencies associated with the new GFE.

Before proceeding further, Section II provides a brief summary of the main findings from the Regulatory Impact Analysis that relate to the final rule.

## **II. Overview of Final Rule**

The Department of Housing and Urban Development has issued a final rule under the Real Estate Settlement Procedures Act (RESPA) to simplify and improve the process of obtaining home mortgages and to reduce settlement costs for consumers. This Regulatory Impact Analysis and Regulatory Flexibility Analysis examine the economic effects of that rule. As this Regulatory Impact Analysis demonstrates, the final rule is expected to improve consumer shopping for mortgages and to reduce the costs of closing a mortgage transaction for the consumer. Consumer savings were estimated under a variety of scenarios about originator and settlement costs. In the base case, the estimated price reduction to borrowers comes to \$8.35 billion or \$668 per loan. This represents the substantial savings that can be achieved with the final rule.

The final RESPA rule includes a new, simplified Good Faith Estimate (GFE) that includes tolerances on final settlement costs and a new method for reporting wholesale lender payments in broker transactions. The final rule allows service providers to use prices based on the average charges for the third-party services they purchase, making their business operations simpler and less costly. Competition among loan originators will put pressure for these cost savings to be passed on to borrowers. The new GFE will produce substantial shopping and price-reduction benefits for both origination and third-party settlement services.

Because the final rule calls for significant changes in the process of originating a mortgage, this Regulatory Impact Analysis identifies a wide range of benefits, costs, efficiencies,

transfers, and market impacts. The effects on consumers from improved borrower shopping will be substantial under this rule. Similarly, the use of tolerances will place needed controls on origination and third-party fees. Ensuring that yield spread premiums are credited to borrowers in brokered transactions could cause significant transfers to consumers. The increased competition associated with RESPA reform will reduce settlement service costs and result in transfers to consumers from service providers. Entities that will suffer revenue losses under the final rule are usually those who are charging prices higher than necessary or are benefiting from the current system's market failure.

Note to Reader: A comprehensive summary of the problems with the current mortgage shopping system and the benefits and market impacts of the final rule is provided in Section I of Chapter 3.

### **III. Problems with the Mortgage Shopping Process and the Current GFE**

The current system for originating and closing mortgages is highly complex and suffers from several problems that have resulted in high prices for borrowers. Studies indicate that consumers are often charged high fees and can face wide variations in prices, both for origination and third-party settlement services. The main points are as follows:

- There are many barriers to effective shopping for mortgages in today's market. The process can be complex and can involve rather complicated financial trade-offs, which are often not fully and clearly explained to borrowers.
- Consumers often pay non-competitive fees for originating mortgages. Most observers believe that the market breakdown occurs in the relationship between the consumer and the loan originator -- the ability of the loan originator to price discriminate among different types of consumers leads to some consumers paying more than other consumers.<sup>1</sup>
- There is convincing statistical evidence that yield spread premiums are not always used to offset the origination and settlement costs of the consumer. Studies, including a recent HUD-sponsored study of FHA closing costs by the Urban Institute, find that yield spread premiums are often used for the originator's benefit, rather than for the consumer's benefit.<sup>2</sup>
- Borrowers can be confused about the trade-off between interest rates and closing costs. It may be difficult for borrowers (even sophisticated ones but surely unsophisticated ones)

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<sup>1</sup> One could see price discrimination in a competitive market that was the result of different costs associated with originating loans for different applicants. For example, those who required more work by the originator to obtain loan approval might be charged more than those whose applications required little work in order to obtain an approval. The price discrimination we refer to in this paragraph and elsewhere in this analysis is not cost-based. It is the result of market imperfections, such as poor borrower information on alternatives that leads borrowers to accept loans at higher cost than the competitive level.

<sup>2</sup> See Section IV.D of Chapter 2 for a discussion of these studies.

to understand the financial trade-offs associated with discount points, yield spread premiums, and upfront settlement costs. While many originators explain this to their borrowers, giving them an array of choices to meet their needs, some originators may only show borrowers a limited number of options.

- There is also evidence that prices paid for third-party services are highly variable, indicating that there is much potential to reduce title, closing, and other settlement costs. For example, a recent analysis of FHA closing costs by the Urban Institute shows wide variation in title and settlement costs. There is not always an incentive in today's market for originators to control these costs. Too often, high third-party costs are simply passed through to the consumer. And consumers may not be the best shoppers for third-party service providers due to their lack of expertise and to the infrequency with which they shop for these services. Consumers often rely on recommendations from the real estate agent (in the case of a home purchase) or from the loan originator (in the case of a refinance as well as a home purchase).

**Today's GFE.** Today's GFE does not help the above situations, as it is not an effective tool for facilitating borrower shopping nor for controlling third-party settlement costs. The current GFE is typically comprised of a long list of charges, as today's rules do not prescribe a standard form or consolidated categories. Such a long list of individual charges can be overwhelming, often confuses consumers, and seems to provide little useful information for consumer shopping. The current GFE certainly does not inform consumers what the major costs are so that they can effectively shop and compare mortgage offers among different loan originators. The current GFE does not explain how the borrower can use the document to shop and compare loans. Also, the GFE fails to make clear the relationship between the closing costs and the interest rate on a loan, notwithstanding that many mortgage loans originated today adjust up-front closing costs due at settlement, either up or down, depending on whether the interest rate on the loan is below or above "par." Finally, current rules do not assure that the "good faith estimate" is a reliable estimate of final settlement costs. As a result, under today's rules, the estimated costs on GFEs may be unreliable or incomplete, and final charges at settlement may include significant increases in items that were estimated on the GFE, as well as additional fees, which can add to the consumer's ultimate closing costs.

Thus, today's GFE is not an effective tool for facilitating borrower shopping or for controlling origination and third-party settlement costs. There is enormous potential for cost reductions in today's market, which is too often characterized by relatively high and highly variable charges for both origination and third-party services.

In addition, today's RESPA rules hold back efficiency and competition by acting as a barrier to innovative cost-reduction arrangements. While today's mortgage market is characterized by increased efficiencies and lower prices due to technological advances and other innovations, that is not the case in the settlement area where aggressive competition among settlement service providers simply does not always take place. Existing RESPA regulations inhibit average cost pricing,<sup>3</sup> which is an example of a cost reduction technique. Thus, a

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<sup>3</sup> The charges reported on the HUD-1 are required to be the specific charge paid in connection with the specific loan for which the HUD-1 is filled out. Pricing based on average charges is the practice of charging all borrowers the

framework is needed that would encourage competitive negotiations and other arrangements that would lead to lower settlement prices. The new GFE will provide such a framework.

#### **IV. Approach of the Final Rule**

There is strong evidence of information asymmetry between mortgage originators and settlement service providers and consumers, allowing loan originators to capture much of the consumer surplus in this market through price discrimination. The RESPA disclosure statute is meant to address this information asymmetry, but the evidence shows that the current RESPA regulations are not effective. The final rule will create a more level-playing field through a more transparent and standard disclosure of loan details and settlement costs; tolerances on settlement charges leading to prices that consumers can rely on; and a comparison page on the HUD-1 that allows the consumer to compare the amounts listed for particular settlement costs on the GFE with the total costs listed for those charges on the HUD-1, and to double check the loan details at settlement double check the loan details at settlement. These changes will encourage comparison shopping by informed consumers, which will place a competitive pressure on market prices, and enable consumers to retain more consumer surplus.

##### **IV.A. Main Components of the New GFE and HUD-1**

The GFE format simplifies the process of originating mortgages by consolidating costs into a few major cost categories.<sup>4</sup> The GFE ensures that in brokered transactions, borrowers receive the full benefit of the higher price paid by wholesale lenders for a loan with a high interest rate; that is, so-called yield spread premiums. On both the GFE and HUD-1, the portion of any wholesale lender payments that arise because a loan has an above-par interest rate is passed through to borrowers as a credit against other costs. Thus, there is assurance that borrowers who take on an above-par loan receive funds to offset their settlement costs. The new GFE also includes a trade-off table that will assist consumers in understanding the relationship between higher interest rates and lower settlement costs.

HUD conducted consumer tests to further improve the GFE form in the 2002 proposed rule. Numerous changes were made to make the GFE more user-friendly. The GFE form in the final rule includes a summary page containing the key information for shopping; during the tests, consumers reported that the summary page was a useful addition to the GFE. The trade-off table, another component of the GFE that consumers found useful, is also included in the final GFE. The final GFE is a form that consumers find to be clear and well written and, according to the tests conducted, one that they can use to determine the least expensive loan. In other words, it is a shopping tool that is a vast improvement over today's GFE with its long list of fees that can change (i.e., increase) at settlement.

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same average charge for a group of similar loans. Average cost pricing requires less record keeping and tracking for any individual loan since the numbers reported to the settlement agent need not be transaction specific. Average cost pricing is not permissible under RESPA because loan-specific prices are required.

<sup>4</sup> See the proposed GFE in Exhibit 3-B of Chapter 3.

The final GFE includes a set of tolerances on originator and third-party costs: originators must adhere to their own origination fees, and give estimates subject to a 10 percent upper limit on the sum of certain third-party fees. The tolerances on originator and third-party costs will encourage originators not only to lower their own costs but also to seek lower costs for third-party services.

The final rule would allow service providers to use pricing based on average charges for third-party services they purchase so long as the average is calculated using a documented method and the charge on the HUD-1 is no greater than the average paid for that service. This will make internal operations for the loan originator simpler and less costly and competition among lenders will put pressure for these cost savings to be passed on to borrowers as well. The end result of all these changes should be lower third-party fees for consumers.

To increase the value of the new GFE as a shopping document, HUD is proposing revisions to the HUD-1 Settlement Statement form that will make the GFE and HUD-1 easier to compare. The revised HUD-1 uses the same language to describe categories of charges as the GFE, and orders the categories of charges in the same way. This makes it much simpler to compare the two documents and confirm whether the tolerances required in the new GFE have been met or exceeded. In addition, the final rule introduces a comparison in the revised HUD-1 that would: (1) compare the GFE estimates to the HUD-1 charges and advise borrowers whether tolerances have been met or exceeded; (2) verify that the loan terms summarized on the GFE match those in the loan documents, including the mortgage note; and (3) provide additional information on the terms and conditions of the mortgage. These components of the rule are required together to fully realize the consumer saving on mortgage closing cost estimated here.

Given that there has been no significant change in the basic HUD-1 structure and layout, besides the addition of a comparison page, generating this new HUD-1 should not pose any problem for firms closing loans -- in fact, the closing process will be much simpler given that borrowers and closing agents can precisely link the information on the initial GFE to the information on the final HUD-1. The HUD-1 has also been adjusted to ensure that the new GFE (a shopping document issued early in the process) and the HUD-1 (a final settlement document issued at closing) work well together. The layout of the revised HUD-1 has new labeling of some lines so that each entry from the GFE can be found on the revised HUD-1 with the exact wording as on the GFE. This will make it much easier to determine if the fees actually paid at settlement are consistent with the GFE, whether the borrower does it alone or with the assistance of the settlement agent. The reduced number of HUD-1 entries that should result, as well as use of the same terminology on both forms should reduce the time spent by the borrower and settlement agents comparing and checking the numbers.

The significant changes made to the final rule from the March 2008 proposed rule are:

- A GFE form that is a shorter form than had been proposed.
- Allowing originators the option not to fill out the tradeoff table on the GFE form.
- A revised definition of application to eliminate the separate GFE application process.

- Adoption of requirements for the GFE that are similar to recently revised Federal Reserve Board Truth-in-Lending regulations which limit fees charged in connection with early disclosures and defining timely provision of the disclosures.
- Clarification of terminology that describes the process applicable to, and the terms of, an applicant's particular loan.
- Inclusion of a provision to allow lenders a short period of time in which to correct certain violations of the new disclosure requirements.
- A revised HUD-1/1A settlement statement form that includes a summary page of information that provides a comparison of the GFE and HUD-1/1A list of charges and a listing of final loan terms as a substitute for the proposed closing script addition.
- Elimination of the requirement for a closing script to be completed and read by the closing agent.
- A simplified process for utilizing an average charge mechanism.
- No regulatory change in this rulemaking regarding negotiated discounts, including volume based discounts.

#### **IV.B. Estimates and Sources of Consumer Savings from the Final Rule**

**Overall Savings.** Chapter 3 discusses the consumer benefits associated with the new GFE form and provides dollar estimates of consumer savings due to improved shopping for both originator and third-party services. Consumer savings were estimated under a variety of scenarios about originator and settlement costs.<sup>5</sup> In the base case, the estimated price reduction to borrowers comes to \$8.35 billion annually, or 12.5 percent of the \$66.7 billion in total charges (i.e., origination fees, appraisal, credit report, tax service and flood certificate and title insurance and settlement agent charges).<sup>6</sup> Thus, there is an estimated \$8.35 billion in transfers from firms to borrowers from the improved disclosures and tolerances of the new GFE. This would represent savings of \$668 per loan. Sensitivity analysis was conducted with respect to the savings projection in order to provide a range of estimates. Because title fees account for over 70 percent of third-party fees and because there is widespread evidence of lack of competition and overcharging in the title and settlement closing industry, one approach projected third-party savings only in that industry. This approach (called the “title approach”) projected savings of \$200 per loan in title and settlement fees. In this case, the estimated price reduction to borrowers comes to \$8.38 billion (\$670 per loan), or 12.6 percent of the \$66.7 billion in total charges –

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<sup>5</sup> Throughout this Economic Analysis, the terms “borrowers” and “consumers” are often used interchangeably.

<sup>6</sup> Government fees and taxes and escrow items are not included in this analysis, as they are not subject to competitive market pressures.

savings figures that are practically identical to the base case mentioned above.<sup>7</sup> Other projections also showed substantial savings for consumers. As explained in Chapter 3, estimated consumer savings under a more conservative projection totaled \$6.48 billion (\$518 per loan), or 9.7 percent of total settlement charges. Thus, while consumer savings are expected to be \$8.35 billion (or 12.5 percent of total charges) in the base case or \$8.38 billion (12.6 percent of total charges) in the title approach, they were \$6.48 billion (or 9.7 percent of total charges) in a more conservative sensitivity analysis. This \$6.48-\$8.38 billion (\$518 - \$670 per loan) represents the substantial savings that can be achieved with the new GFE.

**Industry Breakdown of Savings.** Chapter 3 also disaggregates the sources of consumer savings into the following major categories: originators with a breakdown for brokers and lenders, and third-party providers with a breakdown for the title and settlement industry and other third-party providers.<sup>8</sup> In the base case, originators (brokers and lenders) contribute \$5.88 billion, or 70 percent of the \$8.35 billion in consumer savings. This \$5.88 billion in savings represents 14.0 percent of the total revenue of originators, which is projected to be \$42.0 billion.<sup>9</sup> The \$5.88 billion is divided between brokers, which contribute \$3.53 billion, and lenders (banks, thrifts, and mortgage banks), which contribute the remaining \$2.35 billion. The shares for brokers (60 percent) and lenders (40 percent) represent their respective shares of mortgage originations.

In the base case, third-party settlement service providers contribute \$2.47 billion, or 30 percent of the \$8.35 billion in consumer savings. This \$2.47 billion in savings represents 10.0 percent of the total revenue of third-party providers, which is projected to be \$24.738 billion.<sup>10</sup> The \$2.47 billion is divided between title and settlement agents, which contribute \$1.79 billion, and other third-party providers (appraisers, surveyors, pest inspectors, etc.), which contribute \$0.68 billion. Title and settlement agents contribute a large share because they account for 72.5 percent of the third-party services included in this analysis. In the title approach, title and settlement agents account for all third-party savings, which total \$2.5 billion if per loan savings are \$200 and \$1.88 billion if per loan savings are \$150.

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<sup>7</sup> If the savings in title and settlement closing fees due to RESPA reform were only \$150, then the estimated price reduction to borrowers comes to \$7.76 billion, or 11.6 percent of the \$66.7 billion in total charges.

<sup>8</sup> Readers are referred to Chapter 5 for a more detailed examination of the various component industries (e.g., title services, appraisal, etc.) as well as for the derivations of many of the estimates presented in this chapter.

<sup>9</sup> This assumes a 1.75 percent origination fee for brokers and lenders, which, when applied to projected originations of \$2.4 trillion, yields \$42.0 billion in total revenues from origination fees (both direct and indirect). See Steps (3)-(5) of Section VII.E.1 of Chapter 3 for the explanation of origination costs. Sensitivity analyses are conducted for smaller origination fees of 1.5 percent and larger fees of 2.0 percent; see Step (21) in Section VII.E.4 of Chapter 3.

<sup>10</sup> See Step (7) of Section VII.E.1 of Chapter 3 for the derivation of the \$24.738 billion.

**Table 1. Industry Breakdown of Consumer Savings**

Source of Savings	Transfers (billions)	Savings per loan (12.5 million loans)	Percentage of Total Savings
<b>Loan Origination</b>	<b>\$5.88</b>	<b>\$470</b>	<b>70%</b>
Lenders	\$2.35	\$470 <u>or</u>	28%
Brokers	\$3.53	\$470	42%
<b>Third-Party Services</b>	<b>\$2.47</b>	<b>\$198</b>	<b>30%</b>
Title/Settlement	\$1.79	\$143	22%
Other	\$0.68	\$54	8%
<b>Total*</b>	<b>\$8.35</b>	<b>\$668</b>	<b>100%</b>

\*Savings are 12.5% of \$66.7 billion revenue in charges.

Section III.D of this executive summary presents the revenue impacts on small originators and small third-party providers.

**Sources of Savings: Lower Origination and Third-Party Fees.** The Regulatory Impact Analysis presents evidence that some consumers are paying higher prices for origination and third-party services. The new GFE format in the final rule will improve consumer shopping for mortgages, which will result in better mortgage products, lower interest rates, and lower origination and third-party costs for borrowers.

- The final rule simplifies the process of originating mortgages by consolidating costs into a few major cost categories. This is a substantial improvement over today's GFE that is not standardized and can contain a long list of individual charges that encourages fee proliferation. This makes it easier for the consumer to become overwhelmed and confused. The consistent and simpler presentation of the GFE will improve the ability of the consumer to shop.
- A GFE with a summary page, which includes the terms of the loan, will make it clear to the consumer whether they are comparing similar loans.
- A GFE with a summary page will make it simpler for borrowers to shop. The higher reward for shopping, along with the increased ease with which borrowers can compare loans, should lead to more effective shopping, more competition, and lower prices for borrowers.
- The GFE makes cost estimates more reliable by applying tolerances to the figures reported. This will reduce the all too frequent problem of borrowers being surprised by additional costs at settlement. With fees firmer under the GFE, shopping is more likely to result in borrowers saving money when they shop.
- The new GFE will disclose yield spread premiums and discount points in brokered loans prominently, accurately, and in a way that should inform borrowers how they may be used to their advantage. Both values will have to be calculated as the difference between the wholesale price of the loan and its par value. Their placement in the calculations that lead to net settlement costs will make them very difficult to miss. That placement should also enhance borrower comprehension of how yield spread premiums can be used to

reduce up-front settlement costs. Tests of the form indicate that consumers can determine the cheaper loan when comparing a broker loan with a lender loan.

- The new GFE will better inform consumers about their financing choices by including a tradeoff table on page 3 where originators can present the different interest rate and closing cost options available to borrowers. For example, consumers will better understand the trade-offs between reducing their closing costs and increasing the interest rate on the mortgage.
- The final rule allows settlement service providers to use prices based on average charges for the third-party services they purchase.
- The above changes and the imposition of tolerances on fees will encourage originators to seek lower settlement service prices. The tolerances will lead to well-informed market professionals either arranging for the purchase of the settlement services or at least establishing a benchmark that borrowers can use to start their own search. Under either set of circumstances, this should lead to lower prices for borrowers than if the borrowers shopped on their own, since the typical borrower's knowledge of the settlement service market is limited, at best.

#### **IV.C. Savings and Transfers, Efficiencies, and Costs**

As explained above, it is estimated that borrowers would save \$8.35 billion in origination and settlement charges. This \$8.35 billion represents transfers to borrowers from high priced producers, with \$5.88 billion coming from originators and \$2.47 billion from third-party settlement service providers. In addition to the transfers, there are efficiencies associated with the rule as well as costs.

Mortgage applicants and borrowers realize \$1,169 million savings in time spent shopping for loans and third-party services. Loan originators save \$975 million in time spent with shoppers and from average cost pricing. Third-party settlement service providers save \$191 million in time spent with shoppers. Some or all of industry's total of \$1,166 million in efficiency gains have the potential to be passed through to borrowers through competition. There are additional social efficiencies such as the reduction of non-productive behavior and positive externalities of preventing foreclosures (see Section X.D.).

The total one-time compliance costs to the lending and settlement industry of the GFE and HUD-1 are estimated to be \$571 million, \$407 million of which is borne by small business. These costs are summarized below. Total recurring costs are estimated to be \$918 million annually or \$73.40 per loan. The share of the recurring costs on small business is \$471 million. This Chapter 6 examines in greater detail the compliance and other costs associated with the GFE and HUD-1 forms and its tolerances.

The new GFE in the final rule has some features that would increase the cost of providing it and some that would decrease the cost. Practically all of the information required on the GFE is readily available to originators, suggesting no additional costs. The fact that there are fewer

numbers and less itemization of individual fees suggests reduced costs. On the other hand, there could be a small amount of additional costs associated with the optional trade-off table but that is not clear. Thus, while it is difficult to estimate, it appears that there could be a net of zero additional costs. However, if the GFE added 10 minutes per application to the time it takes to handle the forms today; annual costs would rise by \$255 million at 1.7 application per loan or (\$12 per application or \$20 per loan) or \$405 million at 2.7 applications per loan (\$32 per loan). We assume the high-cost scenario for summary table 5.

The presence of tolerances will lead to some additional costs to originators of making additional arrangements for third parties to provide settlement services. If the average loan originator incurs an average of 10 minutes per loan of effort making third-party arrangements to meet the tolerances, then the total cost to originators of making third-party arrangements to meet the tolerance requirements comes to \$150 million (\$12 per loan). (See Section VII.E.2 of this chapter.)

There is the potential of additional underwriting costs if the number of applications requiring a credit check rise beyond the current ratio of 1.7 applications per loan. Thus, if this ratio remains constant, there will be no recurring compliance costs from additional underwriting. If, however, the demand for preliminary GFEs increases to 2.7 applications per loan, then the total costs for originators will be \$138 million or \$11 per loan (See Section VII.C.).

In addition to the recurring costs of the GFE, there will be one-time adjustment costs of \$383 million in switching to the new form. Loan originators will have to upgrade their software and train staff in its use in order to accommodate the requirements of the new rule. It is estimated that the software cost will be \$33 million and the training cost will be \$58 million, for a total of \$91 million (see Section VII.B.1 of this chapter). We assume that, of the loan originators' software and training costs, \$73 million is attributable to the new GFE and \$18 million to the new HUD-1. Once the new software is functioning, the recurring costs of training new employees in its use and the costs associated with periodic upgrades simply replace those costs that would have been incurred doing the same thing with software for the old rule. They represent no additional costs of the new rule.

Similarly, there will be a one-time adjustment cost for legal advice on how to deal with the changes related to the new GFE. The one-time adjustment cost for legal fees is estimated to be \$116 million (see Section VII.B.2 of this chapter). Once the adjustment has been made, the ongoing legal costs are a substitute for the ongoing legal costs that would have been incurred under the old rule and do not represent any additional burden.

Finally with respect to the GFE, employees will have to be trained in the new GFE beyond the software and legal training already mentioned. This one time adjustment cost is estimated to be \$194 million (see section VII.B.3). Again, once the transition expenses have been incurred, any ongoing training costs are a substitute for the training costs that would have been incurred anyway and do not represent an additional burden.

There are few recurring costs associated with the revised HUD-1. For originators the burden could be very small: loan originators will not have to collect additional data beyond what is required for the GFE. In certain cases, the burden may be noticeable so we assume that the

*average* burden is ten minutes per loan for loan originators. Settlement agents may face a recurring cost, although this is not likely either since loan originators are responsible for providing the data. The settlement agent will have to add final charges not known by the originator, and may have to fill out the entire form if the lender does not transmit the information on an already completed HUD-1 page 3. The settlement agent may also want to check the information concerning settlement costs, tolerances, and loan terms to make sure they agree with the GFE. In some cases, the settlement agent will have to calculate the tolerances. We assume that it will add five minutes *on average* to the time it takes to prepare a settlement. The actual distribution of the total additional time burden will differ by transaction depending on how much of the work is done by the lender. Taking loan originators into account, the total time burden is 15 minutes per loan, for a cost of \$18 per loan. The recurring compliance cost to the industry would be \$225 million annually, of which small business would bear \$107 million annually. During a high-volume year (15.5 million loans annually), the annual recurring compliance cost of the HUD-1 would be \$279 million annually (see Section VIII.C. of Chapter 6)

There will be one-time adjustment costs of \$188 million in switching to the new HUD-1 form. Settlement firms will have to upgrade their software and train staff in its use in order to accommodate the requirements of the new rule. It is estimated that the software and training cost will be \$80 million (see Section VIII.B. of Chapter 6). Once the new software is functioning, the recurring costs of training new employees in its use and the costs associated with periodic upgrades simply replace those costs that would have been incurred doing the same thing with software for the old rule. They represent no additional costs of the new rule.

**Table 2. Summary of One-Time Adjustment Costs (in millions)**

Source of Cost	<i>GFE</i>		<i>HUD-1</i>		<i>Total</i>	
	All Firms	Small Firms	All Firms	Small Firms	All Firms	Small Firms
Software and training	\$73	\$52	\$80	\$59	\$153	\$111
Legal consultation	\$116	\$70	\$37	\$18	\$153	\$88
Training on rule	\$194	\$146	\$71	\$62	\$265	\$208
<b>Total</b>	<b>\$383</b>	<b>\$268</b>	<b>\$188</b>	<b>\$139</b>	<b>\$571</b>	<b>\$407</b>

Similarly, there will be a one-time adjustment cost for legal advice on how to deal with the changes related to the new HUD-1. The one-time adjustment cost for legal fees is estimated to be \$37 million (see Section VIII.B. of Chapter 6). Once the adjustment has been made, the ongoing legal costs are a substitute for the ongoing legal costs that would have been incurred under the old rule and do not represent any additional burden.

Finally, employees will have to be trained in the new HUD-1 beyond the software and legal training already mentioned. This one time adjustment cost is estimated to be \$71 million (see Section VIII.B. of Chapter 6). Again, once the transition expenses have been incurred, any ongoing training costs are a substitute for the training costs that would have been incurred anyway and do not represent an additional burden.

The consumer savings, efficiencies and costs associated with the GFE are discussed further in Chapter 6 and in Chapters 3. A summary of the compliance costs for the base case of 12.5 million loans annually is presented in Table 1.

**Table 3. Compliance Costs of the Final Rule (if 12.5 million loans annually)**

	One-time Compliance Costs incurred during the first year		Recurring Compliance Costs		
	(in millions)		(in millions annually)		\$ cost per loan
	All Firms	Small Firms	All Firms	Small Firms	
<b>GFE</b>	\$383	\$268	\$693	\$364	\$55.40
<b>HUD-1</b>	\$188	\$139	\$225	\$107	\$18.00
<b>Total</b>	<b>\$571</b>	<b>\$407</b>	<b>\$918</b>	<b>\$471</b>	<b>\$73.40</b>

A natural question to raise is whether the costs of the rule will overwhelm the benefits of the rule. The assumption that consumers will benefit by a reduction of settlement costs of at least \$668 per loan has not been forcefully challenged. Indeed, results from a recent statistical analysis of FHA data imply that the savings to consumers may be as much as \$1,200 per loan. To accomplish this, however, industry will incur both adjustment and recurring costs. Suppose firms impose these additional costs on consumers by raising prices. It is likely that the adjustment costs will be spread out over many years, just as the cost of an investment would be. Suppose, for the sake of illustration, that all adjustment costs are all imposed on first-year borrowers only. In a normal year of 12.5 million loans, this cost would \$46 per loan. The recurring compliance costs of the rule is \$73.40 per loan regardless of the year. In such a scenario, the total compliance cost is \$120 per loan in the first year as compared to \$74 for later years. If all compliance costs were passed onto consumers then the net consumer savings is \$548 the first year and \$594 in subsequent years (see Table 4 for a summary). Note that this assumes that all costs are borne by borrowers and not at all by the applicants who do not get a loan. It would be reasonable to assume that in the high-application scenario, where there is an increase in preliminary underwriting costs, that the cost of an initial credit report would be passed on to all applicants.

**Table 4. Predicted Reductions in the Cost of a Loan  
(if firms impose all first-year adjustment costs on first-year borrowers)**

Source of Gain or Loss	First Year	Afterwards
<b><i>Average Consumer Savings</i></b>	<b><i>\$668</i></b>	<b><i>\$668</i></b>
One-time Adjustment Costs	-\$46	-\$0
Recurring Compliance Costs	-\$74	-\$74
<b><i>Net Consumer Savings</i></b>	<b><i>\$548</i></b>	<b><i>\$594</i></b>
Firms' Efficiencies	+\$93	+\$93
Borrowers' Efficiencies	+\$55	+\$55
<b><i>Net Benefits to Consumer</i></b>	<b><i>\$696</i></b>	<b><i>\$742</i></b>

There are other potential benefits to the consumer besides savings on settlement costs. There are aspects of this rule that will save time for industry. The value of these efficiencies could be \$1,166 million for loan originators and settlement agents, for a per loan efficiency of \$93. In a competitive industry, firms would pass these gains along to borrowers in the form of lower costs, a consumer benefit. Borrowers themselves will save time through the new GFE. These time savings are estimated at \$1,169 million but are derived from a time savings worth \$55 per applicant (seventy-five minutes at \$44 per hour). In the summary of net benefits, we only include the per applicant time savings for borrowers. We make the cautious assumption that

successful borrowers have submitted only one application. A fraction of the additional 8.25 million applications (in excess of 12.5 million loans) consist of: applications approved but not accepted; applications denied by the financial institution; and applications withdrawn by the applicant. Although these individuals also realize time savings, it would be misleading to include them in a “per loan” figure in that the time savings of rejected applicant would not benefit the borrower. Adding the firms’ and borrowers’ value of time efficiencies to the net of compliance cost consumer savings gives us an estimate of the potential consumer benefits per loan: \$696 in the first year and \$742 afterwards.

#### **IV.D. Alternatives Considered to Make the GFE More Workable for Small Businesses**

Chapter 3 discusses the many comments that HUD received on the GFE in the 2002 and 2008 proposed rules and the 2005 RESPA Reform Roundtables. Chapter 4 discusses alternatives. The most basic alternative was to make no change in the current GFE. The final rule allows both the current GFE and the new GFE to be used for one year after the GFE is introduced, but requires the new GFE and HUD-1 to be used beginning January 1, 2010. This approximately one-year adjustment period responds to lenders’ comments that there would be significant implementation issues with switching to a new GFE.

The main alternative concerning small businesses considered the brokers’ argument that they were disadvantaged by the reporting of yield spread premiums. The new GFE was designed to ensure that there will not be any anti-competitive impacts on the broker industry. A summary page is included that presents the key cost figures for borrower shopping, that does not report yield spread premiums, and that provides identical treatment for brokers and lenders. The final GFE includes language that clarifies how yield spread premiums reduce the upfront charge that borrowers pay. Section III.E of this Executive Summary discusses this in more detail.

HUD designed the GFE to make it workable for small lenders and brokers. Some examples of the changes are the following:

- In response to concerns expressed by lenders and brokers about their ability to control third-party costs and meet the specified tolerances in the 2008 proposed rule, HUD raised the tolerance on government recording charges from zero to ten percent.
- Consistent with the above, the rule creates a new definition of “changed circumstances” that clarifies and expands on the definition of “changed circumstances” in the proposed rule. For example, material information that was either not known at the time the original GFE was provided or not relied on in providing the original GFE, or information that has changed in a material way since application, may be the basis for providing a modified GFE. For example, if the actual loan amount turns out to be higher than the loan amount indicated by the borrower at the time the GFE was provided, and certain settlement charges that are based on the loan amount increase as a result, the loan originator may provide a revised GFE reflecting those higher amounts. Compliance with the tolerance provisions would be evaluated by comparing the revised GFE with the actual amounts charged at settlement.

- HUD has adopted a streamlined single application process for the final rule. The new definition will allow loan originators more flexibility in determining the information they need to underwrite a GFE.
- The reading at settlement of a closing script is no longer required. Much of the same information will be transmitted to the borrower via a new page 3 of the HUD-1.

**Alternatives.** This chapter and Chapter 4 and Chapter 6 discuss other major alternatives that HUD considered in developing the final rule from the 2008 proposed rule. These chapters discuss the pros and cons of these alternatives and why HUD decided not to include them in this final rule.

#### **IV.E. Market and Competitive Impacts on Small Businesses from the Final Rule**

**Transfers from Small Businesses.** It is estimated that \$4.13 billion, or 49.5 percent of the \$8.35 billion in consumer savings comes from small businesses, with small originators contributing \$3.01 billion and small third-party firms, \$1.13 billion.<sup>11</sup> Within the small originator group, most of the transfers to consumers come from small brokers (\$2.47 billion, or 82 percent of the \$3.01 billion); this is because small firms account for most of broker revenues but a small percentage of lender revenues. Within the small third-party group, most of the transfers come from the title and closing industry (\$0.68 billion, or 60 percent of the \$1.13 billion), mainly because this industry accounts for most third-party fees. In the title approach, small title and settlement closing companies account for \$0.95 billion of the \$2.5 billion in savings. Section VII.E.2 of Chapter 3 explains the steps in deriving these revenue impacts on small businesses, and Section VII.E.4 of Chapter 3 reports several sensitivity analyses around the estimates. In addition, Chapter 5 provides more detailed revenue impacts for the various component industries.<sup>12</sup>

The summary bullets highlight the mechanisms through which these transfers are expected to happen. Improved understanding of yield spread premiums, discount points, and the trade-off between interest rates and settlement costs; improved consumer shopping among originators; more aggressive competition by originators for settlement services; and increased competition associated with discounting -- all will lead to reductions in both originator and third-party fees. As noted earlier, there is substantial evidence of non-competitive prices charged to some in the origination and settlement of mortgages due to information asymmetry between originators and borrowers. Originators (both small and large) and settlement service providers (both small and large) that have been charging high prices will experience reductions in their revenues as a result of the new GFE. There is no evidence that small businesses have been

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<sup>11</sup> In the more conservative scenario of \$6.48 billion in consumer savings, small businesses would account for \$3.21 billion of the transfers to consumers, with small originators accounting for \$2.36 billion, and small third-party providers, \$0.84 billion.

<sup>12</sup> In Chapter 5, see Section II for brokers, Section III for the four lender groups (commercial banks, thrifts, mortgage banks, and credit unions), Section IV for the various title and settlement groups (large insurers, title and settlement agents, lawyers, and escrow firms), Section V.A for appraisers, Section V.B for surveyors, Section V.C for pest inspectors, and Section V.D for credit bureaus.

disproportionately charging high prices; for this reason, there is no expectation of any disproportionate impact on small businesses from the new GFE. The revenue reductions will be distributed across firms based on their non-competitive price behavior.

**Small Brokers.**<sup>13</sup> The main issue raised by the brokers concerned the treatment in the 2008 proposed rule of yield spread premiums on the proposed Good Faith Estimate. Mortgage Broker representatives asserted that the proposed mortgage broker disclosure would achieve the opposite result and would detract from the consumer's ability to understand and comparison shop. They recommended that lenders should be treated similarly to facilitate shopping and promote consumer understanding. The current final rule addresses the concern expressed by brokers that the reporting of yield spread premiums in the 2008 proposed rule would disadvantage them relative to lenders.

The Department hired forms development specialists, the Kleimann Communication Group, to analyze, test, and improve the forms. Starting with the GFE form proposed in 2002, they reworked the language and presentation of the yield spread premium to emphasize that it offsets other charges to reduce settlement charges, the cash needed to close the loan. The subjects tested seemed to like the trade-off table that shows the trade-off between the interest rate and up-front charges. It illustrates how yield spread premiums can reduce upfront charges. There is the summary page designed to simplify the digestion of the information on the form by including only the total estimated settlement charges from page two. This is the first page any potential borrower would see. It contains only the essentials for comparison-shopping and is simple: a standard set of yes-no questions describing the loan and a very simple summary of costs and the bottom line. Yield spread premiums are never mentioned here. Lender and broker loans get identical treatment on page 1. A mortgage shopping chart is included on page 3 of the GFE, to help borrowers comparison shop. Arrows were added to focus the borrower on overall charges, rather than one component. All of these features work against the borrower misinterpreting the different presentation of loan fees required of brokers vis-à-vis lenders.

HUD has designed the GFE form to focus borrowers on the right numbers so that competition is maintained between brokers and lenders. The forms adopted in the final rule were tested on hundreds of subjects. The tests indicate that borrowers who comparison shop will have little difficulty identifying the cheapest loan offered in the market whether from a broker or a lender.

We do not believe that the customer outreach function that brokers perform for wholesale lenders is going to change with RESPA reform. Wholesale lending, which has fueled the rise in mortgage originations over the past ten years, will continue to depend on brokers reaching out to consumer customers and supplying them with loans. Brokers play the key role in the upfront part of the mortgage process and this will continue with the final GFE.

RESPA reform is also not going to change the basic cost and efficiency advantages of brokers. Brokers have grown in market share and numbers because they can originate mortgages at lower costs than others. There is no indication that their cost competitiveness is going to

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<sup>13</sup> Practically all (98.9%) of the 30,000-44,000 brokers qualify as a small business. The Bureau of Census reports that small brokers account for 70% of industry revenue.

change in the near future. Thus, brokers, as a group, will remain highly competitive actors in the mortgage market, as they have been in the past.

While there is no evidence to suggest any anti-competitive impact, there will be an impact on those brokers who are charging non-competitive prices. And there is convincing evidence that some brokers (as well as some lenders) overcharge consumers (see studies reviewed in Chapter 2). As emphasized throughout the Regulatory Impact Analysis, the new GFE will lead to improved and more effective consumer shopping, for many reasons -- the new GFE is simple and easy to understand, it includes reliable cost estimates, it effectively discloses yield spread premiums and discounts in brokered loans without disadvantaging brokers, it provides a vehicle to show consumers options, and it explains the trade-off between closing costs and interests rates to aid in understanding of yield spread premiums. This increased shopping by consumers will reduce the revenues of those brokers who are charging non-competitive prices. Thus, the main impact on brokers (both small and large) of the final rule will be on those brokers (as well as other originators) who have been overcharging uninformed consumers, through the combination of high origination fees and yield spread premiums.<sup>14</sup> As noted above, small brokers are expected to experience \$2.47 billion in reduced fees.

**Small Lenders.** Lenders include mortgage banks, commercial banks, credit unions, and thrift institutions.<sup>15</sup> There are over 10,000 lenders that would be affected by the RESPA rule, as well as almost 4,000 credit unions that originate mortgages. While two-thirds of the lenders qualify as a small business (as do four-fifths of the credit unions), these small originators account for only 23 percent of industry revenues. Thus, small lenders (including credit unions) account for only \$540 million of the projected \$2.35 billion in transfers from lenders.<sup>16</sup>

In general, there was less concern expressed by lenders (as compared with brokers) about potential anti-competitive impacts of the GFE on small businesses. Small lenders -- relative to both brokers and large lenders -- will remain highly competitive actors in the mortgage market, as they are today. Small mortgage banks, community banks and local savings institutions benefit from their knowledge of local settlement service providers and of the local mortgage market. Nothing in the final GFE rule changes that. Generally, lenders and their associations opposed the proposed GFE on the grounds that in their opinion the form is too lengthy and would only confuse borrowers.

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<sup>14</sup> As explained throughout this chapter, it is anticipated that market competition, under this proposed GFE approach, will have a similar impact on those lenders (non-brokers) who have been overcharging consumers through a combination of high origination costs and yield spread premiums.

<sup>15</sup> While it is recognized that the business operations and objectives of these lender groups can differ -- not only between the groups (a mortgage banker versus a portfolio lender) but even within a single group (a small community bank versus a large national bank) -- they raised so many of the same issues that it is more useful to address them in one place.

<sup>16</sup> Section III of Chapter 5 describes the characteristics of these component industries (number of employees, size of firms, etc.), their mortgage origination activity, and the allocation of revenue impacts between large and small lenders. That section also explains that the small business share of revenue could vary from 20 percent to 26 percent

Lenders had numerous comments on most aspects of the 2008 proposed GFE form – some of them dealing with major issues such as the difficulty in predicting costs within a three day period and many dealing with practical and more technical issues. HUD responded to many of the issues and concerns raised by lenders; Sections V, VI, and VIII of Chapter 3 discuss lenders' comments and HUD's response.

Some lenders were concerned about their ability to produce firm cost estimates (even of their own fees) within a three-day period, given the complexity of the mortgage process. Lenders wanted clarification on their ability to make cost adjustments as a result of information they gain during the full underwriting process. The tolerances in the final rule require that lenders play a more active role in controlling third-party costs than they have in the past. However, some lenders emphasized that they have little control over fees of third-party settlement providers, while others seem to not anticipate problems in this regard. As explained in I.B above, the final rule made several adjustments to the tolerance rules, which should make them workable for lenders. In addition, the final rule allows average cost pricing, which should help lenders reduce their costs. Practically all lenders wanted clarification on the definition of application, and HUD did that.

There will be an impact on those lenders (both large and small) who are charging non-competitive prices. Improved consumer shopping with the new GFE will reduce the revenues of those lenders who are charging non-competitive prices. Thus, as with brokers, the main negative impact on lenders (both small and large) of the new GFE will be on those lenders who have been overcharging uninformed consumers.

**Small Title and Settlement Firms.** The title and settlement industry -- which consists of large title insurers, title agents, escrow firms, lawyers, and others involved in the settlement process -- is expected to account for \$1.79 billion of the \$2.47 billion in third-party transfers under the GFE in the final rule. Within the title and settlement group, small firms are expected to account for 38.1 percent (\$0.68 billion) of the transfers, although there is some uncertainty with this estimate.<sup>17</sup> Step (8) of Section VII.E of Chapter 3 conducts an analysis that projects all of the consumer savings in third-party costs coming from the title industry; evidence suggests there are more opportunities for price reductions in the title industry, as compared with other third-party industries. In this case, consumer savings in title costs (\$150-\$200 per loan) ranged from \$1.88 billion to \$2.50 billion. To a large extent, the title and closing industry is characterized by local firms providing services at constant returns to scale. The demand for the services of these local firms will continue under the final GFE.

Section VIII.C of Chapter 3 summarizes the key competitive issues for this industry with respect to the final rule. As noted there, the overall competitiveness of the title and closing industry should be enhanced by the RESPA rule. Chapters 2 and 5 provide evidence that title and closing fees are too high and that there is much potential for price reductions in this industry. Increased shopping by consumers, as well as increased shopping by loan originators to stay within their tolerances, will reduce the revenues of those title and closing companies that have

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<sup>17</sup> Section IV of Chapter 5 describes the component industries and estimates the share of overall industry revenue going to small businesses.

been charging non-competitive prices.<sup>18</sup> Excess charges will be reduced and competition will ensure that reduced costs are passed through to consumers.

The title industry argued that greater itemization was needed in order for consumers to be able to adequately comparison shop among estimates. HUD's view is that the consolidated categories on the new GFE form provide consumers with the essential information needed for comparison-shopping. Itemization encourages long lists of fees that confuse borrowers.

It is important to keep in mind the local nature of the title industry when considering the impacts of the final RESPA reform (new GFE, tolerances, etc.) on the title industry. The title industry demonstrates a high degree of geographic specialization. Although title insurance companies do not need to be close to the properties insured, until there is widespread use of standardized electronic land record keeping accessible by the Internet,<sup>19</sup> the information-gathering service the industry provides will require proximity to land title records (or the establishment of "title plants," i.e., duplicates of local records, the maintenance of which requires proximity to local government records). Even if a provider is efficient and charges low prices, it will not be able to compete against title and closing firms who are located sufficiently closer to the site in question. Thus, title and closing companies are by economic necessity provided by local firms. Reinforcing the local orientation are the value of local expertise and the importance of personal networks in receiving referrals.

The local orientation of the title industry could change over time. However, it is unlikely that RESPA reform would be the catalyst. The advances in technology that would change business practices are independent of what HUD does about RESPA. The only change that the final rule will introduce is that title and closing services may occur at lower prices negotiated between providers and lender originators. There will be no significant change in the local provision of title and closing work. Nor will there be a reduction of the number of these services purchased since this reform will not result in a drop in the number of mortgages that require these services. Large lenders will have to deal with multiple settlement services providers in order to ensure complete geographic coverage, and large multi-jurisdictional title firms have no apparent cost advantages over smaller title firms. In fact, large multi-jurisdictional title firms may have location-related cost disadvantages. There is no reason to believe that small title firms charging competitive prices will be adversely impacted by the changes in this rule. The demand for the services of these local firms will continue under the final GFE.

**Appraisers.** Like surveys and pest inspections, traditional appraisals are provided on-site at the mortgaged property. The transportation cost of visiting individual sites, especially the opportunity cost of the time spent in transit, adds substantially to the cost of providing the service. The transportation costs counterbalance, or overwhelm, any scale economies that may otherwise exist in the production of these services. The countervailing transportation cost

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<sup>18</sup> The reasons why the proposed GFE and its tolerances will lead to improved and more effective shopping for third-party services by consumers and loan originators has already been discussed, and need not be repeated here.

<sup>19</sup> The proposed rule does nothing to advance or retard this fundamental change in the nature of the business. It is possible that governments responsible for maintaining title records could advance to the level demonstrated in British Columbia (Canada), where even title insurance is not part of real estate transactions.

pressures creates an effective constant returns to scale production function for this industry and can serve to explain the wide range of firm size as well as the continued success of small businesses in the appraisal industry. This explains why approximately 99.8 percent of traditional appraisal firms qualify as small businesses.

Even if large appraisal firms are efficient and charges low prices, they will not have the same advantage as providers who are located sufficiently closer to the site in question. Thus, traditional appraisals are by economic necessity provided by local firms. Reinforcing the local orientation of the appraisal industry is the value of local expertise. A profound understanding of the characteristics of the local real estate market is essential for a successful appraisal. In addition, local appraisal firms maintain local networks of customers and clients, based on their established track records, which should give them a solid business advantage.

The local orientation of the appraisal industry could change over time. There has been a trend towards the increasing use of automated valuation appraisals, particularly for appraising properties that are being refinanced and properties that are being used as collateral for home equity loans. The necessity for appraisers to visit all homes in need of an appraisal could be rendered less by the automated value model (AVM), but it is also the case that the databases used to create AVMs tend not to have data on whether or not there is water in the basement of the subject property. It is unlikely that RESPA reform would be the catalyst for increases in AMVs, as the technological advances are already taking place. While RESPA reform could accelerate the use of AVMs, it will not likely have an impact as to whether AVMs are eventually accepted more broadly by the lending industry. The adoption of AVMs will depend on the accuracy of these estimation models, their appropriateness for different types of properties, and their performance in mitigating the risk of default losses.

## **V. Statement of Need for and Objectives of the Rule**

**Chapter 1** is an introductory chapter that explains the requirements for this economic and small business analysis, discusses the need for the proposed rule, gives an overview of the main components of the proposed rule, and summarizes the topics covered in Chapters 2-6. **Chapter 2** is a technical background chapter that supports the discussion of the GFE in Chapters 3 and 4, respectively. Chapter 2 provides a brief overview of the mortgage market and discusses several topics (e.g., yield spread premiums) related to the RESPA regulation. Mortgage pricing studies are reviewed here, particularly recent work by the Urban Institute that suggests substantial overcharging of fees by originators and third-party providers. **Chapter 3** explains in detail the proposed GFE including: the proposed GFE form; treatment of yield spread premiums and discount points; average cost pricing; tolerances in settlement costs; additional topics and alternatives related to the GFE, including changes that HUD made to improve the GFE and the HUD-1; consumer benefits and estimates of industry and small business transfers; and competitive impacts, with a focus on the market effects on small businesses. **Chapter 4** discusses alternatives that HUD considered including packaging. **Chapter 5** supports Chapters 3, 4, and 6 by providing basic mortgage-related descriptive data on each origination and third-party industry and by explaining the various methodologies for estimating the share of each industry's revenue accounted for small businesses. **Chapter 6** examines compliance and regulatory costs and demonstrates how this document meets the requirements of a Regulatory

Flexibility Analysis under Section 604 of the Regulatory Flexibility Act (RFA). The requirements of the RFA are stated along with references to where in this document the requirements are covered.

**CHAPTER 1**  
**INTRODUCTION**

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The Department of Housing and Urban Development issued a final rule under the Real Estate Settlement Procedures Act (RESPA) to simplify and improve the process of obtaining home mortgages and to reduce settlement costs for consumers. This Regulatory Impact Analysis and Final Regulatory Flexibility Analysis examine the economic effects of that rule. As this Regulatory Impact Analysis demonstrates, the final rule is expected to improve consumer shopping for mortgages and to reduce the costs of closing a mortgage transaction. A number of benefits, costs, transfers, efficiencies, and market impacts are identified in this Regulatory Impact Analysis.

Section I of this chapter briefly summarizes the rule and Section II explains the need for the rule. Section III discusses the objectives of a Regulatory Impact Analysis and discusses the need for a small business analysis, since many of the provisions of the rule cover industries composed predominantly of small businesses such as mortgage brokers. Section IV discusses the scope of the analyses covered in this Regulatory Impact Analysis. Section V describes the remaining chapters in this Regulatory Impact Analysis.

Readers are referred to the Executive Summary for an overview of the main findings of this Regulatory Impact Analysis and to Section I of Chapter 3 for a detailed summary of all findings related to the Good Faith Estimate.

**I. Main Components of the Rule**

The GFE format simplifies the process of originating mortgages by consolidating costs into a few major cost categories.<sup>1</sup> The GFE ensures that in brokered transactions, borrowers receive the full benefit of the higher price paid by wholesale lenders for a loan with a high interest rate; that is, so-called yield spread premiums. On both the GFE and HUD-1, the yield spread premium, which is the portion of any wholesale lender payments that arise because a loan has an above-par interest rate, is passed through to borrowers as a credit against other costs. Thus, there is assurance that borrowers who take on an above-par loan receive funds to offset

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<sup>1</sup> See the proposed GFE in Exhibit 3-B of Chapter 3.

their settlement costs. The new GFE also includes a trade-off table that will assist consumers in understanding the relationship between higher interest rates and lower settlement costs.

HUD conducted consumer tests to further improve the GFE form in the 2002 proposed rule. Numerous changes were made to make the GFE more user-friendly. The GFE form in the final rule includes a summary page containing the key information for shopping; during the tests, consumers reported that the summary page was a useful addition to the GFE. The trade-off table, another component of the GFE that consumers found useful, is also included in the final GFE. The final GFE is a form that consumers find to be clear and well written and, according to the tests conducted, one that they can use to determine the least expensive loan. In other words, it is a shopping tool that is a vast improvement over today's GFE with its long list of fees that can change (i.e., increase) at settlement.

The final GFE includes a set of tolerances on originator and third-party costs: originators must adhere to their own origination fees, and give estimates subject to a 10 percent upper limit on the sum of certain third-party fees. The tolerances on originator and third-party costs will encourage originators not only to lower their own costs but also to seek lower costs for third-party services.

The final rule would allow service providers to use pricing based on average charges for third-party services they purchase so long as the average is calculated using a documented method and the charge on the HUD-1 is no greater than the average paid for that service. This will make internal operations for the loan originator simpler and less costly and competition among lenders will put pressure for these cost savings to be passed on to borrowers as well. The end result of all these changes should be lower third-party fees for consumers.

To increase the value of the new GFE as a shopping document, HUD is proposing revisions to the HUD-1 Settlement Statement form that will make the GFE and HUD-1 easier to compare. The revised HUD-1 uses the same language to describe categories of charges as the GFE, and orders the categories of charges in the same way. This makes it much simpler to compare the two documents and confirm whether the tolerances required in the new GFE have been met or exceeded. In addition, the final rule introduces a comparison in the revised HUD-1 that would: (1) compare the GFE estimates to the HUD-1 charges and advise borrowers whether tolerances have been met or exceeded; (2) verify that the loan terms summarized on the GFE match those in the loan documents, including the mortgage note; and (3) provide additional information on the terms and conditions of the mortgage. These components of the rule are required together to fully realize the consumer saving on mortgage closing cost estimated here.

Given that there has been no significant change in the basic HUD-1 structure and layout, besides the addition of a comparison page, generating this new HUD-1 should not pose any problem for firms closing loans -- in fact, the closing process will be much simpler given that borrowers and closing agents can precisely link the information on the initial GFE to the information on the final HUD-1. The HUD-1 has also been adjusted to ensure that the new GFE (a shopping document issued early in the process) and the HUD-1 (a final settlement document issued at closing) work well together. The layout of the revised HUD-1 has new labeling of some lines so that each entry from the GFE can be found on the revised HUD-1 with the exact wording as on the GFE. This will make it much easier to determine if the fees actually paid at

settlement are consistent with the GFE, whether the borrower does it alone or with the assistance of the settlement agent. The reduced number of HUD-1 entries that should result, as well as use of the same terminology on both forms should reduce the time spent by the borrower and settlement agents comparing and checking the numbers.

The significant changes made to the final rule from the March 2008 proposed rule are:

- A GFE form that is a shorter form than had been proposed.
- Allowing originators the option not to fill out the tradeoff table on the GFE form.
- A revised definition of application to eliminate the separate GFE application process.
- Adoption of requirements for the GFE that are similar to recently revised Federal Reserve Board Truth-in-Lending regulations which limit fees charged in connection with early disclosures and defining timely provision of the disclosures.
- Clarification of terminology that describes the process applicable to, and the terms of, an applicant's particular loan.
- Inclusion of a provision to allow lenders a short period of time in which to correct certain violations of the new disclosure requirements.
- A revised HUD-1/1A settlement statement form that includes a summary page of information that provides a comparison of the GFE and HUD-1/1A list of charges and a listing of final loan terms as a substitute for the proposed closing script addition.
- Elimination of the requirement for a closing script to be completed and read by the closing agent.
- A simplified process for utilizing an average charge mechanism.
- No regulatory change in this rulemaking regarding negotiated discounts, including volume based discounts.

## **II. Need for Final Rule<sup>2</sup>**

The current GFE format contains a long list of individual charges that can be overwhelming, often confusing to consumers, and that provide little useful information for consumer shopping. Current RESPA regulations have led to a proliferation of charges that makes

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<sup>2</sup> For a detailed discussion of problems with the current system, and thus the need for this proposed rule, see Sections IV and V of Chapter 2 and Sections I and VII of Chapter 3.

consumer shopping and the mortgage settlement process both difficult and confusing, even for the most informed shoppers. Long lists of charges certainly do not highlight the bottom-line costs so consumers can shop and compare mortgage offers among different originators. In addition, under today's rules, the estimated costs on GFEs may be unreliable or incomplete, or both, and final charges at settlement may include significant increases in items that were estimated on the GFE, as well as additional unexpected fees, which can add substantially to the consumer's ultimate closing costs. The process of shopping for a mortgage can also involve complicated financial trade-offs, which are not always clearly explained to borrowers. Today's GFE is not an effective tool for facilitating borrower shopping nor for controlling origination and third-party settlement costs.

Studies indicate that consumers are often charged relatively high fees and can face wide variations in settlement prices, both for origination and third-party settlement services. Chapter 2 offers convincing evidence that not only do borrowers find it difficult to comparison shop in today's mortgage market, but that they are sometimes charged relatively high prices in today's mortgage market. The enormous potential for cost reductions in today's market is indicated by studies showing that yield spread premiums do not always offset consumers' origination costs. Studies show that consumers are, in effect, charged relatively high prices in some transactions involving yield-spread premiums, and that the mortgage market is characterized by "price dispersion." In other words, some borrowers get market price deals, but other borrowers do not. Studies show that less informed and unsuspecting borrowers are particularly vulnerable in this market. But given the fact that a borrower may be more interested in the main transaction (the home purchase), even more sophisticated borrowers may not shop aggressively for the mortgage or may not monitor the lending transaction very closely.

The potential for cost reductions in today's market is also indicated by studies showing relatively high and highly variable charges for third-party services, particularly for title and closing services that account for the major portion of third-party fees. There is not enough incentive in today's market for loan originators to control settlement costs by negotiating lower costs from third-party providers; rather, they too often simply pass through increases in third-party costs to consumers. Because of their lack of expertise, consumers may not be the best shoppers for third-party services providers, leaving them to rely on recommendations from real estate agents and lenders. Thus, increasing borrowers' understanding of settlement costs would encourage competitive arrangements that would lead to lower third-party settlement prices.

Current RESPA regulations are acting as a major barrier to competition and lower settlement costs. Today's mortgage market is increasingly characterized by the introduction of efficiency enhancing improvements such as automated underwriting systems and, through competition, these improvements are leading to lower prices for consumers. But the one area where efficiencies and competition are being held back is the production and pricing of settlement services. Under current law, average cost pricing (another cost reduction technique) is inhibited by existing RESPA regulations.

**GFE Example.** As explained throughout this Regulatory Impact Analysis, the complexity of the origination process, combined with the fact that consumers have limited experience taking out mortgages, places a premium on having a process that is simple, easy to understand, and clear about the various mortgage options available to the consumer. The new

GFE is an important step in that direction, and its many benefits are described in Chapter 3. Therefore, it is useful to briefly outline the benefits of the new GFE, in terms of the issues discussed above concerning (1) high origination costs and (2) high third-party fees.

Under the new GFE, consumers will save \$6.48 billion to \$8.38 billion, or approximately 10% to 13% of the \$66.7 billion in total origination and settlement charges. The consumer savings comes from two sources: (1) lower origination costs due to improved consumer shopping; and (2) lower settlement fees due to lenders negotiating down third-party fees.

**(1) Sources of Savings: Lower Origination Costs.** As noted above, studies indicate that some borrowers pay relatively high origination fees. In addition, there is evidence that many if not most consumers are poor shoppers for mortgages. For these reasons, the shopping benefits of the new GFE-- its simplified form and its guaranteed pricing concept -- should lead to reduced origination fees for a substantial number of borrowers.

- The new GFE simplifies the process of comparing loan offers. Many categories of fees are combined into major categories of fees.
- Thus, the new GFE does away with the proliferation of fees that borrowers are often charged in today's market.
- With the new GFE, yield spread premiums will directly offset the borrowers' closing costs. The new GFE ensures that brokers explicitly disclose the full amount received for originating the loan and that borrowers receive the full credit towards closing costs for any yield spread premium.
- The origination charge cannot change, that is, it is subject to zero tolerance. This will increase the certainty of the shopping process for borrowers.

**(2) Sources of Savings: Lower Third-Party Prices.** As also noted above, there is substantial evidence that consumers pay high prices for third-party services, particularly for title and settlement services. All too often, high third-party costs are simply passed through to the consumers, with little effort by originators to negotiate lower prices for consumers. Thus, reductions in third-party fees are an important source of potential consumer savings under the final GFE.

- The new GFE includes tolerances on third-party costs that will encourage originators to seek lower costs for third-party services. A better shopper -- the originator -- is substituted for the borrower as the searcher for third-party settlement services.
- Originators and third party service providers would be allowed to use average cost pricing for third-party services, which would reduce their costs.

Essentially, innovative vendor arrangements, average cost pricing, and a host of business techniques will be used to reduce high third-party fees to competitive levels.

This example illustrates how the new GFE responds to the current problems with mortgage shopping. These benefits of the new GFE are detailed throughout this Regulatory Impact Analysis.

### **III. Regulatory Impact Analysis and Regulatory Flexibility Analysis**

#### **III.A. Requirement for an Regulatory Impact Analysis under E.O. 12866**

Under Executive Order 12866 (October 4, 1993), federal agencies are required to determine whether a regulatory action is economically “significant” and therefore subject to review by the Office of Management and Budget (OMB). The executive order defines an economically significant regulatory action as one that is likely to result in a rule that may have an annual effect on the economy of \$100 million or more; it is estimated that this rule meets this threshold and thus qualifies as economically significant.

The primary objectives of the executive order are to encourage the cost-effectiveness of regulatory actions and to make the regulatory process transparent to the public. Thus, an economic analysis of a regulation must provide adequate information indicating the need for and consequences of the action; a demonstration that the potential benefits to society of the rule justify the potential costs; a discussion and analysis of alternative actions; and evidence that agency decisions are based on the best reasonably obtainable information.

Specifically, the executive order requires the rulemaking agency to provide the following additional information developed as part of the agency's decision-making process (unless prohibited by law):

1. An assessment, including the underlying analysis, of benefits anticipated from the regulatory action (such as, but not limited to, the promotion of the efficient functioning of the economy and private markets,...) together with, to the extent feasible, a quantification of those benefits;
2. An assessment, including the underlying analysis, of costs anticipated from the regulatory action (such as, but not limited to, the direct cost both to the government in administering the regulation and to businesses and others in complying with the regulation, and any adverse effects on the efficient functioning of the economy, private markets including productivity, employment, and competitiveness...), together with, to the extent feasible, a quantification of those costs; and
3. An assessment, including the underlying analysis, of costs and benefits of potentially effective and reasonably feasible alternatives to the planned regulation, identified by the agencies or the public (including improving the current regulation and reasonably viable non-regulatory actions), and an explanation why the planned regulatory action is preferable to the identified potential alternatives.

This document is provided to meet the requirements for a Regulatory Impact Analysis of the final rule under Executive Order 12866. Sections IV and V of Chapter 2 and Sections I and VII of Chapter 3 provide information indicating the need for the action. Chapters 3 and 6 demonstrate the potential benefits to society of the rule and describe how the rule will promote the efficient functioning of the mortgage and settlement services markets (E.O. requirement 1 above). Chapters 3 and 6 also discuss the costs of the rule including the costs to businesses and others in complying with the regulation (E.O. requirement 2). Alternative actions considered by HUD are described throughout chapters 3, 4, and 6 (E.O. requirement 3). Extensive documentation of sources of data and analysis are included in Chapters 2 and 5, and in Section VII.E of Chapter 3, to provide evidence that HUD's decisions in establishing the final rule were based on the best reasonably obtainable information.

### **III.B. Small Business Analysis Requirements under the Regulatory Flexibility Act (RFA)**

The Regulatory Flexibility Act (5 U.S. 603) requires a Final Regulatory Flexibility Analysis examining the effects on small businesses of major regulations. Each Final Regulatory Flexibility Analysis is required to contain:

1. A description of the reasons why action by the agency is being considered.
2. A succinct statement of the objectives of, and legal basis for, the final rule.
3. A description of and, where feasible, an estimate of the number of small entities to which the final rule will apply.
4. A description of the projected reporting, recordkeeping and other compliance requirements of the final rule, including an estimate of the classes of small entities which will be subject to the requirement and the type of professional skills necessary for preparation of the report or record.
5. An identification, to the extent practicable, of all relevant Federal rules which may duplicate, overlap or conflict with the final rule.

This Final Regulatory Flexibility Analysis accomplishes the above steps.

In addition to the requirements for a Regulatory Impact Analysis under E.O.12866, this document also meets the requirements of the Final Regulatory Flexibility Analysis (FRFA). The parts of this Regulatory Impact Analysis that satisfy the requirements of the FRFA are indicated here. As explained in Chapter 3, the final rule includes provisions that apply to small businesses such as brokers, small lenders, and small settlement service providers. Chapter 3 discusses: the reasons for and objectives of the rule (requirement 1 above); the significant issues raised in public comments on the 2008 proposed rule and on the IRFA of the 2008 proposed rule and HUD's response to those comments (requirement 2); and the steps taken to minimize the significant economic impact on small entities in selecting the alternatives adopted and rejected in this final rule (requirement 5). Chapter 5 describes and estimates the number of small entities to which the rule will apply (requirement 3). Chapter 6 describes the projected reporting, recordkeeping, and other compliance requirements of the rule, the classes of small entities that

will be subject to the requirement, and the types of professional skills necessary for preparation of the report or record (requirement 4).

#### **IV. Nature of the Economic Impacts**

Because the final rule calls for significant changes in the process of originating a mortgage, this Regulatory Impact Analysis identifies a wide range of benefits, costs, efficiencies, transfers, and market impacts. The first sections of Chapter 3 provide detailed summaries of the anticipated benefits and efficiencies from improved borrower shopping that will result from the rule. Improved borrower shopping using simplified forms will result in transfers from firms currently charging non-competitive prices to borrowers whose shopping ability has been enhanced by the new GFE. Ensuring that yield spread premiums are properly credited to borrowers in brokered transactions will cause transfers to borrowers, as it will be more difficult for brokers to be able to use yield spread premiums to charge high prices to borrowers. Similarly, increased competition associated with the new GFE could result in large reductions in settlement service costs, and associated income transfers from service providers who are earning “economic rents” in today’s system, to borrowers who would most likely be the ultimate beneficiaries of more competition among settlement service providers. As these examples suggest, entities that experience reductions in revenues under the final rule are usually those who are charging non-competitive prices, who are relatively high-cost producers, or who are benefiting from the current system’s restrictions on competition. As explained in Chapters 2-3, there is substantial evidence that some originators and settlement service providers are charging consumers non-competitive prices in today’s market.

This Regulatory Impact Analysis not only identifies the numerous anticipated benefits of the GFE, it also quantifies the major ones, showing that there are large and significant financial benefits for consumers. Still, in some cases, it is difficult to quantify and provide precise estimates of these benefits. For example, it is difficult to quantify the extent to which the simplicity and user-friendliness of the new GFE will increase the market participation of certain low-income, minority, and immigrant families who in the past have not shopped for mortgages because of a “fear of the mortgage shopping process.” However, as is shown in Chapter 3, the fact that it is not always possible to report the exact size of the benefits of the rule does not undermine the desirability of the rule, as it is fairly convincing that the benefits of better disclosure, improved shopping, and increased competition among settlement service providers far outweigh any costs and negative effects associated with the rule. Chapter 3 provides estimates demonstrating the potential magnitude of the benefits<sup>3</sup> to consumers of this rule; the substantial estimates of consumer benefits obtained derive mainly from applying the effects of improved borrower shopping and a more competitive third party settlement service industry to the sheer magnitude of mortgage transactions that take place each year. Improvements to the mortgage origination process are important because of the substantial size of the mortgage market.

Chapter 3, supported by analyses conducted in Chapter 5, estimates anticipated revenue impacts of the final rule on different industry segments. Analysis of revenue transfers is

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<sup>3</sup> The term “consumer benefits” includes savings realized by consumers from either transfers or efficiencies.

particularly important given concerns about small business. The estimates reported in this Regulatory Impact Analysis of industry and small business revenue transfers are based on solid analytical techniques and the best available data. This Regulatory Impact Analysis pulls together substantial data from the Bureau of the Census and industry sources to provide estimates of revenue transfers for different industries and for small businesses within those industries. In some cases (e.g., determining the share of all lawyers who work on real estate settlements), the data are not as complete as desired; in these cases, the approach is to make reasonable assumptions based on the limited data that are available, and then conduct sensitivity analyses to gauge the effects of alternative assumptions on the transfer estimates. Chapter 5 provides a full technical review of the data used and the various methodologies for estimating the small business share of industry revenues. Chapter 3 includes the step-by-step process for estimating the consumer savings and industry revenue transfers, the distribution of revenue transfers among major industry sectors, and the small business share of each industry's transfers.

Chapter 3 also examines the anticipated effects of the final rule on the nature of the mortgage origination and settlement industry, and on the key actors (emphasizing small businesses) within that industry. It is not always easy to reach firm conclusions about the precise nature of future market changes resulting from this rule. Still, there is available information on which to draw some conclusions. The discussion in Chapter 3 examines likely market effects based on changes already taking place in the market, statements about anticipated outcomes by industry actors, and the past roles that the various industry sectors have played in the market. The discussion emphasizes factors that are likely to be important determinants of final outcomes. A number of possible market scenarios are examined which highlight the fact that there should be ample market opportunities in the more competitive environment associated with the new RESPA rule. While much of this analysis is justifiably based on basic tenets of competitive market behavior, it is also necessary to consider market changes in the context of less competitive conditions, such as uninformed consumers and subprime markets.<sup>4</sup>

Chapters 3, 4, and 6 include extensive analyses of alternatives considered with respect to the GFE. HUD received numerous comments on the 2002 and 2008 proposed rules, which led to many alternatives being considered. The chapters highlight the many changes that HUD made so that small firms could more easily implement the new GFE.

## **V. Organization of the the Regulatory Impact Analysis**

**Chapter 2** is a technical background chapter that supports the discussion of the economic effects of the rule in Chapter 3. Chapter 2 provides a brief overview of the mortgage market and several background analyses of topics related to the RESPA regulation. Important topics are discussed such as: major trends in the mortgage market over the past 15 years, with an emphasis on the growing origination share of brokers and the related growth of large wholesale lenders; the level of competition in the mortgage market; the complexity of the mortgage process; barriers

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<sup>4</sup> Few, if any, markets fully meet all the requirements for perfect competition. Competition, in practice, is a matter of degree. While mortgage markets exhibit many of the characteristics that promote competition; many borrowers, many originators, and ease of entry; some of the characteristics are missing, such as perfect information. A goal of this rule is to make the mortgage market more competitive.

to consumer shopping; dispersion among mortgage prices and price discrimination (charging borrowers different prices) by lenders; and the growth of yield spread premiums, which have been increasingly used over the past few years (ideally, as a mechanism for reducing upfront closing costs). Chapter 2 addresses issues and questions that deal not only with yield spread premiums and origination fees charged by lenders but also with fees charged by third-party providers. Examples of questions addressed include: What are the main barriers hindering effective consumer shopping for home loans? How can consumers be charged high prices in a market characterized by over 40,000 brokers and lenders vigorously competing with each other? To what extent do consumers understand yield spread premiums and to what extent are yield spread premiums used to offset consumer settlement costs (versus increasing broker or lender compensation)? Are there potential gains from better shopping for third-party settlement services? Are title and settlement fees too high in some cases? Are small third-party firms disadvantaged by RESPA reform? Will any third-party cost savings be passed on to consumers or retained by lenders? These issues are discussed mainly in the context of the prime mortgage market. Mortgage pricing and other issues are then discussed with respect to the subprime market.

**Chapter 3** discusses the new Good Faith Estimate (GFE) and revised HUD-1 settlement statement, including improvements that have been made to the GFE and HUD-1 in the final rule. Chapter 3 explains in detail the new Good Faith Estimate including: the new GFE form; treatment of yield spread premiums and discount points; tolerances in settlement costs; average cost pricing; additional topics and alternatives related to the GFE; consumer benefits, market effects, and estimates of industry and small business transfers; and competitive impacts, with a focus on the market effects on small businesses. Section I of Chapter 3 provides a detailed summary of the chapter's findings. The topics covered in Section I serve as a good overview of the entire chapter. They include: problems with the mortgage shopping process and the current GFE; components and benefits of the new GFE; alternatives considered to make the new GFE more workable for small businesses; estimates of consumers savings; lower origination fees as a source of consumer savings; lower settlement service fees as a source of consumer savings; summary of savings, transfers, efficiencies, and costs associated with the new GFE; and competitive and market impacts of the new GFE on small businesses (e.g., brokers, lenders, and title companies). The impacts of the new GFE on small businesses are highlighted throughout Chapter 3. The steps for estimating the consumer savings and the revenue transfers for small businesses are outlined in Chapter 3.

**Chapter 4** discusses major alternatives considered by HUD in developing the final rule from the 2008 proposed rule such as the clarification of volume discounts and removing the requirement for a settlement script to be read at closing.

**Chapter 5** supports Chapters 3 and 6 by providing basic data on each mortgage-related industry and by explaining the various methodologies for estimating the share of industry revenue accounted by the different component industries and by small businesses within each component industry. Chapter 5 presents an overview of the industries involved in the origination and settlement of mortgage loans: mortgage brokers, mortgage lenders, settlement and title services as well as other third-party settlement services. Industry trends are briefly summarized and special issues related to RESPA are noted. There is also a description of the economic statistics for each industry, with an emphasis on each industry's share of small business activity.

Both the estimation of the revenue share for various industry sub-sectors (e.g., large title insurers' share of total revenue in the title and settlement industry) and the estimation of the small business share of mortgage-related revenue within the industry, often involve several technical analyses that pull together data from a variety of sources, in addition to Census Bureau data. This leads to several sensitivity analyses to show the effects of alternative estimation methods and assumptions. This chapter also reports the revenue transfers from the RESPA rule for the specific industry sectors; these transfers are reported in dollar terms and, where possible, as a percentage of industry revenue. Finally, a number of technical issues and special topics, such as techniques for estimating the number of commercial bank employees engaged in mortgage origination activities, are discussed. Chapter 5 provides extensive discussion on each of the following industries in turn: brokers; lenders, including commercial banks, thrift institutions, mortgage banks, and credit unions; title and settlement industry, including large title insurers, title and settlement agents, lawyers, and escrow firms; appraisers; surveyors; pest inspectors; credit bureaus; and real estate agents. A technical appendix provides relevant definitions and explains the methodology associated with the economic data obtained from the Census Bureau. A data appendix includes tables with the economic data (number of firms, employment, revenue, etc.) for each industry sector.

**Chapter 6** examines compliance and regulatory costs and demonstrates how this document meets the requirements of a Final Regulatory Flexibility Analysis under Section 604 of the Regulatory Flexibility Act. The requirements of the flexibility analysis are listed along with references to the sections in this document where the requirements are covered. Chapter 6 provides a complete summary of alternatives considered in the RESPA rulemaking process with specific references to the sections where the alternatives are fully discussed elsewhere in the text. Chapter 6 discusses comments received on the 2008 proposed rule dealing with compliance and regulatory burden and HUD's responses to those comments. Chapter 6 also contains detailed discussions of regulatory burden and compliance costs for the new GFE. These include: one-time compliance costs that are only felt during the start-up period; recurring compliance costs; changes in the final rule that reduce regulatory burden; and compliance issues related to the tolerances on third-party settlement costs.

## Chapter 2

### OVERVIEW OF THE MORTGAGE ORIGINATION MARKET AND AN ANALYSIS OF SPECIAL RESPA-RELATED TOPICS

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#### I. Introduction

This chapter provides an overview of the mortgage market and several background analyses of topics related to the RESPA regulation. In addition, it reports the results of recent empirical analyses of broker fees and title and settlement fees. Important topics are covered such as: the level of competition in the mortgage market; the complexity of the mortgage process; barriers to consumer shopping; dispersion among mortgage prices; price discrimination<sup>1</sup> by lenders; yield spread premiums, which have been increasingly used over the past few years as a mechanism for reducing upfront closing costs; and title and settlement closing fees. While much of the analysis in this chapter focuses on consumer and lender issues, there is also a discussion of several issues related to the market for third-party settlement services.

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<sup>1</sup> As explained in Section IV, price discrimination involves a provider charging different prices to different buyers. When different prices reflect different costs associated with different buyers, there is no breakdown in competition and efficiency. There is a breakdown in competition when the price differences do not reflect cost differences.

This chapter addresses issues such as: What are the main barriers hindering effective consumer shopping for home loans? How can consumers be overcharged in a market characterized by over 40,000 brokers and lenders vigorously competing with each other? To what extent do consumers understand yield spread premiums and to what extent are yield spread premiums used to offset consumer settlement costs (versus increasing broker or lender compensation)? How much do title and settlement fees vary? Are there potential gains from better shopping for third-party settlement services? Will any third-party cost savings from RESPA reform be passed on to consumers or retained by lenders?

Note: This chapter includes new empirical analyses of both broker and title fees. The chapter also includes an academic review of market conditions in the title industry as well as first-ever analyses of title costs from a large sample of HUD-1 closing statements. This material therefore complements recent work on the title industry by the GAO and others.

## **I.A. Chapter Summary and Main Findings**

This chapter first reviews the growth of the market mortgage market, noting the overall efficiency and competitive nature of today's mortgage market. There are more than 40,000 brokers and lenders competing to offer consumers loans in this market. Even among the so-called "mega" wholesale lenders there is vigorous price competition driven by the desire for market share. This discussion suggests that, in general, the nation's mortgage market is efficient and competitive. Combined with the growth in the secondary market, technological improvements and other advances in the primary origination market have allowed homeowners to quickly obtain financing at reasonable interest rates that reflect the unique risks (e.g., credit and prepayment risk) of mortgages relative to benchmark Treasury securities. The ability of the mortgage market to deliver was readily apparent during 2002-2004, which were record years of refinancing.

But the chapter emphasizes that this does not mean that everyone has ready access to mortgage credit or that all aspects of the mortgage market operate in an efficient and cost-minimizing manner. There are two convincing conclusions: (1) borrowers can find it difficult to comparison shop in today's mortgage market; and (2) borrowers are often overcharged in today's mortgage market. The chapter summarizes evidence on overcharging, price dispersion, and problems that consumers face shopping in today's mortgage market.

**Evidence of Overcharging.** Until recently, there have been few statistical studies of overcharging in the mortgage market. However, recent studies arising from court cases involving yield spread premiums and from analysis of FHA data have empirically documented overcharging of borrowers and, in general, a wide dispersion in mortgage fees. The chapter reviews these studies as well as more limited anecdotal and industry analyses that have looked at overcharging in the mortgage market. Together, these analyses provide the most convincing evidence to date that some consumers are overcharged in today's mortgage market. The three main findings are:

- Studies show that some consumers are overcharged in transactions involving yield spread premiums. The yield-spread premium that a borrower pays (through a higher

interest rate) is not always used to fully offset that borrower's closing costs. Or stated differently, brokers receive more compensation in transactions involving yield spread premiums than they receive in other transactions (all other things equal).

- The chapter also finds that the mortgage market is characterized by "price dispersion", that is, originators charge consumers different prices (fees, yield spread premiums, etc.). There is also evidence that originators make varying levels of profits on their loans. Findings of overcharging and price dispersion, combined with characteristics of the mortgage shopping process (see below), suggest that originators engage in "price discrimination" among borrowers: charging certain types of borrowers (less sophisticated or less informed) more than other types of borrowers (more sophisticated or more informed).
- The chapter summarizes findings on title and settlement fees from analyses by the Urban Institute of a large data base on FHA closed loans. The Urban Institute finds there is substantial variation in title and settlement fees even after controlling for loan amount. Other studies, such as the recent one by the GAO, finds that the title industry is non-competitive.

**Consumer Shopping for Mortgages.** In all, there are several features of the mortgage market that make overcharging possible. The evidence suggests the following with respect to why consumers are poor shoppers for mortgages and why they are overcharged in today's mortgage market:

- Consumers are in general not familiar with the complicated real estate and mortgage settlement process. Many consumers deal only infrequently with the mortgage process. Many borrowers do not take the time to educate themselves on this inherently complex process.
- While most consumers shop extensively, there is evidence that a substantial minority contact only one lender. There is also evidence that those who do little shopping end up paying more.
- The complex, multi-faceted nature of real estate settlement transactions further complicates the operation of market forces. The real estate transaction itself (i.e., the home purchase) represents a huge sum of money and will appear more significant to the consumer than any one of the many settlement services. In other words, consumers might focus on the home purchase, rather than closely monitoring the "second-order" mortgage costs.
- One specific area where consumers may become confused concerns the various financial trade-offs among mortgages. Distinguishing the present value differences between a "par-value" loan with a lower interest rate and an "above par" loan with a higher interest rate can be a daunting task. There is more opportunity for originators to take advantage of borrowers in cases where a mortgage involves complicated financing techniques such as yield spread premiums.

To summarize, the chapter finds that there are many barriers to effective shopping for mortgages. The process can be complex and can involve rather complicated financial trade-offs, which are often not fully and clearly explained to borrowers. Less informed and unsuspecting borrowers are particularly vulnerable in this market. But given the fact that a borrower may be more interested in the main transaction (the home purchase), even more sophisticated borrowers may not shop aggressively for the mortgage or may not monitor the transaction very closely. Price dispersion and price discrimination characterize the mortgage market, which is surprising given that there are more than 40,000 brokers and lenders supplying mortgages in this market (suggesting that a competitive market outcome should be obtained). Most observers believe that the market breakdown occurs in the relationship between the consumer and the loan originator -- the ability of the loan originator to price discriminate among different types of consumers leads to some paying more than others, and to excessive fees being charged to originate a loan.

**Consumer Shopping for Third-Party Services.** The chapter also finds that consumers may not be the best shoppers of third-party providers. In addition to the lack of consumer expertise, there are other problems with today's methods for delivering third-party services. Consumers may directly shop for settlement services or may rely on recommendations from the real estate broker (in the case of a home purchase) or the broker/lender (in the case of a refinance as well as a home purchase). One concern is that there may not be any incentive for the referring party (e.g., the loan originator) to direct the consumer to the lowest cost provider, and because settlement services may be a secondary consideration to the consumer (rather than the primary one of buying a home), the consumer may not closely monitor settlement costs, much less engage in some intensive search for them.

**Title and Settlement Fees.** The chapter reviews evidence on the potential for reducing third-party fees, particularly title and settlement fees. In general, anecdotal evidence and statistical evidence suggest that the title and settlement industry is characterized by a wide variability of prices and that there is much potential for reducing title and settlement fees in today's market. As noted above, recent work by the Urban Institute has highlighted the substantial variation in title fees even for similar loan amounts. There appears to be no reasonable explanation for such wide distributions of title charges. Consistent with the data analyses, industry studies also highlight the non-competitive conditions in the title industry. At the same time, court cases and investigations by HUD and State Attorney Generals point to an industry characterized by consumer abuse.

The chapter also examines several other topics related to the proposed new GFE. For example, there is substantial evidence that competition among originators will ensure that any cost reductions under RESPA reform will be passed through to consumers, rather than retained by lenders.

## **I.B. Chapter Organization**

The chapter is organized as follows. Mortgage origination trends are examined in Section II. The industry has shown a remarkable ability to handle substantial numbers of mortgage transactions over the past few years. Section III summarizes major developments in the mortgage market and highlights the role of key industry actors (such as brokers and

wholesale lenders). Section IV reviews several studies that address issues related to the process of obtaining a mortgage; the issues and topics discussed are those listed in the above paragraph (e.g., yield spread premiums). Section V examines shopping and other issues related to the market for third-party settlement providers with a particular focus on title and settlement fees. New data on title and settlement fees are presented. Section IV and V provide new studies on YSPs and title fees by the Urban Institute. Section VI summarizes the recent growth of the subprime market, where concerns about shopping and pricing are more serious than in the prime market. Section VII summarizes criticisms by the National Association of Mortgage Brokers of the literature review in the RIA of the 2008 proposed rule as well as responses by HUD.

## **II. Mortgage Market Volume**

This rule will impact each mortgage transaction, including applications (which are the basis for a Good Faith Estimate) as well as originations (which are the basis for a HUD-1). The following data indicate the volume of business that will be impacted by the rule.

Single-family mortgage originations doubled during the 1990s, rising from \$458 billion in 1990 to \$1,048 billion in 2000, then doubling during the refinancing wave of 2001 to \$2,215 billion, before rising further during the continued refinancing waves of 2002 and 2003 to \$2,885 billion and \$3,945 billion, respectively. According to OFHEO, originations were approximately \$3 trillion during 2004 (\$2,920 billion), 2005 (\$3,120 billion) and 2006 (\$2,980 billion).<sup>2</sup> Originations are highest during years of refinancing; for example, the refinance share was one-half or more during the origination years of 2001 (57 percent), 2002 (59 percent), and 2003 (70 percent). In their March 2007 forecasts, Freddie Mac, Fannie Mae, and the Mortgage Bankers Association of America projected a normal home purchase environment during 2008, as the average projected mortgage origination volume (over the three organizations) was almost \$2.4 trillion. This serves as the basis for the baseline projection of \$2,400 billion used in this economic analysis<sup>3</sup>. The analyses of consumer savings in Chapters 3 and 4 will examine alternative, higher-volume projections.

In terms of number of transactions, mortgage volume increased from over 7 million single-family loans in 1997 to 8-9 million in 2000 before jumping to 15-17 million in 2001-02 and over 24 million in 2003. Loan origination transactions then dropped to approximately 15-16 million during 2004 and 2005. There is a slight decrease in 2006 to approximately 14 million transactions. The 2007 HMDA count shows a drop to 10 million. However, this figure is certainly an undercount as many of the subprime originators that went out of business would not have reported.

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<sup>2</sup> Mortgage origination estimates do vary. For example, Freddie Mac estimated \$2.9 trillion in 2004, \$3.3 trillion in 2005, and \$3.0 trillion in 2006; Fannie Mae estimated \$2.8, \$3.0, and \$2.5 trillion, respectively; and the Mortgage Bankers Association of America (MBAA) estimated \$2.6, \$3.0, and \$2.5 trillion, respectively. The average 2004-2006 origination estimates of these three organizations were \$2,762 billion in 2004, \$3,088 billion in 2005, and \$2,671 billion in 2006.

<sup>3</sup> The term "Economic Analysis" is used throughout this document to refer to the Regulatory Impact Analysis and Initial Regulatory Flexibility Analysis together.

While the above data focuses on mortgages that are actually originated, it is also important to look at loan applications, as a Good Faith Estimate is required for each loan application. Unfortunately, the industry sources that provided the origination data do not provide corresponding estimates of mortgage applications. To obtain application data, one must rely on data reported by lenders under the requirements of the Home Mortgage Disclosure Act (HMDA). While HMDA data underreport overall mortgage volume,<sup>4</sup> the data can be used to show the relationship between applications and originations. Table 2.1 reports application and origination data as reported by lenders under HMDA. In 2000, for example, lenders reported \$1,455 billion in mortgage applications, compared with \$861 billion in originations, for a dollar-based applications-to-originations ratio of 1.69. Over the 1997-2005 period, the dollar-based applications-to-originations ratio averaged 1.61 while the transactions-based applications-to-originations ratio averaged 1.70. These ratios can be applied to the industry origination estimates. If the rule were in effect during the year 2008 and if mortgage originations were equal to the \$2,400 billion projection (the average projection of Freddie Mac, Fannie Mae, and the MBAA), then the rule would impact \$3.9 billion in applications (covering 21,250,000 loans) and \$2,400 billion in originations (covering 12,500,000 loans).<sup>5</sup> This number of loans is somewhat higher than the number of mortgages used in the 2002 Economic Analysis (11,111,111). Assuming a loan volume of \$2,400 billion instead of \$1,700 billion, and using an average loan amount of \$192,000 instead of \$153,000, the number of loans is 12,500,00 instead of 11,111,111. Thus, this economic analysis uses a higher number of projected loans in its baseline than the earlier 2002 economic analysis. As noted above, the \$2,400 billion projection used here is consistent with those estimates that project a return to a more normal “home purchase” environment. Of course, the number of loans and applications would be much larger in a refinancing environment. Sensitivity analyses in Chapters 3 and 4 will show the effects on projected consumer savings of larger volumes of mortgage activity.

The application figures reported above are based on data that lenders report to HMDA. There are rules governing the conditions under which lenders are to report loans as formal applications under HMDA. These HMDA-reported applications, of course, do not include either “pre-qualifications” or simple “inquiries” (e.g., when a consumer calls several lenders to obtain current rates and points and projected settlement costs). Chapters 3 and 4 discuss several issues related to defining an application, particularly the distinction between a “shopping application” and an application that would be reported to HMDA (e.g., a written application after a potential borrower accepts a lender’s Good Faith Estimate or Mortgage Package Offer). An important

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<sup>4</sup> HMDA’s underestimation of mortgage originations can be seen by comparing industry origination estimates with HMDA data. For example, industry estimates place year 2005 mortgage volume at \$3,120 (based on OFHEO, see text) or \$3,088 billion (based on averaging estimates by Freddie Mac, Fannie Mae, and the MBAA, as explained in previous footnote). HMDA places 2005 originations at \$2,715 billion, or 87-88% of industry origination estimates. For a discussion of the reasons (e.g., certain small lenders are not required to report, loans in non-metropolitan are not fully reported, etc.) for HMDA’s under coverage of mortgage originations, see Randall M. Scheessele, *HMDA Coverage of the Mortgage Market*, Working Paper No. HF-009, Office of Policy Development and Research, U.S. Department of Housing and Urban Development, 1998.

<sup>5</sup> In 2005, the average loan amount based on HMDA data was \$187,000; to obtain an estimate for 2008, this 2005 HMDA number was increased to \$192,000 based on the projected percentage growth in median house prices from 2005 to 2008. Dividing the \$2,400 billion origination projection by the \$192,000 average loan amount produces the projected number of loans --12,500,000.

issue concerns whether there will be an increase in the number of “shopping applications” (which are similar to “pre-qualifications” in today’s market) and HMDA-reported applications as a result of the changes in this rule. Under this rule, the Good Faith Estimate (GFE) and the Mortgage Package Offer (MPO) will be better shopping documents, so one would expect an increase in borrower shopping as well as a more efficient borrower shopping process. The implications of this for the number of shopping applications and HMDA-reported applications are discussed in Chapters 3 and 4.

### **III. Developments and Main Actors in the Mortgage Origination Market**

This section summarizes developments over the past 10-15 years in the mortgage origination market, focusing on the major actors such as brokers. The discussion is primarily derived from five papers:

- A. Michael G. Jacobides, “Mortgage Banking Unbundling: Structure, Automation, and Profit,” *Mortgage Banking*, January 2001, pages 28-40.
- B. Morgan Stanley, “U.S. Mortgage Finance: The American Dream Industry, 2002-2020,” (An industry analysis written by Kenneth A. Posner and Mita Nambiar), February 5, 2002.
- C. Joint Center for Housing Studies, Harvard University, *The 25<sup>th</sup> Anniversary of the Community Reinvestment Act: Access to Capital in an Evolving Financial Services System*, March 2002.
- D. Tom LaMalfa, “Who’s Who in Wholesale 2005” *Mortgage Banking*, August 2006, pp. 74-83; Tom LaMalfa, “Who’s Who in Wholesale 2004” *Mortgage Banking*, June 2005, pp. 49-59; Tom LaMalfa, “Who’s Who in Wholesale 2001” *Mortgage Banking*, February 2002, pp. 48-59.
- E. Wholesale Access. “Mortgage Brokers 2004”, July 2005.

Related research by others is also included in the discussion of these papers.

#### **III.A. Jacobides’ Paper**

Jacobides documents the so-called “unbundling” of mortgage lending over the past 15 years. During the 1980s and 1990s, mortgage lending has evolved from the traditional portfolio lender model where single companies (bank and thrift depositories) performed all steps in the mortgage process -- making, closing, funding, servicing, and holding the loan – to a new atomized, more specialized industry of originators, funding lenders, warehouse lenders, separate secondary market buyers of loans, and servicers. A major driving force behind this unbundling of the mortgage functions was the rise and eventual dominance of mortgage securitization (led by Ginnie Mae, Fannie Mae, and Freddie Mac), which separated the provision of capital from loan origination and servicing. Increasing technical sophistication and information technology were also important factors in the restructuring of the mortgage finance system and the rise of

mortgage securitization. Jacobides also notes that the traditional mortgage banking function (defined by independent mortgage bankers that sell their originations in the secondary market but retain servicing) has recently also been disintegrating into component service industries, highlighted by the birth of the mortgage brokerage function and the corresponding development of the wholesale segment:<sup>6</sup>

“Now front-end loan origination is increasingly in the hands of mortgage brokers rather than mortgage bankers;.....specialized subservicers and focused wholesalers now mediate activities that used to be internalized within firms’ boundaries.....Mortgage origination, in particular, has seen significant change....Mortgage brokers, for instance, who hardly existed before 1980, reportedly increased their origination volumes to as much as 65 percent of total originations over a few year’s time span. Some mortgage bankers have shed their origination branch networks and have instead focused on wholesaling loans or restricted themselves to building networks of correspondent lenders. Still other mortgage banks focused on servicing...” (Jacobides, page 30)

As a result of the unbundling trend, the mortgage production process takes place in three different channels. LaMalfa (2006) estimates that in 2005 (2004), the retail channel accounted for 43 percent (43 percent) of total originations, the correspondent channel, 26 percent (27 percent), and the brokerage channel, 31 percent (30 percent).<sup>7</sup> LaMalfa (2001) notes that during the 1990s, each production channel accounted for approximately one-third of total production. LaMalfa’s findings with respect to these mortgage production channels and the rise of wholesale lending will be discussed below in subsection III.C. LaMalfa’s finding that the brokerage channel accounted for about one-third of mortgage production during the 1990s, versus other estimates that brokers account for about 60 percent of mortgage originations, will be discussed below in both subsections III.C and III.D.

**Mortgage Channel.** As shown below, in recent years there has not been a dramatic shift in production channels, with just a slight decline in loans originated through retail channels. The share of loans produced through retail channels has declined from 41.3 percent in 2004 to 37.9 percent in 2006. The broker channel also declined slightly over this period from 30.9 percent to 29.5 percent, with the gains made up in the correspondent channel, which rose from 27.5 percent to 32.9 percent.

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<sup>6</sup> Jacobides notes that the wholesale segment, which in 1989 accounted for 19 percent of all originations, reached 37 percent in 1993 and then stood at around 32-43 percent during the remainder of the 1990s.

<sup>7</sup> See Section III.D below for further discussion of the three channels of mortgage origination. As explained there, the correspondent channel includes loans sold to wholesale lenders by closed-end loan sellers, who are originators that fund mortgages (e.g., with a warehouse line of credit) prior to selling them to wholesale lenders. The brokerage channel includes loans from originators who do not fund loans using lines of credit, but rather close loans through either table funding or concurrent funding arrangements (defined in Section III.D). The retail channel includes loans originated through the retail outlets of banks, thrifts, and mortgage banks and are not sold to wholesale lenders (of course, wholesale lenders can originate loans on a retail basis, as well as purchase them from brokers and loan correspondents).

## Originations by Production Channel

### A. Dollars (in Billions)

	RETAIL	WHOLESALE		TOTAL Production
		Broker	Correspondent	
2002	\$1,161	\$887	\$786	\$2,885
2003	\$1,622	\$1,104	\$1,185	\$3,945
2004	\$1,206	\$903	\$802	\$2,920
2005	\$1,224	\$976	\$920	\$3,120
2006	\$1,130	\$880	\$980	\$2,980

### B. Percentage shares

	RETAIL	WHOLESALE		TOTAL Production
		Broker	Correspondent	
2002	40.2%	30.7%	27.2%	100%
2003	41.1%	28.0%	30.0%	100%
2004	41.3%	30.9%	27.5%	100%
2005	39.2%	31.3%	29.5%	100%
2006	37.9%	29.5%	32.9%	100%

Source: Inside Mortgage Finance, 2007 Mortgage Market Statistical Annual.

## III.B. Morgan Stanley Report and Technological Advances in Mortgage Lending

Morgan Stanley examined changes in the origination market, as a basis for making market projections over the next few years. Morgan Stanley echoed several of Jacobides' points. Some of main findings from the Morgan Stanley analysis are summarized below. This section also summarizes trends in technology affecting the mortgage origination process.

Morgan Stanley concludes that the prime mortgage market is highly competitive and efficient, and that brokers are an important reason for this. The report notes that "tens of thousands of independent brokers" have competed away business from traditional (small and medium-sized) banks and thrifts, and Morgan Stanley does not foresee any reversal in this trend. According to Morgan Stanley, brokers are not hampered by high fixed costs (due to maintaining a large in-house sales force, for example) and are flexible enough to respond to the extreme cyclicity of the mortgage origination function. In other words, it appears that brokers can originate loans more economically than heavily staffed lenders -- brokers also have more flexibility to increase and decrease staff than lenders. This was demonstrated in 2001, when brokers doubled their originations in response to the substantial increase in refinancing activity. Morgan Stanley says there is little evidence of economies of scale in mortgage origination and cites evidence that brokers are more efficient originators than mid-size and large lenders.

The Morgan Stanley report emphasizes that technology and automated underwriting systems are making big changes in the mortgage industry in areas such as servicing, pricing, connectivity, and unit costs. Brokers are increasing using technology supplied by lenders and the GSEs when submitting loans for electronic approval. Morgan Stanley also concludes that the

spread of automated underwriting and “open architecture” systems (allowing brokers to quickly qualify applicants and obtain prices from several lenders) should further improve brokers’ price sensitivity and competitive position (also see discussion below of Forrester report and of the GSEs’ automated underwriting systems).

Morgan Stanley notes that despite the trend toward dis-integration, there has been a rise in a handful of “mega” wholesale lenders with efficient business processes and low costs. These lenders -- such as Countrywide, Wells Fargo, Chase Manhattan, and Washington Mutual -- have been a byproduct of the consolidation process in the banking and thrift industries. They serve as wholesale lenders purchasing loans from brokers and correspondents as well as operating their own retail operations. Brokers and correspondents allow these large wholesalers to expand their sales force in a low-cost way and to enter markets that they otherwise would not find profitable. According to Morgan Stanley, the market share of the top 15 retail lenders more than doubled from 27 percent to 56 percent between 1994 and 2000; the share of top 15 wholesale lenders purchasing loans from brokers and correspondents exhibited a similar increase since 1994. Morgan Stanley concludes that this industry concentration will improve competitive rivalry in the origination and wholesale processes, as episodes of irrational pricing will be less frequent.

The concentration of the mortgage lending industry has continued since Morgan Stanley completed their analysis. *Inside Mortgage Finance* (January 24, 2003) reports that the top five originators boosted their share of the mortgage market from 38 percent in 2001 to 47 percent in 2002. The top 25 as a group increased their market share from 71 to 79 percent during the same one-year period.<sup>8</sup> (LaMalfa’s comments on these patterns are discussed below.)

**Technology in Mortgage Lending.** With respect to overall competition in the prime mortgage market, Morgan Stanley echoes the comments of Jacobides, who said that intense competition has reduced mortgage fees by almost 40 percent in recent years. Morgan Stanley sees advances in technology continuing the trend toward lower origination costs. Given the commodity-like nature of mortgages and the price sensitivity of consumers, Morgan Stanley sees the cost savings from technology advances being quickly passed through to consumers, with little increase in lenders’ profit margins.

With respect to the impact of technology advances on small lenders and brokers, a report by Forrester Research, Inc. entitled “Resuscitating Mortgage Lending” echoes many of the sentiments of the Morgan Stanley report.<sup>9</sup> The Forrester report, based on interviews with lenders, states that the benefits of the automated underwriting (AU) systems deployed by the GSEs and third-party vendors have accrued mainly to smaller lenders and brokers. The fact that the GSEs’ systems go directly to brokers means that brokers do not have to rely on the AU systems of large lenders. The GSE systems enable brokers to make fast decisions (without collecting a lot of paperwork or committing to a specific lender), to shop their GSE-accepted mortgages among lenders for the best deal, and to accomplish all this without having to make a large investment in technology infrastructure. Even on important issues such as credit risk, brokers can often rely on

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<sup>8</sup> According to *Inside Mortgage Finance* (January 24, 2003), the share of the top five (25) originators was only 28 percent (54 percent) in 1998.

<sup>9</sup> Forrester Research, Inc., *Resuscitating Mortgage Lending*, May 2001.

the GSE and private mortgage insurance automated systems, without having to be tied down to specific rules of large lenders.

Jacobides also says that the GSEs' new underwriting tools "would enable smaller lenders to compete more easily with larger ones" (p. 120).<sup>10</sup> Point-of-sale systems allow brokers to get an approval from the GSEs' systems and then shop the loan among different wholesalers for the best rate. Jacobides also notes that internet connectivity has allowed brokers to link with lenders (without the need for specialized software), making disaggregated production even more attractive. Any broker can prepare a loan and then hook up with a lender to do comparison-shopping. Jacobides says brokers are reaching more consumers from Internet inquiries and reaping productivity benefits such as elimination of price fax sheets and faster approval and rate lock communication.<sup>11</sup>

**Trends in Automated Underwriting.** The trade publication *Inside Mortgage Technology* surveyed mortgage lenders with respect to their use of automated underwriting (AU).<sup>12</sup> Key results included:

- Most lenders surveyed said their top objective is to have the ability to change the rules they write into the AU system on a real-time basis to accommodate the ever-changing underwriting guidelines.
- Of the lenders that responded to the survey, only 27% said their AU system currently provides some form of connectivity to third-party service providers.
- One third of respondents said they plan to upgrade or switch to a different AU system in the next 24 months because they want to have more flexibility or better features.
- A key reason for switching AU systems is to improve connectivity with third-party service providers such as appraisers.

### **III.C. Joint Center Study of the Evolving Financial Services System**

A study of HMDA data by the Joint Center also focuses on trends in the mortgage origination market, particularly the rise of large banking organizations. The study identified a number of key features and trends of the mortgage market including:

- As state and federal restrictions on intrastate banking were eliminated in the 1980s and 1990s, commercial banks were able to expand beyond their previous boundaries, often through mergers and acquisitions. Many of the functions of mortgage lending,

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<sup>10</sup> Michael G. Jacobides, "Technology With A Vengeance: The New Economics of Mortgaging," *Mortgage Banking*, October, 2001, pp. 119-131.

<sup>11</sup> Jacobides does say that there is a potential that traditional retail banks could now use the internet to reach out directly and capture brokers' customers.

<sup>12</sup> "Lenders Want AU Flexibility, More Features", *Inside Mortgage Technology*, June 16, 2003, page 1.

such as marketing, account management, and servicing, involve high fixed costs and benefit from consolidation, to allow costs to be spread across a larger customer base.

- Technology advances allowing loan applications to occur by phone, fax, and internet, and the growing use of electronic loan processing and underwriting make centralized operations more feasible. At the same time, the high fixed costs for such technology encourage consolidated operations, to spread the costs over more customers.
- The front-end part of the mortgage process still requires a local presence, and benefits less from economies of scale. As a result, mortgage brokers, working on a fee-for-service basis, have become a larger part of the industry to handle the front end of the process on the local level.
- As a result of these influences, mortgage lending has become substantially more consolidated. In 1993 only 4 lenders made more than 50,000 conventional home purchase loans a year, comprising 11 percent of such loan originations. By 2000, 12 lenders made that many loans, and they accounted for 39 percent of the market. By contrast, while the number of lenders making fewer than 5,000 home purchase loans a year fell only slightly from 6,083 in 1993 and 5,944 in 2000, their share of loans fell from 46.7 percent to 29 percent.
- While this consolidation was driven primarily by large banking institutions, which accounted for 78 percent of the total increase in home purchase loans between 1993 and 2000, two independent mortgage and finance companies, Countrywide Home Loans and Cendant Mortgage, also made more than 50,000 home purchase loans in 2000. Many other independent mortgage banking firms merged with, or were acquired by large banking firms.

The Joint Center viewed these large lenders as competing in a highly competitive environment. They stated that these trends will persist with continued technological change and that low marginal costs will spur competition “as large firms seek to identify and exploit competitive advantage in their pursuit of customers in an increasingly competitive marketplace.” (page 17)

### **III.D. LaMalfa’s Reports on Wholesale Lending**

**Basic Facts, Consolidation, and Competitive Nature of the Wholesale Market.** Tom LaMalfa has published two recent articles that best characterize trends in wholesale lending, as well as some issues related to brokers. (See LaMalfa, 2005, 2006.) LaMalfa’s results are based on a survey of wholesale lenders that his firm (Wholesale Access) has been conducting for 14 years. The 28 surveyed firms accounted for 68 percent of total mortgage originations during 2005. LaMalfa makes several interesting comments with respect to the market role of wholesale lenders:

- With respect to the consolidation trends noted earlier, LaMalfa notes that the mortgage banking ranks have been thinning for two decades, as each year there are

fewer firms and they are bigger. With respect to wholesale lenders, in particular, LaMalfa reports that significant regional and national wholesalers have dwindled as over 100 firms since 1994 have merged, been acquired or closed. He notes while economies of scale or scope can be found in certain functions -- servicing, secondary marketing or specific production channels (such as correspondent lending) -- the driving force for consolidation is uncertain. He notes that textbook economies of scale (increased production per firm leads to lower average cost) have not yet been accomplished in mortgage production.

- In 2005, the top nine wholesale lenders were Countrywide Financial Corp, Wells Fargo Home Mortgage, Washington Mutual, Chase Home Finance, CitiMortgage, Aurora Loan Services, Greenpoint Mortgage Funding, ABN AMRO Mortgage Group, and Indymac Bank.
- LaMalfa emphasizes the competitive nature of the wholesale lender industry. He notes: “since 1994, more than 100 wholesalers have merged, been acquired or closed up shop. This high mortality rate reflects the perfectly competitive nature of the origination industry serving the primary market.” (LaMalfa, 2002, p.51) He further notes, “Today’s giants leapfrogged their way to size through acquisitions and mergers. However--and let us underscore this point--market “dominance” is not market power, in the sense of pricing power, of which a perfectly competitive market like mortgage banking has none.” (LaMalfa, 2002, p.58). LaMalfa also notes the thin profit margins found in the mortgage origination business.
- LaMalfa believes that the rapid expansion of wholesaling that has occurred over the past decade is over, and that purchased production (i.e., wholesalers’ mortgage purchases from correspondents and brokers) will move with overall mortgage volume.

Section V below compares findings of LaMalfa with several commenters who reached different conclusions concerning the competitiveness of the mortgage lender market.

**Broker Versus Correspondent.** LaMalfa (2006) provides a detailed discussion of the different channels through which mortgages are produced. He estimates that in 2005, the retail channel accounted for 43 percent of total originations, the correspondent channel, 26 percent, and the brokerage channel, 31 percent. When discussing these channels, LaMalfa makes two distinctions that are important for understanding the concept of brokers and correspondents.

First, LaMalfa (2006) distinguishes between the correspondent and brokerage channels. Correspondents are closed-loan sellers; they fund their obligations by drawing down funds from warehouse lines they establish and maintain with creditors. Brokers, on the other hand, are originators without warehouse lines of credit; they close their loans through either (a) table funding or (b) concurrent funding arrangements. In both cases, the wholesale lender funds the loan at closing. The difference between (a) and (b) depends on whose name is on the mortgage and who handles closing. In the case of (b), concurrent funding, the wholesale lender’s name is on the loan rather than the broker’s and the lender, not the broker, handles closing. In the case of

(a), table funding, the broker's name is on the loan and the broker handles closing. It should be noted that LaMalfa's definition of brokers follows the HUD definition of brokers.

Second, LaMalfa (2006) distinguishes between (a) his more narrow definition of brokers (described above) and brokers as they are usually defined. The need for an explanation is highlighted by the following seemingly conflicting pieces of data -- LaMalfa (2006) reports that the brokerage channel accounts for 31 percent of mortgage production while others (including LaMalfa and David Olson, as described below) report that "brokers" account for over 60 percent of mortgage originations. In discussing this issue, LaMalfa notes that:

"Do not conclude...that overall broker market share was 31 percent in 2005. Unfortunately, broker originations leak into both the correspondent and retail channels, but especially correspondent, where Wholesale Access estimates that more than half of correspondent volume actually comes originally from brokers. In retail, we estimate that one-quarter of applications are broker-driven meaning a loan officer at a brokerage took the loan application from the borrower." (LaMalfa, 2006, p. 82).

The specific definition of "brokers" that is used as the basis for the 68 percent figure is discussed in the next subsection.

### **III.E. Analysis of the Broker Industry**

The most complete information on the characteristics of mortgage brokers and the rise of this sector during the 1990s comes from Wholesale Access, who has conducted several surveys of the brokerage industry.<sup>13</sup> This review of Wholesale Access' work first explains how they define a broker and then presents some of their main findings.

**Wholesale Access' Definition of a Broker.** Wholesale Access defined a broker as any independent (not connected with a bank, thrift, or credit union) firm who table funds more than half its production, does not service loans, and does not buy whole loans from other firms. This broker definition includes brokers that use lines of credit to finance up to half their production; it is therefore broader than the definition used by HUD and LaMalfa. As discussed above, LaMalfa estimates that approximately one-third of mortgage production has come through the brokerage channel (defined as table funding and concurrent funding) while another quarter has come through the correspondent channel. Wholesale Access' larger estimate that brokers account for about 68 percent of market originations is due to his more expansive definition that covers brokers with warehouse lines of credit that also operate through correspondent arrangements with larger wholesale loan purchasers (rather than simply table funding loans).

**Wholesale Access' Findings About the Broker Industry.** Some of Wholesale Access' (2005) main findings are summarized below:

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<sup>13</sup> In fact, others commenting on the industry, such as Morgan Stanley, rely heavily on Wholesale Access' research. Tom LaMalfa is also the managing director Wholesale Access.

- Brokers increased their share of the origination market from practically zero in 1980 to 20 percent in 1987 to 55 percent in 2000 to 65 percent during the heavy refinancing wave in 2001, and further to 68% in 2004. Brokers accounted for \$1.75 trillion (or 68 percent) of the \$2.589 trillion of mortgages originated during the heavy refinance year of 2004.
- According to Wholesale Access, in 2004 there were 53,000 brokers selling their loans to about 100 wholesale lenders. These are typically small firms -- the median firm has one office and four workers including the owner. The median firm is only five and a half years old. The median firm originated 200 loans in 1998 and 125 loans in 2000 and 90 in 2004.
- Wholesale Access sees brokers as low-cost, highly competitive firms, vigorously competing with one another and with little opportunity to earn above-normal profits. According to Wholesale Access, if brokers do not provide the consumer with good service, they go out of business.
- Specifically with respect to broker profits, Wholesale Access notes, “most brokers are just breaking even”. They say that if brokers were so profitable there would not be a net exodus from the industry, as the average firm lasts only five and one-half years.
- Wholesale Access also reports that their surveys find no economies of scale in mortgage production – a one-person firm produced as many loans per employee as a larger firm.
- Wholesale Access concludes that brokers are particularly needed in today’s volatile mortgage market, as they can grow and contract their work forces much more quickly than existing retail firms. According to Wholesale Access, brokers were the main reason the industry was able to handle the refinance-induced doubling in mortgage origination demand during the 2001 through 2004 period.

Wholesale Access (2005) contains results from its survey of the 2004 market. The main points from this study included the following:

- In 2004, there were 53,000 brokers actively making loans.
- Brokers accounted for 68% (or \$1,748 billion) of all mortgages originated during the heavy refinance year of 2004. Retail originations accounted for the remaining \$841 billion.
- The typical broker sells to an average of ten different wholesale lenders, but only three account for 80% of the broker’s production.
- The average broker firm has 4.5 loan officers and 1.5 managers.
- Similar to Wholesale Access’s five previous studies of the broker market, the typical broker firm has been in business five and one-half years.

- There are 418,700 workers in the broker industry, and 93% of these originate loans on a full-time basis.
- Slightly more than three out of every four brokerages have only one office.

The various data that Wholesale Access reports about the characteristics of broker firms are, in general, consistent with the data reported for brokers by the Census Bureau (see Chapter 5). In addition, Wholesale Access' statements about the competitive market behavior of brokers are generally consistent with what many say about the industry (see comments by Morgan Stanley). However, research reported in Section IV below suggests brokers overcharge borrowers by not giving them the full benefits of yield spread premiums; at first glance this seems inconsistent with Wholesale Access' statements about the absence of above-normal profits in the broker industry. It is possible that brokers and other originators overcharge some borrowers (say the less informed borrowers) and undercharge other borrowers (say the more informed borrowers) with the end result being that the firms earn, on average, normal profits. (This issue of overcharging is discussed in Section IV below.) But others have suggested that the industry may be more profitable than indicated by Wholesale Access.

In fact, David Olson of Wholesale Access testified before the Senate Committee on Banking, Housing, and Urban Affairs and stated that the brokerage business is not very profitable. Following the hearing, Senator Sarbanes asked Howell E. Jackson (a Harvard law school professor who also testified at the hearing) if he had any information on the profitability of the brokerage industry and, if so, to respond in writing.<sup>14</sup> In his written response, Jackson stated, "While I have not undertaken an independent investigation of the profitability of the mortgage brokerage business, I reviewed several reports on the subject that Mr. Olson himself prepared. Contrary to Olson's testimony at the hearing, these reports indicate that mortgage brokers have been extremely profitable in the past decade and, in particular, during the 1996-2000 period..." (p. 85). Jackson made the following points based on his review of surveys of the mortgage brokerage industry conducted by Olson:

- Citing the substantial growth in the industry, Jackson said he "would be skeptical of any claims that an industry experiencing such a sustained rate of growth 'is not very profitable'" (p. 85). He noted that while the number of mortgage brokers more than doubled between 1991 and 1998, the level of originations of the median firm also increased by one-third, based on Olson's survey data.
- After citing Olson's conclusion that brokers earned a higher rate of profit in 1998 than earlier years, Jackson also notes that the \$160,000 earned by the typical mortgage broker (operating as a sole proprietorship) in 1998 is "an extraordinary

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<sup>14</sup> See Howell E. Jackson, "Response to Written Questions of Senator Sarbanes," *Predatory Mortgage Lending Practices: Abusive Uses of Yield Spread Premiums*, Hearing Before the Committee on Banking, Housing, and Urban Affairs, United States Senate, 107<sup>th</sup> Congress, U.S. Government Printing Office: Washington, D.C., January 8, 2002, pp. 85-89. Reference is Jackson (2002b).

median income for an industry that does not require substantial training or advanced degrees”.<sup>15</sup>

A article in the Wall Street Journal (February 24, 2003) also raised several issues about the financial returns earned by brokers. The following points are drawn from that article:

- The article included several examples of brokers without much know-how and training earning substantial sums of money during the past two years of heavy refinancing. The article notes that unlike many high-paying professions, mortgage brokers typically aren't required to have much more training than what they get on the job, as only 13 states require a state license for individual brokers. (The article recognized that these large payments would likely decline with any fall off in refinancing activity.)
- The article quoted Olson as evidence for the anecdotal stories of high payments. Olson said the average mortgage broker made \$120,000 last year, while owners of brokerage firms took home \$400,000. According to Olson, both figures were double the levels of only two years ago. At least five percent of the 120,000 individual brokers earned \$1 million or more that year (the 120,000 individual brokers operate in the approximately 30,000 broker firms mentioned earlier).
- The article quoted industry sources as estimating that brokers receive 1 percent to 1.5 percent as fees, which highlights the potential revenue for a high-volume broker. The article explains that sometimes the broker fees come directly from borrowers themselves but in other cases brokers get paid by lenders, who will pay a premium for a mortgage with an above-market interest rate (see discussion of yield spread premiums in Section IV).
- The article also quoted Howell Jackson as saying his research suggests that \$1,600 would be a fair fee, no matter the size of the loan -- this figure would cover the broker's cost and still provide a reasonable profit. But according to Jackson, brokers have been earning twice that sum and thus earning “supra-normal profits”. (See the discussion of Jackson's analysis in Section IV below.)
- The article quotes Jack Guttentag (professor of finance emeritus at the University of Pennsylvania's Wharton School) as saying that improved disclosure could cut brokers' fees in half because it is fairly difficult to comparison-shop for mortgages in today's market.

The Wall Street Journal article was highly anecdotal and focused on a period of heavy demand for broker services. As Jackson states, he has not conducted any independent analyses of broker profitability. Thus, the major work on broker profits remains the work of Olson, who concludes that most are just breaking even.<sup>16</sup> But as noted earlier, there are research studies that

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<sup>15</sup> *Ibid.*, 85.

<sup>16</sup> In his comments on the Wall Street Journal article, Olson emphasizes: (a) the competitive nature of the broker industry (individual firms can't affect price and there are no barriers to entry); (b) the high turnover of firms in the

have examined the issue of fee overcharging by brokers (as well as lenders) and have found that some do overcharge; these studies will be reviewed in Section IV below.

**AARP Study.** A survey by the American Association of Retired Persons (AARP) examined elderly homeowner views concerning the performance of brokers. This national study was conducted by Market Facts for AARP and surveyed 1,008 older homeowners (over age 65) by telephone concerning their recent lending experience with brokers and lenders.<sup>17</sup> The AARP noted that a concern had arisen that “mortgage brokers may focus more on the short-term profitability incurred at the origination of the loan rather than on the long-term performance of the loan since they are intermediaries who do not hold loans through maturity” (page 1) – specifically, the AARP was concerned whether the compensation system (i.e., yield spread premiums) for mortgage brokers inevitably resulted in higher interest rates and higher costs. AARP also noted that aggressive “push marketing” by some mortgage brokers had also raised questions that many refinance loans are “sold, not sought.” Selected findings from the AARP survey are as follows:

- Older mortgage borrowers with broker-originated refinance loans (as opposed to older borrowers with lender-originated loans) reported more broker-initiated contact, more reliance on the broker to find the best loan, and a higher response to advertisements that guaranteed loan approvals.
- Among older borrowers with broker-originated loans, only 16 percent reported that they returned to the same broker to refinance, while 40 percent of older borrowers with lender-originated loans did so.<sup>18</sup>
- Older borrowers with broker-originated loans were more likely to respond that the loans were not the best for them, the rates and terms were not fair, they did not receive accurate and honest information from their brokers, and they obtained worst terms than expected. For example, 23 percent of older borrowers with broker-originated loans said they did not feel the terms were fair, versus 8 percent of older borrowers with lender-originated loans. Twenty percent reported they received loans worse than expected (versus 8 percent for lender-originated loans).

Based on these findings, the AARP paper concluded that it is important to assure that older households receive appropriate loans.

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industry (most firms last only one or two years, according to Olson); and (c) the median profit of a broker was only \$100,000 in 2000 (only 2%-5% of the industry made large profits). Olson’s response is in “Letter to the Editor of the *Wall Street Journal* in Rebuttal of the February 24, 2003 Article Titled, “Take-Home Pay, the Refinancing Boom Spells Big Money for Mortgage Brokers”, which can be found at Olson’s web site [www.wholesaleaccess.com](http://www.wholesaleaccess.com).

<sup>17</sup> See Kellie K. Kim-Sung and Sharon Hermanson, “Experiences of Older Refinance Mortgage Loan Borrowers: Broker- and Lender-Originated Loans,” published by the AARP Public Institute, January, 2003.

<sup>18</sup> Older borrowers with broker-originated loans were also more likely to have refinanced in the past and to predict that they would refinance in the future.

The discussion in this chapter suggests that, in general, the nation's mortgage market is efficient and competitive. Combined with the growth in the secondary market, advances in the primary origination market have allowed homeowners to quickly obtain financing at reasonable interest rates that reflect the unique risks (e.g., credit and prepayment risk) of mortgages relative to benchmark Treasury securities. Compared to the traditional depository-based system that dominated home funding as recently as the early 1980s, the current system provides homeowners with ready access to both national and global capital markets.

This does not mean that everyone has ready access to mortgage credit or that all aspects of the mortgage market operate in an efficient and cost-minimizing manner. The above statement by Guttentag, as well as additional analysis in Section IV below, suggest that it may be difficult for some borrowers to comparison shop in today's mortgage market. In addition, Section IV presents statistical evidence that consumers are overcharged in today's mortgage market. The preamble to the proposed rule and Chapter 3 also outlines several problems with the mortgage shopping and settlement (closing) processes that have raised concerns of fairness and cost-effectiveness, even in the prime (or so-called "A") part of the mortgage market. The complexity of the origination process, combined with the fact that consumers have limited experience taking out mortgages, place a premium on having a process that is simple, easy to understand, and clear about the various mortgage options available to the consumer -- unfortunately, the current mortgage shopping process is too often characterized as confusing and providing little useful information to guide the consumer in making a final decision. The costs of settlement can not only be too high -- thereby combining with the down payment requirement to serve as an up-front barrier to homeownership for lower-income families -- but they can also be uncertain and subject to change between initial application and final closing, further frustrating consumers in their efforts to obtain homeownership. In addition, there are opportunities for further innovation in the mortgage origination process through volume discounting and other methods that would allow lenders to provide services at a lower cost. Chapter 3 will discuss these issues and concerns in more detail and explain how the RESPA Rule seeks to correct them and thereby improve the shopping and settlement process.

**Other Studies of Broker Fees.** A 2005 study<sup>19</sup> found that subprime borrowers who obtained loans through mortgage brokers paid lower annual percentage rates than borrowers using lenders directly. The study used data from 10 large lenders and contained over 2 million subprime loans originated between the third quarter of 1995 and the fourth quarter of 2004. Subprime borrowers using mortgage brokers save 53 basis points on the APR of fixed-rate first-mortgages compared to those borrowing directly from lenders, 84 basis points on variable-rate first-mortgages, 426 basis points on fixed-rate second-mortgages and 534 basis points on variable-rate second-mortgages.

LaCour-Little (2005)<sup>20</sup> examines whether borrowers obtain more favorable prices on loans using a mortgage broker or through a retail lender directly. His findings revealed that, on

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<sup>19</sup> Anshasy, Amany El, Gregory Elliehausen and Yoshiaki Shimazaki, "The Pricing of Subprime Mortgages by Mortgage Brokers and Lenders," July 2005.

<sup>20</sup> Michael LaCour Little, "The Pricing of Mortgages by Brokers: An Agency Problem?", California State University, Fullerton, 2005.

average, mortgage broker loans are priced approximately 19 basis points higher than comparable retail loans. Lacour-Little notes that this estimate is probably too low because his comparison examined only the differences in note rates and did not include points or fees associated with both groups. The results also revealed, however, that approximately 25 percent of borrowers would receive lower prices from brokers. This suggests that while better rates are usually found directly through retail lenders, some brokers reduce credit costs for borrowers. Some borrowers also prefer mortgage brokers because of the reduction in search costs, increased convenience, and overall ease of transactions.

#### **IV. Information on Yield Spread Premiums and Consumer Shopping**

This section focuses on yield spread premiums, which have recently spread throughout the market as a method for borrowers to trade-off higher interest rates for reduced up-front settlement costs. Studies of yield spread premiums have highlighted numerous pricing and shopping issues in the mortgage process. Therefore, this section examines several topics such as the complexity of the mortgage process, barriers to consumer shopping, dispersion among mortgage prices, price discrimination by lenders, as well as yield spread premiums. In this section, these topics are discussed mainly in the context of the prime mortgage market. Section VI discusses mortgage pricing and other issues with respect to the rapidly growing subprime market.

This section is organized as follows. Subsections IV.A to IV.C define yield spread premiums, provide some basic market facts about them, and summarize concerns about their use in the market.

Subsection IV.D is particularly important because it reviews new studies that address whether yield spread premiums offset the direct origination charges paid by borrowers. Two recent studies by the Urban Institute receive particular attention in this section.

Examples of questions addressed in this section include the following: What are the main barriers hindering effective consumer shopping for home loans? How can consumers be overcharged in a market characterized by over 40,000 brokers and lenders vigorously competing with each other? To what extent do consumers understand yield spread premiums and to what extent are yield spread premiums used to offset consumer settlement costs (versus increasing borrower or lender compensation)?

##### **IV.A. Definition and Role of Yield Spread Premiums**

Upfront cash for a down payment and closing costs is perhaps the main obstacle that families face when considering homeownership. The 1990s saw a host of low-down-payment programs offered by conventional lenders to address the issue of down payments. The industry also came up with a closing-cost-financing option for cash-constrained borrowers, who are at their maximum loan-to-value ratio and are therefore prevented from further increasing their loan amount to finance closing costs. Under this option, commonly known as yield spread premiums, borrowers can finance their closing costs, either fully or partially, by getting a loan with an above market interest rate. Above-market-interest-rate loans are priced at greater than par value (par

value being equal to the loan amount); the excess of this price over par value is defined as the yield spread premium. In the case of a broker selling an above-market-rate loan to a wholesale lender, the broker receives a yield spread premium equal to the difference between the wholesale price of the loan and the loan amount. With a zero-closing-cost loan, the broker uses the yield spread premium as compensation for mortgage closing costs; in this case, the borrower would not pay any closing costs but would have higher monthly payments because of the higher interest rate on the mortgage note. In the same manner, borrowers can also fund a portion of their closing costs (rather than all of them) through loans with above-market interest rates. In fact, the idea behind yield spread premiums is that borrowers would be offered a range of interest-rate, closing-cost combinations and the borrower would choose the one that best suits his or her circumstances.<sup>21</sup>

Of course, yield spread premiums are not confined to broker and wholesale lender transactions (as illustrated in the above example). Portfolio lenders, who do not sell their loans on the secondary market, would pay a yield spread premium on an above-market-rate loan because of the higher return (i.e., the above market rate) they receive over the life of the loan. Mortgage bankers may fund an above-market-rate loan with a line of credit and hold the loan for a period of time prior to selling it on the secondary market. When they sell the loan (assuming that it is still an above-market-rate loan), they would receive a premium (above par) price for the loan, which would be their compensation for originating the loan. There is no reliable information on what proportion of loans made by portfolio lenders or mortgage bankers have a known yield spread premium at closing. For these types of transactions, Chapter 3 below discusses the implications of not being able to measure the yield spread premium at mortgage closing.

#### **IV.B. Concerns About Yield Spread Premiums**

There has been some controversy about how yield spread premiums are being used in the market. While some argue that yield spread premiums are doing their job, providing a vehicle for cash-constrained borrowers to finance their closing costs, others argue that yield spread premium payments from wholesale lenders to brokers do not offset borrower closing costs (on a dollar-for-dollar basis), as they are designed to do. Rather they are seen as providing extra compensation for brokers, with borrowers not receiving the full benefits of the above-market-rate loan.<sup>22</sup> Many feel that unwary or less-sophisticated borrowers are particularly vulnerable to what has been characterized as “rebate abuse”, where a “rebate” is the yield-spread premium collected by mortgage brokers. Guttentag recently provided a good description of the process by which an unwary borrower could be taken advantage of in a brokered transaction. (Of course, as Guttentag

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<sup>21</sup> It should be noted that borrowers who are not at their maximum LTV ratio may also prefer a loan with a yield spread premium. It may be more economical for a borrower who plans to stay at his current residence only a short time to finance closing costs through a high interest rate loan (that would be shortly prepaid when the borrower moved), rather than paying closing costs up-front with cash. Borrowers may also prefer to use their available cash for other uses.

<sup>22</sup> Again, while the issue has been discussed most in the context of broker and wholesale lender transactions, the same points arise in the context of transactions by portfolio lenders (banks and thrifts) as well as mortgage bankers that use a credit line to fund the mortgages that they originate.

recognizes, the result described below could also be obtained in a transaction involving a bank, thrift, or mortgage banker, with some change in the details of the process). Guttentag (October 7, 2002) states:

Rebate abuse is the practice of steering unwary borrowers into high-rate loans on which they should receive a rebate from the lender but don't. A rebate is negative points. Points are an upfront charge to the borrower expressed as a percent of the loan, and a rebate is an upfront credit to the borrower from the lender. When credited to the borrower, rebates are used to cover settlement costs...Most of the attention has been directed toward curbing rebate abuse by brokers. Lenders working through mortgage brokers (called "wholesale lenders") transmit their price information to brokers, not to borrowers. With few exceptions, borrowers are not privy to this information. Borrowers are quoted prices by brokers that include the broker's markup. For example, the lender's quote to the broker is 6 percent plus a rebate of 1 percent, and the broker's quote to the borrower is 6 percent plus a broker fee of .5 percent. The broker's total compensation is 1.5 percent -- 1 percent from the lender rebate and .5 percent from the borrower fee -- but the borrower does not know about the 1 percent rebate unless the broker tells him. By the time borrowers become aware of rebates retained by brokers, they are often too far along in the transaction to back out.

According to Guttentag, rebate abuse (or yield spread premium abuse) has been a "festering sore" in the home loan market. Guttentag has also noted that "most brokers don't want to relinquish their capacity to deceive borrowers" and that "if HUD follows through on its proposal that lenders credit rebates to borrowers, 85 percent of the profit from deception will disappear..."<sup>23</sup>

Because of the proprietary nature of lender files, there has not been much public information to date on yield spread premiums and the extent to which they actually offset borrower closing costs. Prior to recent HUD-sponsored research by the Urban Institute (summarized below), the information that was available was based on industry surveys and studies that have been conducted as part of recent court cases. The empirical findings from these earlier, court-based studies are reasonably consistent with Guttentag's views. Section IV.D summarizes the available information on yield spread premiums and existing evidence about their relationship to mortgage closing costs. Before doing that, a somewhat related topic, overages, is briefly discussed.

**Overages.** While yield spread premiums are legally defined in a way that precludes them from being earned by originators that are not mortgage brokers, loan officers in non-brokers establishments can derive similar benefits by charging "overages." An overage results when a loan officer charges a customer a rate that is higher than the minimum rate that could have been charged; for instance, a commercial bank's mortgage lending department might issue a rate sheet indicating a rate of 6% / zero points for 30-year conventional loan, but a loan officer at the bank might tell a customer the only available rate is 6% / one point. The additional point is an

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<sup>23</sup> As quoted to Broderick Perkins in *Realty Times*, July 17, 2003.

overage. Loan officers typically keep all or part of the overages they generate as a supplement to their salaries and commissions. Overages have been examined by several scholars. Courchane and Nickerson argue a key reason that overages exist is that mortgages are very complex and difficult for consumers to master.

No matter what kind of research buyers do before applying and settling a mortgage loan, it is unlikely that they know all the options available at any one bank, at competitive lending institutions in that area or nationally. Nor will they be likely to fully understand what those options mean. We learned from interviews at banks even loan officers struggle to distinguish between origination points, discount points, and overage points, except insofar as the definition affected the commissions they were paid for loan origination.<sup>24</sup>

Courchane and Nickerson further argue that high search costs (i.e., the cost of search of the best priced mortgage) lead to market power across lenders, which can facilitate overages in general.

Black *et al.* state, “[m]any lending institutions allow and even encourage their loan officers to charge overages.”<sup>25</sup> They believe a key reason for overages is that borrowers do not understand the mortgage process, among other things.<sup>26</sup> They also believe that another common reason for overages is that borrowers may request a long rate-lock period, but receive a short one from a loan officer who believes rates will fall. They find that minorities who purchase homes pay larger overages than whites, but they believe the differences may stem from non-discriminatory reasons such as differential bargaining skills.

#### **IV.C. Some Basic Facts About Yield Spread Premiums**

As noted above Olson has conducted several surveys of the mortgage industry that focus on the business operations of mortgage brokers. In testimony before Congress, Olson (2002) noted that about 2 percent of the loan amount (or \$2,800) was required to compensate brokers for their cost, time, and profit in originating mortgages. In more recent work (summarized earlier), Olson’s firm, Wholesale Access, estimated that 1.71 percent of the loan amount was needed to compensate brokers. According to Olson, most buyers either don’t have that amount of cash or prefer to finance the fee. In addition, Olson estimates that 45 percent of the income of mortgage

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<sup>24</sup> M. Courchane and D. Nickerson, “Discrimination Resulting from Overage Practices”, *Journal of Financial Services Research*, 1997, pp. 133-151.

<sup>25</sup> H. Black, T. Boehm, and R. DeGennaro, “Is There Discrimination in Mortgage Pricing? The Case of Overages”, *Journal of Banking and Finance*, 2003, pp. 139-1165.

<sup>26</sup> For example: “for the borrower, a lack of financial information, a severe liquidity constraint, risk aversion, or the unwillingness to pursue negotiations for a better deal could lead to an overage. Because the borrower may be unaware of how the loan is priced, the most common way that an overage results is if the borrower agrees to a mortgage rate that is above the minimum quoted in the lender’s rate sheet. Since the consumer is generally unaware of the terms listed on the rate sheet, the lender may quote a higher rate or a larger number of points, resulting in an overage.” (page 1142).

brokers comes from yield spread premiums (paid by wholesale lenders to brokers) while 55 percent comes from direct fees paid by borrowers.

Jackson and Berry (2002) also provide some descriptive information based on their analysis of a sample of approximately 3,000 mortgages originated by a group of affiliated lending institutions in the late 1990s.<sup>27</sup> Approximately 85 percent of Jackson's sample had yield spread premiums. For these loans, the total compensation to brokers<sup>28</sup> was similar to the number reported above by Olson -- \$2,548 to \$2,852 or slightly over 2 percent of the loan amount; the average yield spread premium was \$1,850 per transaction.

The market's widespread use of yield spread premiums is also suggested by analysis of FHA data. Table 2.2 reports the distribution of interest rates for 30-year fixed-rate mortgages for the month of May 2001. When these loans were locked in, the average interest rate on a "par" value FHA-insured loan was about 7.25 percent, or even slightly less.<sup>29</sup> As shown in the third column of Table 2.2, 44 percent of FHA-insured loans had an interest rate above 7.25 percent, suggesting that yield spread premiums were common in the FHA market, although not nearly as prevalent as in Jackson's sample of loans. It is interesting that 36 percent (fourth column) of FHA-insured loans had an interest rate equal to or greater than 7.5 percent; and 9 percent had an interest rate equal to or greater than 8.0 percent. In general, a 7.5 percent mortgage in a 7.25 percent environment is priced about one point over par (\$1,000 on a \$100,000 loan) and an 8.0 percent mortgage is priced about 2.5 points over par (\$2,500 on a \$100,000 loan). Thus, there were significant YSPs in the FHA market.<sup>30</sup>

The other indication that yield spread premiums are being used in the market is based on data for conventional home purchase loans from the Federal Housing Finance Board (FHFB). The FHFB data show that the average initial fees and charges on mortgages have fallen from 1.87 in 1990 (when yield spread premiums were first being used in the market) to less than one since 1998 (e.g., 0.75 in 2000). This trend suggests that yield spread premiums have increasingly been used to finance borrower closing costs.

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<sup>27</sup> Jackson used this analysis as an expert for the plaintiff class in *Glover v. Standard Federal Bank*, Civil No. 97-2068 (DWF/SRN) (U.S. District Court of Minnesota) (pending). Jackson also draws on the larger paper he did with Jeremy Berry; see Jackson and Berry (2002), "Kickbacks or Compensation: The Case of Yield Spread Premiums."

<sup>28</sup> Defined as yield spread premium plus loan origination fees plus other compensation minus offsets for settlement costs paid by the mortgage broker. See page 87 of Jackson and Berry (2002).

<sup>29</sup> From March 1 through April 13, FHA rates averaged slightly over 7.0 percent. They jumped to 7.13 percent on April 13 and were 7.37 for the last week in April.

<sup>30</sup> The same patterns were observed the two other months (April and June) that were analyzed.

## **IV.D. Studies of Yield Spread Premiums and Shopping for Mortgages**

### **IV.D.1. Introduction**

There is no academic literature examining the extent to which the presence of a yield spread premiums results in an offsetting reduction in direct payments of closing costs by the borrower. However, findings of two empirical studies that were conducted as part of a recent court case<sup>31</sup> have been reported in Congressional Testimony by the authors (Jackson, 2002a; Woodward 2002) – and this work has been followed-up by more detailed papers co-authored by Jackson (Jackson and Berry, 2001) and Woodward (2003). In addition, Benson (2001) also conducted an empirical analysis of yield spread premiums as part the court case that Woodward and Jackson were involved in. The next two subsections (D.2 and D.3) examine these studies in some detail, particularly the papers by Jackson and Berry (2002) and Woodward (2003), which are useful because they provide their insights about problems consumers face when shopping for a mortgage and the possible reasons that consumers are overcharged in the mortgage market. Other analyses of consumer shopping and market dynamics are incorporated in this discussion by Guttentag, staff from the Federal Trade Commission, in subsection D.3.a and Olson in subsection D.4. Subsection D.5 provides useful comments from FTC staff on issues such as price dispersion, price discrimination, and consumer shopping. A 2003 study by the CFI, discussed in subsection D.6, provides evidence that the complexity of the mortgage lending process should be reduced and consumers should be provided with more choices and information. In subsection D.7, a 2003 Bankrate.com survey is discussed that provides additional support reinforcing the confusing nature of fees and closing costs experienced by consumers when shopping for competitive rates and lower costs. A recent study by the FTC, in subsection D.8, investigates consumers’ understanding of loan disclosures and borrowing terms and tests whether improved disclosure forms increase borrowers’ understanding of mortgage costs and their ability to compare lenders. Subsection D.9 argues that the citation of Mark Shroder’s study of good faith estimates by the National Association of Realtors as evidence that the “bait and switch” is not widespread is hampered by selection bias and thus limits its usefulness in testing this technique.

### **IV.D.2. Jackson and Berry Analysis: Yield Spread Premiums, Broker Compensation, and Consumer Shopping Strategies**

As noted above, Jackson served as an expert witness in a recent court case involving yield spread premiums. His work consisted mainly of an empirical analysis of approximately 3,000 mortgages originated by one group of affiliated institutions in the late 1990s. According to Jackson, his analysis represents the most extensive empirical investigation of yield spread premiums to date. Jackson reported his findings publicly in a recent Congressional Hearing and in a paper co-authored with Jeremy Berry; see:

Howell E. Jackson, “Prepared Statement of Howell E. Jackson” in *Predatory Mortgage Lending Practices: Abusive Uses of Yield Spread Premiums*, Hearing

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<sup>31</sup> See above reference to *Glover v. Standard Federal Bank*.

Before the Committee on Banking, Housing, and Urban Affairs, United States Senate, 107<sup>th</sup> Congress, U.S. Government Printing Office: Washington, D.C., January 8, 2002, pp. 54-59. Reference is Jackson (2002a).

Howell E. Jackson and Jeremy Berry, "Kickbacks or Compensation: The Case of Yield Spread Premiums," unpublished manuscript, 2001. This paper was submitted as part of the public record and is partially reprinted in Hearing Before the Committee on Banking, Housing, and Urban Affairs, United States Senate, 107<sup>th</sup> Congress, U.S. Government Printing Office: Washington, D.C., January 8, 2002, pp. 155-171.

This subsection will focus on the longer 151-page paper by Jackson and Berry. After briefly presenting their findings, the discussion will summarize their main insights about the mortgage shopping process and the interaction between consumers and brokers. Their discussion of the mortgage shopping process will be compared with the insights on mortgage shopping expressed by Woodward, Guttentag, Olson, staff at the Federal Trade Commission, and others.

Jackson and Berry state their analysis shows that mortgage brokers receive substantially more compensation in transactions involving yield premiums than they receive in transactions without yield spread premiums.

Depending on the method of comparison, the estimated difference in costs to borrowers ranges from \$800 to over \$3000 per transaction, and our best guess of the cost impact is approximately \$1,046.... These findings strongly suggest that yield spread premiums are not a good deal for borrowers, but serve primarily to increase compensation to mortgage brokers. (page 8)

Based on their regression analysis, Jackson and Berry further conclude that consumers get only twenty-five cents of value for every dollar of yield spread premiums -- seventy-five percent of yield spread premiums serve only to increase payments to mortgage brokers.<sup>32</sup>

Jackson and Berry next offer some interesting findings that provide evidence that the payment of yield spread premiums allows mortgage brokers to engage in price discrimination among borrowers. First, they find that in situations where there is no yield spread premium involved (e.g., a par value loan where the consumer pays all closing costs), there appears to be a pretty clear market price for brokers.

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<sup>32</sup> Professor George Benson, another expert witness for the defendant, reported that average homeowners' settlement outlays decrease by 59-65 cents for each dollar increase in YSP, suggesting 35-41 cents in extra compensation (Benson, 2001). Jackson and Berry (2001) say these results from Benson are based on the 100-loan Heartland sample, which they considered unrepresentative. They report some later estimates from Benson based on the larger and more representative Defendants' Sample. (See pages 139-143 of Jackson and Berry (2001) for a critique and discussion of Benson's August 8<sup>th</sup> results.) Benson (2001) covers his July 9<sup>th</sup> results, which are also discussed by Jackson and Berry. These results (labeled Benson's August 8<sup>th</sup> results in Jackson and Berry, 2001) are somewhat similar to his initial results; for example, as shown by Jackson and Berry's Figure 27, Benson's models 2a-2c suggest 34 cents in extra compensation due to YSPs. Thus, Benson concluded that YSPs offset borrower closing costs to a much greater extent than the expert for the plaintiff (Jackson).

In transactions where yield spread premiums are not at issue, the vast majority pay mortgage brokers total compensation of not more than 1.5 percent of loan value, and the largest group (on the order of 40 to 45 percent) pay mortgage brokers compensation in the range of 1.0 to 1.5 percent of loan value.

But according to Jackson and Berry, the problem occurs when yield spread premiums are present, because in these situations there is no single price for broker services:

Most borrowers pay more than 1.5 percent of loan value; more than a third pay more than 2.0 percent of loan value; roughly ten percent pay more than 3.5 percent of loan value.

Jackson and Berry find this “price dispersion” troubling, as it suggests that brokers use yield spread premiums as a device “to extract unnecessary and excessive payments from unsuspecting borrowers” (page 9).

Jackson and Berry also claim that the compensation practices of brokers disadvantage “less well-educated and less financially sophisticated borrowers”. Their results indicated that mortgage brokers charge African-Americans (by \$474) and Hispanics (by \$580) substantially more for settlement services than other borrowers.

To summarize, the above findings of Jackson and Berry present a picture of a market characterized by excessive fees, price dispersion, and price discrimination -- with some borrowers getting market-rate deals while others (less-sophisticated borrowers) getting bad deals. As discussed below, others have reached similar conclusions.

Next, Jackson and Berry note several features about the real estate process that make the above market results possible. Consumers are in general unsophisticated about the real estate and mortgage settlement process. The complex, multi-faceted nature of real estate settlement transactions further complicates the operation of market forces. The real estate transaction itself (i.e., the home purchase) represents a huge sum of money and will appear more significant to the consumer than any one of the many settlement services. Jackson and Berry state there is ample evidence in the economics literature that consumers, when faced with complex, multi-faceted transactions, will tend to limit their attention to the major expense (the home purchase), so it is not surprising that consumers don’t carefully monitor the prices of settlement services. Finally, they note that the “mysterious” nature of the process allows market professionals (such as brokers) to discriminate in the price they charge different types of consumers (sophisticated versus unsophisticated). According to Jackson and Berry, this ability to price discriminate is where the market breaks down, preventing ordinary competitive pressures to benefit all consumers, particularly those who are less informed.

Jackson and Berry go a step further and relate the above themes to the actual case of yield spread premiums. Individual consumers rely on brokers for an array of settlement services and for the selection of a funding lender (i.e., a wholesale lender). According to Jackson and Berry, wholesale lenders offer products with YSPs to compensate brokers and attract their business. Many borrowers may not understand the financial complexities of YSPs, and in these cases,

YSPs offer mortgage brokers an opportunity to enhance their own compensation -- by receiving direct fees from the consumer as well as being compensated by the lender through a YSP.

Perhaps the most important factor in the above process concerns the consumers' ability to monitor and understand the YSP. Jackson and Berry (as well as many others) question whether consumers have much understanding of what YSPs are, and that the costs of YSPs are financed by the consumer through higher monthly interest payments. Even with a basic understanding, evaluating the various trade-offs (distinguishing the present value differences between a "par-value" loan with a lower interest rate and an "above-par" loan with a higher interest rate) can be a daunting task for even the most informed consumer. Brokers typically have much discretion on the particular product (from a wide range of products available to the broker) that they could offer to any particular consumer. An individual consumer, even a relatively informed one, may not be shown the full range of available products. Furthermore, given the fact that the consumer may be more interested in the main transaction (the home purchase), or given the normal time pressures in settlements, consumers may not inquire too strenuously about broker compensation. According to Jackson and Berry, these are the situations where brokers can price discriminate -- crediting informed borrowers for all or a portion of any YSP while not crediting less informed borrowers (and thereby retaining the YSP as compensation). They note that this price discrimination takes place in the context of a market where wholesale lender prices are set competitively in the secondary market. The market breakdown occurs in the relationship between the consumer and the broker. The broker can steer consumers into financial arrangements that increase their overall costs.

As explained in Chapter 3, an addition to the new Good Faith Estimate requires that lenders show lower-interest-rate and higher-interest-rate options to the selected loan indicated on the GFE. The intention is to reinforce to consumers the fact that lenders provide consumers with a variety of interest rate and closing cost options so that the consumer can choose the option that best suits his or her circumstances. This is designed to prevent the situation described above where brokers (and lenders) do not always clearly explain that YSPs represent one of several options, that the shopper can voluntarily choose and instead may steer shoppers to above-rate mortgages with YSPs. Jackson (2002a) states that, in his experience, YSPs are not described as an optional way to finance closing costs and that consumers are not given enough advice to compare the higher monthly payments over the life of above market-rate loan with the savings in closing costs due to the YSP.

#### **IV.D.3. Woodward Analysis: Yield Spread Premiums, Broker Compensation, and Consumer Shopping Strategies**

Susan Woodward's recent study echoed many of the same themes of the study by Jackson and Berry.<sup>33</sup> Woodward used the same mortgage data as these authors, a sample of 2700 loans, funded through one national lender but written by thousands of mortgage brokers.<sup>34</sup> Woodward

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<sup>33</sup> Susan E. Woodward, "Consumer Confusion in the Mortgage Market," Sand Hill Econometrics, July 7, 2003.

<sup>34</sup> As Woodward notes, this sample is not a representative sample, but a sample of loans drawn during a court case. Woodward says her analysis covered approximately 2,700 loans from three data sets. (1) 108 loans funded by a single lender and originated through a single mortgage brokerage over the period 1996-2001. (2) A total of roughly 600 brokered loans comprised of 200 each that were above par, at par, and below par. These loans were selected by

defined total fees to brokers as cash from the borrower plus the cash paid in the form of a yield spread premium to the broker by the lender, minus credits from the broker to the borrower. The average broker fee was \$2,425. In her analysis of broker fees, Woodward controlled for characteristics of the loan (e.g., FRM versus ARM, loan amount, LTV ratio), borrower (e.g., credit score, race), census tract where the property was located (e.g., median house value, median income, education of population), and mortgage market environment (e.g., refinancing activity, level of interest rates). According to Woodward, her data confirmed that shopping for a mortgage was not easy, particularly for borrowers attempting more difficult shopping strategies. Woodward defines a "more difficult shopping strategy" as one that involves a tradeoff of interest rates and points. This contrasts with an "easier shopping strategy" that involves rolling either the broker's fee or all settlement costs into the interest rate (the latter being a "no-cost" loan). Borrowers choosing "no-cost" loans can shop on the basis of interest rate alone, which is less complicated than shopping based on both interest rates and points.

**Woodward's Main Findings.** According to Woodward, borrowers choosing the more difficult strategy pay higher broker fees on average than borrowers who roll closing costs into the interest rate and thus can shop on the basis of rate alone. Borrowers who roll at least the broker's fee (plus possibly some or all other closing costs) into the interest rate pay broker fees that are \$900 lower on average than other borrowers. Borrowers who roll all closing costs into the interest rate pay fees that are \$1,500 lower than those paid by other borrowers. In addition, borrower confusion is strongly related to the level of interest rates. According to Woodward, the higher interest rates are, the more borrowers try to pay points to reduce their rate, and the more mistakes they make, to the broker's benefit. This costs them about \$440 for each percentage point rise in the level of interest rates. Borrowers benefit from education. Those with a bachelor's degree on average pay \$1,500 less in broker fees than borrowers with only a high school education. The race of the borrower matters – on average, African-Americans pay their brokers an additional \$500 and Hispanic borrowers, \$275, compared to other borrowers, after accounting for education and other characteristics.

**Insights from Woodward's Study.** While the above paragraph captures her main findings, Woodward's study includes numerous insights on the shopping behavior of consumers and the business strategy of brokers. For the most part, her insights are consistent with the price discrimination argument also put forward by Jackson and Berry, including the notion that brokers take advantage of less sophisticated borrowers, particularly on loans that require complicated net present value calculations (that is, loans that involve tradeoffs between interest rates and points). In her paper, Woodward commented on several topics related to this RESPA rule. Because she is one of the few authors who have actually conducted empirical analysis, it is useful to describe her study in more detail and to note some of her views and comments concerning consumers and brokers and how mortgage shopping takes place. The points made below are taken from her study.

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a judge, again from the 1996-2001 period. (3) A set of roughly 2,000 brokered loans originated on another set of dates selected by a judge; there was not an effort to over-sample par or discount loans in this sample of 2,000. According to Woodward, the combined set (1)-(3) over-samples par and discount loans. While Woodward notes that the sample is not a representative national sample, she concludes that "the data appear to be satisfactory for the questions addressed here. No aspect of the sample design depended on the key variables of my analysis." (page 25)

**(1) Importance of Broker Fee.** Broker fees are negotiated one-on-one between borrower and broker. The broker is not the borrower's agent, but a salesperson. It is safe to say that the brokers know a great deal more about this transaction than the borrowers do. How the borrowers cope with this information disadvantage as well as the resources they bring to the task manifest themselves in the fees they pay to their mortgage brokers. The charges to the borrower for a home mortgage origination are substantial. In the set of roughly 2,700 loans studied here, originated between 1996-2001, (covering two refinancing booms) average total closing costs are \$4,050 on an average loan amount of \$130,000.<sup>35</sup> The broker's fee is usually the single largest item among the closing costs, as it averaged \$2,425 in Woodward's sample.

**(2) Complexity of Shopping For a Mortgage.** Taking out a mortgage loan is not only the largest, but also the most complex transaction most consumers ever undertake -- involving many options (FRM versus ARM, 15-year versus 30-year, and so on). In addition, the choice regarding how to pay for closing affects the borrower's interest rate, which in turn influences her inclination to prepay for any given move in interest rates. At one extreme, the borrower can seek a "no cost" loan, on which the lender will absorb all of the closing costs through a higher interest rate. At the other extreme, borrowers can also pay the closing costs in cash. Borrowers also have the inferior options of providing some cash themselves and having the lender provide some. But borrowers have yet another alternative, which is to pay cash not only for the closing costs, but to bring additional cash to the closing in exchange for an interest rate even lower than the rate offered if the borrower just paid the closing costs in cash. This is often described as "paying points" on a loan. If the borrower expects to move in a few years, the higher interest rate (on a no-cost loan) may have a lower expected present value cost for her than if she expects to stay in the house and keep the loan for a longer period. A borrower's lowest cost way to pay for closing costs, and best overall mortgage deal, will depend on how long she expects to have her loan, or stay in the house. The different shopping strategies identified by Woodward are discussed in (5) below.

**(3) Rate Sheets.** Mortgage brokers typically do business with a dozen or so wholesale lenders. The wholesale terms on the various alternatives offered are communicated to mortgage brokers on "rate sheets" that lenders send at least daily to mortgage brokers.<sup>36</sup> A cell in a "rate sheet" indicates the amount the lender will pay for a loan of a specified interest rate and lock period -- for example, the lender will pay \$100,500 for a \$100,000 mortgage with a 7.00% interest rate and a 30-day lock period. In this example, the lender will provide \$500 in cash at

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<sup>35</sup> Closing costs include the services of the broker or loan officer, title insurance, appraisals, fees to the settlement agent, fees to local authorities (county, city) for recording the transaction and mortgage, services of a lawyer in some States, various inspection fees (flood, pests, earthquake), and sometimes fees to the lender as well. These fees are all in addition to any sales commissions paid to realtors involved in a house purchase transaction, and do not include additional cash the borrower may need at the closing for items such as hazard insurance, mortgage insurance, property taxes, and accrued interest, which are not appropriately classified as costs of closing.

<sup>36</sup> Lenders who provide such rate sheets are making what are called "table funded" loans in mortgage banking. This means that the loan is funded by the lender at the closing table, and the broker never owns the loan. This arrangement is in contrast to that of "correspondent brokers" who have capital and substantial lines of credit and can fund loans temporarily themselves, and do in fact temporarily own the borrower's loan, though these loans are usually shortly sold into the secondary market.

closing which can be used to cover closing costs, including the broker's fee, or returned in cash to the borrower. This \$500 is called the yield spread premium.

**(4) Points.** According to Woodward, the term *points* is a source of confusion in mortgage lending. Generally speaking, a point is one percent of the loan amount. In reference to the wholesale lender's rate sheets for a brokered loan, it is money paid by (or received by) the borrower to (from) the wholesale lender (through the broker) in exchange for a lower (higher) interest rate. Woodward provides a useful discussion of the many types of points and the sources of confusion on this subject. For example, the "points" that a broker shows a consumer will not likely be those on the wholesale lender's "rate sheet" -- they will be "points" from the broker's pricing sheet, which will typically be a marked up version of the wholesale lender's "rate sheet". Typically, the consumer is not shown the wholesale lender's rate sheet.

**(5) Consumer Shopping Strategies Ranked By Difficulty.** Much of Woodward's paper involved her insights about different mortgage shopping strategies of consumers. Woodward ranks by increasing difficulty the borrower's strategy for paying for closing costs as follows: (a) incorporate all closing costs into the rate and search for a loan with the lowest rate; (b) incorporate the broker's fee into the rate, pay other closing costs with cash, and shop on rate; (c) pay all closing costs, including the broker's fee, in cash, and shop on both broker fee and rate; (d) pay some closing costs with cash, and some with a payment from the lender for a premium interest rate (i.e., yield spread premium); and (e) pay all closing costs in cash and pay discount points to reduce the interest rate. According to Woodward, (d) and (e) are the two most difficult, both of which require skill in evaluating the rate/point tradeoff.

Woodward also emphasizes, that in the negotiations between mortgage broker and borrower over the broker's compensation, the broker has many more advantages than the borrower. The broker has the rate sheets, plus certified financial information about the borrower, but also, the broker has far more practice and skill with the transaction. The broker can use these advantages both to charge consumers direct fees and also to place consumers in high interest rate loans, thus collecting lucrative yield spread premiums from wholesale lenders. Woodward also points out that with respect to (e) above, consumers may also fail in their objective of buying down interest rates through payment of discount points (or negative yield spread premiums).

**(5a) No-Cost Loan.** For the borrower, the simplest transaction to understand is the no points, or no-cost loan. The borrower seeking a no-cost loan can simply shop for the best interest rate (similar to how they shop for a car loan). According to Woodward, this strategy of rolling all costs into the rate and shopping for the best rate is a desirable strategy for borrowers who do not expect to have their loans for more than seven to ten years.<sup>37</sup> If a borrower has chosen, because she is refinancing or because she expects to move or refinance within a seven to ten year horizon, to shop on the basis of rate, her shopping difficulty is greatly reduced compared to the borrower

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<sup>37</sup> Most mortgage loans are prepaid well before they mature, so lenders set their rates to recoup their up-front costs sooner than the loan's full term. Rate sheets typically offer terms that imply an expected loan life of roughly seven years. As a result, the borrower who actually pays off her 30-year loan over 30 years ends up paying for the closing costs several times over if she rolled closing costs into the rate.

who is trying to evaluate rate/point tradeoffs.<sup>38</sup> In addition, the borrower's comparative informational disadvantage to the broker is reduced because the broker is not in a position to offer the borrower rate/point choices that lure her towards the mortgage choice with a lower present value for her, but higher value to the broker.

Woodward's regression analysis relates the fee negotiated between the borrower and broker to a "borrower's confusion" variable, defined as the ratio of YSP to the broker fee. Thus, the "no-cost" strategy was identified by loans with the YSP/broker fee ratio greater than one. For loans with a ratio greater than one, the YSP is sufficient to cover the broker's fee plus at least some other closing costs as well.

**(5b) Finance Broker Charges.** The next simplest shopping strategy for the borrower is to pay non-broker closing costs in cash, and shop on the basis of rate. This would roll the broker's fee, but not other closing costs, into the rate. For loans in this category, the broker's fee is exactly equal to the YSP, and the "borrower confusion" variable (the ratio of YSP to broker fee) in the regression analysis equaled one for these cases. Woodward showed there was a concentration of loans with the YSP exactly equal to broker's fees.

**(5c) Pay Closing Costs in Cash.** A more difficult shopping strategy is to pay all closing costs, including the broker's fee, in cash, but pay no additional points, and shop on rate. Here the borrower would have to have a correct idea of what the broker's reservation fee might be, and there is the additional complication over strategies #1 (all rolled into the rate), and #2 (broker's fee, but not third-party closing costs, rolled into the rate). Here the borrower is at a clear disadvantage to the broker in that the broker's information on broker reservation prices is surely better than hers.

In the regression analysis, the loans that are included in this strategy would all be "par" loans, and have a ratio of YSP to broker fee of zero, because the YSP on par loans is zero.

**(5d) Loans with Trade-Offs: YSPs.** This strategy involves paying for closing costs partly with cash and partly with a YSP. For the borrowers intending to pay some closing costs in cash and some with a YSP, the ratio of the YSP to the broker's fee will be between zero and one. According to Woodward, for loans with a ratio of YSP/broker fee between zero and one, there will be three types of loans – borrowers who intended to pay some closing costs with cash and some with a YSP, and did well; some who aimed for this choice and did poorly; and some who were trying to buy down their interest rate (through discount points, as explained below) but did not shop well on the basis of interest rate and thus paid both a high direct broker fee and a high interest rate, inducing the wholesale lender to pay the broker a YSP.

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<sup>38</sup> Woodward notes that opting for the simplest shopping strategy is not necessarily the best long-run cost minimizing strategy for the borrower. Because most loans are prepaid well before maturity, sometimes because interest rates fall and borrowers refinance, and sometimes because borrowers move, lenders build their rate sheets to recoup any up front costs (yield spread premium) in roughly seven years. The farther is the borrower's coupon rate above par, the faster the implied terms in the rate sheet recoup the lender's upfront costs. This is true in both directions – the cells at a discount on the rate sheet reflect expectations of later prepayment the farther is the interest rate below par. Woodward points out that here lies the one informational advantage possessed by the borrower: how long will the borrower have the loan?

In the regression analysis, the loans included in this strategy would be those with YSP/broker fee ratio between zero and one.

**(5e) Loans With Trade-Offs: Discount Points.** According to Woodward, the hardest shopping task is to pay all settlement costs in cash and in addition to pay discount points to reduce the interest rate on the loan. Here the broker has the advantage of seeing all the rate sheets, plus experience and presumably, some skill. The borrower who expects to hold a loan to maturity can, in principle, get a lower present value cost for her total mortgage transaction by paying cash for her closing costs and paying some points. This however, requires that the borrowers search for both a reasonable broker fee and a good rate, and be able to make the rate/point tradeoff.<sup>39</sup>

In the regression analysis, the loans included in this strategy would be those with a rate buy-down amount, or discount points, reported (a “negative YSP” so that the YSP/broker fee ratio is less than zero). These loans were grouped with the par loans (described in (5c) above) in the regression because brokers are receiving compensation from fees paid by borrowers and not in the form of a YSP for these loans. Willingness to pay discount points to reduce monthly payments suggests these borrowers have knowledge of the point/rate tradeoff so that while this shopping strategy is difficult, it may also be indicative of a higher level of shopping sophistication and ability to get a better deal.

**(6) Brokers Know the Rate/Point Trade-Off.** Woodward expects that mortgage brokers will be much better at gauging the rate/point trade off on mortgages than consumers are. Brokers have more experience and they have the wholesale lenders’ prices in the form of rate sheets, which are not shown to consumers. The straightforward capture of present value in the rate sheets assures that brokers get the trade-off right, according to Woodward. On the other hand, the borrowers who pay part of their closing costs in cash and pay for the rest with a yield spread premium -- as well as borrowers who pay discount points -- have more a complicated shopping task, because they must have an idea of appropriate compensation for the broker and other settlement providers (like those borrowers who pay all closing costs in cash), but they also must be able to compare rates and points. If they could examine the wholesale lender's rate sheets, which are available to the broker, their task would be easier, but still not easy.

**(7) Factors in the Regression Analysis.** Woodward classified the determinants of broker compensation into three broad categories:

- A. True cost factors, which are measures of the time and trouble to the broker for a loan involving more paper shuffling, documentation, and effort on the part of the broker that cause the loan to be more expensive;<sup>40</sup>

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<sup>39</sup> According to Woodward, it is difficult for the borrower to know which points are paid for origination and which actually go to buy down the interest rate, because the HUD-1, even on a table-funded loan, seldom discloses the precise payment to the lender for points.

<sup>40</sup> Examples of variables used by Woodward to measure time and trouble included the borrower’s credit score, an indicator for A-minus credit, the loan-to-value (LTV) ratio, whether the loan is a refinancing or a purchase transaction, the calendar time the broker has to close the loan, the day of the month on which the loan is closed, and the general level of earnings in the area.

- B. Factors that reflect the potential for price discrimination. In the one-on-one negotiation, brokers know more about the level of wholesale interest rates and points than borrowers do, and they have other information (e.g., credit score) about the borrower that could assist them in negotiations. For example, Woodward uses the median income of the census tract as a proxy for the borrower's income, under the notion that the higher the borrower's opportunity cost of time relative to money, the more likely the borrower will accept an inferior-to-market deal.
- C. Borrower confusion factors, which consisted mainly of the varying complexity of the borrower shopping strategies (see 5a-5b above) and education level of the borrower's census tract, as a proxy for the borrower's education level.

**(8) Results for Relative Difficulty of Borrower Shopping Strategy.** For purposes of this economic analysis, the most useful of Woodward's results dealt with the relative costs associated with different shopping strategies.<sup>41</sup> Table 2.4 lists the coefficients on the ratio of YSP to Broker Fee in Woodward's regression explaining broker compensation.<sup>42</sup>

**Table 2.4 Coefficient of Ratio of YSP to Broker Fee**

Shopping Strategy Category Number	Definition	Coefficient
(1)	0.0 Ratio (the par loans and loans where borrowers paid discount points)	-\$617
(2)	0.5 Ratio (maximal rate/point confusion -- most difficult shopping)	+\$68
(3)	1.0 Ratio (where the broker's fee is paid entirely by the lender in the form of a YSP)	-\$847
(4)	1.5 Ratio (where at least some closing costs are rolled into the rate)	-\$1,038
(5)	2.5 Ratio (where nearly all closing costs are rolled into the rate -- easiest shopping)	-\$2,731
(6)	4.0 Ratio (where even more closing costs are rolled into the rate -- also easiest shopping)	-\$2,071

Source: Woodward (2003a)

Woodward interprets her results as confirming the relative difficulty of different shopping strategies. The above coefficient values at 1.0, 1.5, and 2.5 show that that broker fees fall as borrowers roll more and more of their closing costs into the rate and the ratio of YSP to

<sup>41</sup> As shown in Woodward's Table I, the R-squared of her regression was 0.390.

<sup>42</sup> Because the actual ratio can be affected by the difference in interest rates on the date the borrower's rate was locked and the day the loan was sold, few loans in the database have exactly the YSP to Broker Fee ratios shown. Loans are classified according to which ratio they are closest to.

broker fee rises. According to Woodward, the loans on which borrowers are struggling hardest to evaluate the rate/point tradeoff (at ratio = 0.5) have the highest fees, on average, with a differential of more than \$900 compared to no cost (and more) loans and of nearly \$700 compared to par and discount point loans.<sup>43</sup> Borrowers pay the broker more when they are pursuing strategies where the broker's informational advantage is greater -- the highest broker fees are those on which both the borrower and the wholesale lender (by paying a yield spread premium) bring substantial cash to closing.

**(9) Education.** While brokers have negotiating advantages over the average borrower, Woodward's regression results indicate that education is one advantage for the borrower. According to Woodward, the difference between living in a census tract in which all adults have a bachelor's degree versus one in which no adult has a bachelor's degree is savings of \$1,472 in mortgage broker's fees.<sup>44</sup> Woodward explains that the value of education in negotiating the broker's fee is higher for the difficult strategies than in the overall estimates, and lower for the easier strategy of rolling costs into the rate.

**(10) Other Statistical Findings.** According to Woodward, race does matter, even after controlling for all the other factors including education. African-Americans pay an additional \$500 in broker fees, and Hispanic borrowers \$275 more. In addition, A-minus credit borrowers pay higher broker fees (an additional \$1500, although there were only 14 in Woodward's sample). Broker fees are positively and strongly related to neighborhood family income, suggesting that brokers charge more to borrowers with a high time value of money.<sup>45</sup> Broker's fees exhibit a negative relationship with credit scores (meaning lower fees are associated with higher credit scores), a small positive relationship with LTV ratio, and strong positive relationships the loan amount and the market rate of interest. With respect to the latter, broker fees rise by \$440 for each percentage point rise in market interest rates.<sup>46</sup>

**(11) Suggestive Findings Related to Third-party Costs.** When commenting on the shopping strategy where the borrower finances all broker fees with a YSP but pays the third-party fees in cash (see 5b above), Woodward reported some interesting empirical findings. In Woodward's sample, the higher the fraction of settlement charges rolled into the interest rate, the

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<sup>43</sup> More specifically, the coefficients are interpreted as follows (using the 0.5 group as a reference): the loans on which borrowers are struggling hardest to evaluate the rate/point tradeoff (at ratio = 0.5) have the highest fees, on average, with a differential of \$915 more than loans with a broker's fee that equals the YSP (the 1.0 group) and with a differential of \$685 more than par loans (the 0.0 group).

<sup>44</sup> Woodward says the measured impact of education would probably have been larger if data had been available on the borrower's education level (versus the census tract measure, which was used as a proxy for borrower education). However, it should be noted that there are probably not any census tracts that have 100% college education or 0% college educated adults. In addition, the income effect works in the opposite direction, so lower educated consumers with lower incomes may not actually experience a \$1,500 penalty.

<sup>45</sup> Woodward calculates that moving from a census tract with income of \$40,000, the 10<sup>th</sup> percentile in her data, to a census tract of \$100,000, the 90<sup>th</sup> percentile, adds an additional \$550 to the cost of a loan. And as Woodward emphasizes, her measure is for the census tract, not the individual borrower, which means that it is measured with error and biased downward. The true value is likely higher.

<sup>46</sup> See pages 31-32 for Woodward's interpretation of this coefficient estimate.

lower are the total closing costs on the loans, not just the broker's fee. In addition, there is a set of 50 loans in Woodward's sample with no itemized settlement charges at all, but only disclosure of a YSP. These loans had even lower total closing costs than the loans with itemized charges paid for through a YSP.

**(12) Comments on Wholesale Lenders.** Although not the focus of her analysis, Woodward references to the wholesale lending market were consistent with statements by LaMalfa (2002) and the Joint Center for Housing Studies (2002). When explaining the results of a regression analysis of interest (coupon) rates, Woodward says:

The wholesale lending market is highly competitive and well-informed on both sides. The lenders have numerous metrics of the market, and the brokers have many rate sheets from competing lenders. Thus, we should infer that pure cost forces give rise to highly systematic differentials in coupon rates, and that they are not the result of price discrimination or confusion. (p. 38)

Also, Woodward notes, that "the competing wholesale lenders are surely setting rate sheets so as to leave themselves indifferent as to which rate/point cells the broker and/or borrower select. It would not be profit maximizing for the wholesale lender to do otherwise." (p. 39 – also see below)

**(13) Woodward's Comments on Findings.** In her conclusions, Woodward offers the following comment on her main finding:

...the discovery of just how ill-prepared some borrowers are to deal with the mortgage market and how much it costs them is disheartening. That less well-educated borrowers do less well may be not too surprising, but the size of the disadvantage, nearly \$1500 per loan, on average, is shocking. (p. 39)

In commenting on how this situation came about, Woodward notes that the technology of rate sheets provides opportunities for brokers to exploit consumers:

In the brokered mortgage world, the rate sheet allows the broker to capture all of the profits on a loan that he can, because in posting prices to the brokers, the competing wholesale lenders are surely setting rate sheets so as to leave themselves indifferent as to which rate/point cells the broker and/or borrower select. It would not be profit maximizing for the wholesale lender to do otherwise. We can infer that in the old retail branch office world, banks left a lot of money on the table due to the poorer technology and the inherent rigidities of a bureaucracy. The mortgage broker leaves less. (p. 39)

Finally, Woodward notes while some borrowers (particularly those who are savvy about mortgages and have a high value of time) are not exploited by brokers, other borrowers are.<sup>47</sup>

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<sup>47</sup>While Woodward and Jackson and Berry examine costs at the front-end of the mortgage transaction, Susin (2003) recently examined variations in mortgage interest rates. Susin used 2001 American Housing Survey data to determine racial and ethnic differences in mortgage rates. He found that non-Hispanic Blacks pay interest rates 24

#### **IV.D.3.a. Olson's Comments on Shopping**

The themes outlined above by Jackson and Berry and Woodward of poor consumer shopping in a complex market and price discrimination by brokers and lenders are consistent with comments by other observers of the mortgage process, such as Guttentag and staff from the Federal Trade Commission (FTC). Before reviewing the work by Guttentag and FTC staff, this subsection reviews work by David Olson, who provides a contrasting perspective on consumer shopping. Also reviewed are a study by the CFI Group on consumer satisfaction with the mortgage lending process, a survey of mortgage fees that sheds light on the difficulty experienced by consumers attempting to shop for competitive mortgage rates, and the FTC's recent study of mortgage disclosure.

In his statement before the Senate Committee on Banking, Housing, and Urban Affairs, David Olson stated that his analysis of 4,000 broker firms leads him to conclude there is little abuse in that industry, and that brokers have simply priced everyone else out of business.<sup>48</sup> Consumers have flocked to brokers because they guide consumers through the complex, paper-intensive process. Olson says consumers only need two numbers -- interest rate and fees -- and that it is easy to get a quote from one or more of the 33,000 brokers and 8,000 lenders operating in today's mortgage market. His experience is that consumers get multiple quotes (as he says they should) and "make it difficult for brokers" (p.24). According to Olson, market information is widespread and prices are readily available from the internet, television, or newspapers for thousands of competing firms. Mortgages have become a commodity with very little variation in prices among lenders.

#### **IV.D.4. Guttentag's Comments on Shopping**

Jack Guttentag has commented extensively on mortgage issues for years. His recent comments on the shopping process appeared in a short paper on the mortgage settlement process that he submitted to the Senate Committee on Banking, Housing, and Urban Affairs.<sup>49</sup> Guttentag's conclusions about the mortgage process are similar to those of Jackson and Berry. Guttentag states the core problem is that effective shopping for a mortgage is extraordinarily difficult for even sophisticated borrowers. In this "inherently complex" market, few borrowers want to take the time to educate themselves on its complexities. In an analysis of 774 brokered

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basis points higher than non-Hispanic Whites, controlling for differing characteristics of the household, home, mortgage, and neighborhood, but not controlling for credit scores or non-mortgage debt. Using the same model, he also found that college graduates paid 33 basis points less than high school dropouts, and 14 basis points less than high school graduates.

<sup>48</sup> See David Olson, "Statement of David Olson, Managing Director, Wholesale Access Mortgage, Research and Consulting, Inc.," (pp. 24-26) and "Prepared Statement of David Olson," (pp. 78-84), *Predatory Mortgage Lending Practices: Abusive Uses of Yield Spread Premiums*, Hearing Before the Committee on Banking, Housing, and Urban Affairs, United States Senate, 107<sup>th</sup> Congress, U.S. Government Printing Office: Washington, D.C., January 8, 2002.

<sup>49</sup> See Jack Guttentag, "Another View of Predatory Lending," *Predatory Mortgage Lending Practices: Abusive Uses of Yield Spread Premiums*, Hearing Before the Committee on Banking, Housing, and Urban Affairs, United States Senate, 107<sup>th</sup> Congress, U.S. Government Printing Office: Washington, D.C., January 8, 2002, pp. 129-154.

loans, Guttentag finds a very large dispersion in gross profits per loan, with larger loans yielding more profits than smaller loans. According to Guttentag, "it is clear that brokers take advantage of the inability of borrowers to shop effectively by extracting more from those who can afford to pay more." Guttentag says brokers tell him that a major determinant of profit per loan is the sophistication of the borrower relative to the sales skills of the loan officer. Guttentag said this was illustrated in his analysis of 17 conventional loans that had a loan amount of exactly \$100,000 -- the profit per loan ranged from \$1,077 to \$2,748 with no relationship between profit and work load. Guttentag states:

Some economists find it difficult to comprehend how profits per customer can vary so widely in a market with so many lenders and such easy entry. The reason is that borrowers can't shop effectively... (page 138).

According to Guttentag, one consequence of the combination of easy market entry with barriers to effective consumer shopping is excess capacity among loan officers. According to Guttentag, many if not most loan officers spend as much as four-fifths of their time looking for customers and only one-fifth of their time dealing with customers.

Guttentag lists several reasons why consumers are not effective shoppers for mortgages. For example, market "nichification" -- meaning the specialization of mortgage products and prices to reflect the wide variety of borrower, property, loan, and documentation characteristics -- causes problems for shoppers because they might choose a lender based on a generic price (in the newspaper) but find out later that the "specific product" that they qualify for is much more expensive. Many shoppers have difficulty understanding "rebate pricing" (or yield spread premiums) and existing settlement disclosures are no help in doing so -- which means shoppers cannot determine the compensation that the broker or lender is receiving. The many steps and players (loan officer, processor, underwriter, appraiser, title insurer, abstract company, credit reporting agency, pest inspector, and many more) in the process of obtaining a home loan provide lenders and others ample opportunity to increase their fees between the good faith estimate and final closing -- with lenders telling the "overwhelmed" borrower at closing that the increased charges were due to circumstances beyond their control. Borrowers may suspect otherwise, but they have little choice except to proceed with the closing, according to Guttentag.

In his comments on HUD's proposed rule, Guttentag, also commented on another important problem -- called "float abuse" -- that consumers face when obtaining a mortgage.<sup>50</sup> In fact, Guttentag states that "float abuse" is the "most pervasive abuse in the home loan market" (p. 7).<sup>51</sup> "Float abuse" is the practice of a loan originator understating the interest rate when quoting it to shoppers, and then overstating the interest rate on the day it is locked by the consumer. For example, on a given day an originator might quote good credit customers making initial inquires 6% / zero points for a thirty-year, conventional loan. Some customers may lock

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<sup>50</sup> Jack Guttentag, "HUD's Proposals For RESPA Reform," submitted to Rules Docket Clerk at HUD, regarding Proposed Rule on *Real Estate Settlement Procedures Act (RESPA): Simplifying and Improving the Process of Obtaining Mortgages to Reduce Settlement Costs to Consumers*; Docket No. FR-4727-P-01; (July 29, 2002), October 18, 2002.

<sup>51</sup> Guttentag offers no study or data to support these claims; they appear to be based his own knowledge of and experience in the market.

into this rate, while others may chose to float. Those that choose to float will lock the rate at some later date. Suppose on some later date the originator quotes good credit customers making an initial inquiry  $6\frac{1}{8}$  / zero points, but tells customers who have previously submitted their applications and want to lock that the current rate is  $6\frac{1}{4}$  / zero points. This differential treatment ( $6\frac{1}{4}$  vs.  $6\frac{1}{8}$ ) is float abuse. It is possible to overcharge the rate-locking customer because the customer has already invested considerable time (and possibly money) in completing his or her mortgage application and may be planning to close the loan within days. Guttentag argues that customers making rate lock requests should be treated as “twin siblings” of those making initial rate inquires. That is, customers with identical credit and loan profiles should receive identical rate quotes even if one customer is merely shopping for rates while another customer has already shopped and is ready to lock. Guttentag argues that float abuse can be eliminated if originators post rate quotes on the internet for all to see.

According to Guttentag, "float abuse is pervasive, practiced by mortgage brokers as well as lenders, and often institutionalized " (p.8). Chapter IV discusses a posted pricing mechanism to ensure that consumers are not subjected to "bait and switch" schemes by originators who are offering Mortgage Package Offers.

#### **IV.D.5. FTC Staff Comments on Shopping for a Mortgage**

Comments on HUD’s proposal from staff at the Federal Trade Commission provided useful insights into several of the issues (e.g., price dispersion, price discrimination, and consumer shopping) being discussed in this section.<sup>52</sup> FTC generally supported HUD’s approach to provide consumers with more information about the mortgage process, emphasizing the importance of conducting consumer research on any proposed changes (which HUD has done, as discussed in Chapter 3).<sup>53</sup> Some of the other points offered by FTC staff are discussed below. (Also see Section IV.D.8 below for a summary of the FTC’s recent study of mortgage disclosure.)

FTC staff offered perhaps the best explanation of why the process of shopping for a home loan is so complicated (HUD has underlined what it thinks are the key points about consumer shopping in this quote from FTC staff):

Currently, shopping for a mortgage can be a complicated process. The mortgage and settlement service options for consumer are diverse, and, in response to demand, new alternatives become available relatively often. The mortgage and settlement service field can also involve complex terminology, with which some consumers may not be familiar. Consumers do not purchase or refinance homes with the regularity that they may purchase other products and therefore they may deal with these issues infrequently. In addition, the loan and origination costs in mortgage transactions can

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<sup>52</sup> “Comments of the Staff of the Bureau of Economics, the Bureau of Consumer Protection, and the Office of Policy Planning of the Federal Trade Commission,” October 28, 2002.

<sup>53</sup> As discussed in Chapter 3, the FTC staff raised questions about why HUD was requiring additional disclosures for mortgage brokers since HUD had indicated in its Economic Analysis that the broker industry was highly competitive.

involve various types of charges, with the loan price consisting of an interest rate, possibly points, and possibly a number of contingency prices, such as adjustable interest rates and prepayment penalties. Loan originators may charge different types of fees, such as those for underwriting, document preparation, and document review, which also do not have standardized (let alone simple) terminology. (page 11)

FTC staff recognize that the dispersion of prices in the mortgage market suggest that there could be potential savings from more effective consumer shopping. They also note that empirical studies indicate (a) that price dispersion is common in retail markets, even markets where entry is relatively easy and economic profits are rare; and (b) that the extent to which consumers shop for low prices helps to explain why some consumers pay less than others. They go on to note that if the mortgage market is characterized by easy entry and little economic profit, then price dispersion in the mortgage market is probably explained by imperfect information and a lack of consumer search. As explained in Chapters 3 and 4, these are the very features of the mortgage market that HUD seeks to change.

FTC staff also summarized evidence on consumer search in the mortgage market, noting that consumers vary greatly in the extent to which they search for mortgages. While most consumers shop extensively, a substantial minority contacts only one mortgage source. Based on a 1997 telephone survey of 1,001 consumers, Hogarth and Lee (2000) find that 14 percent of those refinancing contacted only one lender and 23 percent of home purchase borrowers contacted only one lender. A 1998 survey sponsored by the Mortgage Bankers Association of 965 borrowers found that more than half reported they shopped three or more lenders for information before getting a loan; less than 30 percent shopped only one lender and only 14 percent contacted only one lender throughout the entire process. FTC also mentioned that surveys indicate that some consumers may be confused by mortgage terms. Hogarth and Lee (2000) concluded “there is a general consensus that consumers’ lack of understanding is a problem in credit markets”; these authors noted that 40 percent of respondents in the University of Michigan’s “Surveys of Consumers” did not understand the relationship between the interest rate and the APR.

The FTC staff also included a useful discussion of the marginal benefits and costs of additional search in the mortgage market. They note “differences in the expected marginal benefits of shopping across consumers might be explained by differences in consumer awareness of the extent of price dispersion, in awareness of the present value of interest rate differences, and in perceptions of broker services.” (p. 6). Again, as explained in Chapters 3 and 4, HUD’s intentions are to increase consumer awareness in these areas. FTC also makes an important point concerning the potential benefits of shopping: “HUD’s characterization of substantial competition on the supply side of the market also suggests that consumers who engage in information search should be able to find competitively priced loan products...” (p. 6). In other words, if consumers could increase and improve their shopping, there are many suppliers of funds (over 40,000 brokers and lenders) in the market that would compete for their business. This situation contrasts with the all-too-often-found situation in today’s market of an uninformed shopper being subject to price discrimination by a broker or lender.

#### IV.D.6. Survey of Consumer Satisfaction with Mortgage Process

An October 2003 study by the CFI Group on consumer satisfaction with the mortgage lending process indicates the need to reduce complexity in the process and provide consumers with more information, choices and predictability.<sup>54</sup> The study found that mortgage lending ranks relatively low on consumer satisfaction among financial services. Overall, consumers gave the process a satisfaction score of 69 out of a possible 100, placing the mortgage lending process at the low end of the scale among all financial service industries. A serious shortfall, the study found, was that consumers feel they have limited ability to effectively shop rates and settlement costs. First-time homebuyers rated their ability to shop for settlement costs at a very low 49 out of 100.

The study used a nationwide random sample of homeowners who had either purchased or refinanced their homes in the first half of 2003. Reflecting the current market for mortgage financing, two-thirds of respondents had refinanced and one-third had purchased their homes. Respondents were about asked about key components of the lending process including: ability to research and find a lender, documentation, lender's performance, the closing process and costs. As described in a recent article, the study found,

"a sense among borrowers that they have very little means by which they can shop rates and settlement costs effectively. This is reflected in very low ratings on their ability to do research to find a lender. This component is measured with questions related to the availability of accurate information about lenders, their rates and fees; and the possibility to compare fees and closing costs across lenders effectively – which borrowers rated at a poor 55."<sup>55</sup>

The results of the survey show that consumers regard the process as too complex. Consumers were asked if they agreed with the statement that the “current system for home financing is too complex.” There was strong agreement with this statement among both home purchasers and refinancers. On a scale with zero indicating complete disagreement and 100 indicating complete agreement, an average score of 61 was reported, ranging from 59 among refinancers to 65 among all purchasers to a high of 71 among purchasers not buying for the first time.

Key components of the mortgage lending process received low scores from consumers surveyed in the study. These included: information about lenders, rates and fees – 65; ability to effectively compare fees and closing costs across lenders – 55; degree to which you felt you could control the process – 63; and whether the system lets people shop effectively for the best rates and closing costs – 59. Of those surveyed, refinancers had higher satisfaction levels than purchasers, reporting an overall satisfaction rating of 71 compared with 67 for buyers (and an even lower 66 for first-time buyers). These low scores indicate there is substantial room for

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<sup>54</sup> CFI Group, *Consumer Satisfaction with the Mortgage Lending Process*, October, 2003.

<sup>55</sup> Wilhite, Clayton and Park, Rodger, “Consumers Rate the Industry,” *Mortgage Banking*, pp. 32-43, October 2003.

improvement in consumer satisfaction when compared with other financial services industries and with leading customer service organizations in other fields. It should also be noted that the study probably underestimates dissatisfaction with the process, because it included responses only from successful buyers and refinancers and not from those who may have been turned away or given up out of frustration.

The study shows serious room for improvement in the lending process and further supports updating RESPA requirements to reduce complexity and improve the ability of consumers to shop for competitive rates and settlement costs. As stated in the article in *Mortgage Banking*,

“There are many indications in the survey results that suggest the ballpark is overdue for an overhaul and that HUD Secretary Martinez’s proposed rules for RESPA reform would be well-received by many borrowers. A closer look at the individual questions making up the satisfaction index score shows customers’ satisfaction is restrained by a nagging sense that the mortgage process could be improved.”

The article goes on to state, “Certainly the notion of helpless homeowners at the mercy of a lending system that leaves them prey to confusion and even exploitation by a few unscrupulous players is a central feature of many of the arguments in favor of RESPA reform.” Other results of the survey further indicate the potential benefits of RESPA reform, including more positive satisfaction scores on other aspects of the lending process. The lowest scores were given to the category, “research to find a lender,” which includes items on consumers’ ability to shop rates and settlement costs effectively, availability of accurate information and the ability to compare fees and closing costs across lenders effectively – which borrowers rated at a very low 55.

Given the potential of RESPA reform to improve these aspects of the lending process which consumers reported the most frustration with, consumer satisfaction with mortgage lending overall can be expected to rise significantly.

#### **IV.D.7. Survey on Fees in Mortgage Market**

A 2003 survey conducted by Bankrate.com sheds further light on the confusing nature of fees and closing costs and the difficulty experienced by consumers attempting to shop for competitive rates and lower costs.<sup>56</sup> According to the survey, “[l]enders, brokers and third-party mortgage originators charge all sorts of fees to borrowers. It’s hard for borrowers to know whether they’re being overcharged.”

The survey was conducted using closing cost information from 50 states and the District of Columbia and included a sample of 306 good faith estimates. This data was analyzed to determine the highest, lowest and average fees charged by the lenders in the sample. For a \$180,000 loan to an applicant with good credit and a minimum 20 percent downpayment, total

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<sup>56</sup> “Bankrate Closing Costs Survey: Mortgage fees vary widely and confuse borrowers,” <http://www.bankrate.com/brm/news/mortgages/20031106a1.asp?print=on> also see:

<http://www.bankrate.com/brm/news/mortgages/20031106b1.asp?print=on>

closing costs varied widely from a low of \$1,020 to a high of \$11,395, with an average of \$3,350. According to an analysis of the survey by Holden Lewis, writing for Bankrate.com,

“The survey shows that the pricing of mortgage fees is a shell game, with different lenders calling the same fees different things. Some lenders charge a slew of separate little fees and others charge a few bigger fees.”

Clearly, consumers are faced with a daunting task in attempting to obtain accurate and comparable information in order to locate the most competitive costs. This task is complicated not only by the widely varying costs, but also by the lack of uniformity in which fees and costs are included in estimates and what those fees are called as well as paperwork of various completeness and which costs are included in the estimates (e.g. title insurance, state and local taxes, etc.). As Mr. Lewis cogently points out,

“The lesson is that you not only have to shop around, but you must compare and probe to find out which lender is really offering the best deal. Mortgage fees vary widely, lenders make errors when calculating things such as taxes and the good faith estimate doesn’t always include every cost.”

#### **IV.D.8. Recent FTC Study of Mortgage Disclosure**

Like the Department’s recent inquiry, the object of the FTC’s study is to investigate how consumers shop for mortgages, how well consumers understand various loan disclosures and borrowing terms, and whether or not “better” forms of disclosure improve consumers’ understanding of mortgage costs and ability to discriminate among lenders. At issue is the role that information plays in the home mortgage market—and what, if anything, can improve its quality. The study’s objectives are motivated by a lack of extant empirical evidence on the matter and are addressed via a series of 36 in-depth interviews with recent mortgage customers and a quantitative analysis of data on another 819 mortgage customers. The results, which are largely in agreement with the Department’s findings, suggest that, overall: (1) current forms of disclosure fail to fully inform consumers; (2) alternative forms of disclosure can significantly enhance the quality of information in the marketplace; (3) prime and sub-prime borrowers alike have trouble with current forms of disclosure and benefit from the alternatives; and (4) the benefits of improved disclosures are positively correlated with the complexity of loan terms. En route to these findings, the study also illustrates that careful testing is fundamental to developing effective disclosure instruments. The following paragraphs elaborate on the research design, specific findings, and how these line up with those of the Department’s study, which was similar in many respects.

To begin, the FTC’s study was designed to develop both specific and generalizable conclusions via a combination of qualitative and quantitative analysis. The former approach involved conducting 36 in-depth interviews with consumers who had obtained mortgages in the four months previous. The interviews were conducted between September 2005 and February 2006, and sought detailed information on approaches to shopping, consumers’ understanding of their mortgages, and the utility of alternative disclosure instruments. Participants from

Montgomery County, Maryland—who were demographically diverse and had made use of a wide array of financial instruments to purchase their homes—were recruited via telephone and then interviewed in person. During the interview, consumers’ understanding of loan disclosures and borrowing terms were compared against their actual loan documents. The latter approach involved conducting a quantitative analysis of data on 819 recent mortgage customers in 12 locations around the country. Specifically, participants—an approximate 50/50 split between consumers who had obtained their mortgages through prime and sub-prime lenders—were asked to examine two hypothetical mortgage loans and then explain their understanding of the costs, terms, and other conditions. About half of the respondents were presented with the two scenarios via “current” forms of disclosure and the other half via alternative forms of disclosure. Since no standardized good faith estimate (GFE) form exists, a form similar to many currently in use was created specifically for this purpose; both the FTC and the Department believe that the instrument is representative of mainstream practices. The results of the survey were then analyzed in order to determine whether or not the two groups of participants understood the alternative loan scenarios differently. More specifically, a series of so-called “difference of means tests” was used to identify statistically significant differences in how well participants understood the loans, based on the type of forms they received.

The interviews revealed that consumers are often confused by current forms of mortgage cost disclosures and commonly do not understand key terms and conditions—a finding that extends to participants own mortgages. Rather predictably, many consumers had mortgages that were more costly than they believed, even if they were savvy customers who had “shopped around” by consulting with multiple lenders. Participants reacted positively to the alternative disclosure instrument, and most characterized it as an improvement over what they had seen in the past. Taken together, these findings suggest that there is substantial room for improvement in the quality of information that consumers receive when shopping for—and agreeing to—home mortgages. The statistical analysis revealed a number of detailed findings that underpin the four general conclusions listed above. For example, the study reports systematic evidence of a failure on the part of lenders to convey key mortgage costs—a finding that probably understates the true scope of the problem, because survey respondents were provided with more information than required by law. The detailed outline of findings includes a chart that reports the number of respondents who received current versus prototype forms who could not correctly identify key costs terms and conditions. These findings are listed below, which, wherever possible, also includes corresponding results from the Department’s study, which is detailed in Chapter 3.

The table below gives the percentage of respondents in the FTC study and in the first two (out of six) rounds of the Department’s study. The first two columns of percentages correspond to the FTC’s current and alternative, or improved, forms, respectively, and the second two columns of percentages correspond to rounds one and two of the Department’s study. All of the percentages in the latter two columns relate to survey questions that were either identical or closely analogous to those in the FTC’s survey; results for the latter rounds are not included even though they produced improvements, because the methodology of those surveys was different enough to preclude direct one-to-one comparison. As a set, the percentages listed below point to two straightforward conclusions: (1) there is clearly a lot of room for improvement in the quality of information available to consumers in the market for home mortgages; and (2) relatively simple changes in the way that this information is communicated, such as presenting it in simple terms, can have an appreciable impact.

Percentage of Respondents Who Could Not Correctly Identify Loan Costs, Terms and Conditions

	FTC Study		HUD Study	
	Current	Alternative	Round One	Round Two
APR	20%	5%	n/a	n/a
Amount of Cash Due at Closing	20%	17%	n/a	n/a
Monthly Payment	21%	10%	5%	0%
Settlement Charges	23%	8%	9%	3%
Presence of a Balloon Payment	30%	30%	7%	10%
Interest Rate	32%	20%	7%	0%
Finance Settlement Charges	33%	24%	n/a	n/a
Less Expensive of Two Loans	37%	24%	27%	14%
Loan Amount	51%	13%		
Presence of a Prepayment Penalty	68%	44%	9%	3%
Presence of Charges for Optional Credit Insurance	74%	30%	n/a	n/a
Reason Why the Interest Rate and APR Sometimes Differ	79%	59%	n/a	n/a
Property Tax and Homeowner's Insurance Amount	84%	21%	n/a	n/a
Total Upfront Cost	87%	22%	n/a	n/a
Prepayment Penalty Amount	95%	42%	n/a	n/a

Note: n/a denotes that a direct comparison is not applicable.

#### IV.D.9. Mark Shroder's Study of Good Faith Estimates

The National Association of Realtors questioned the benefits of the 2008 proposed rule and cited a study<sup>57</sup> by Mark Shroder as evidence that “bait and switch” is not a widespread phenomenon. Such a conclusion can not be based on Shroder’s study. The sample in the study suffers from a selection bias that limits its usefulness in investigating the “bait and switch”

<sup>57</sup> Mark Shroder, “The Value of the Sunshine Cure: The Efficacy of the Real Estate Procedures Act Disclosure Strategy,” *Cityscape: A Journal of Policy Development and Research*, Vol. 9, Number 1, 2007

phenomenon. Mark Shroder examined 146 FHA insurance binders. The GFE was present in only 47 of the 146 FHA binders. FHA does not require lenders to include GFEs in case binders. It is natural to suspect that those lenders that voluntarily submitted a GFE had nothing to hide. One can only speculate about those GFEs that are not present, but would a lender that purposefully tried to mislead a borrower knowingly report their activity to the FHA? HUD concludes that it is not likely that one would be able to detect “bait and switch” behavior from a study where disclosure by the lender is voluntary.

#### **IV.E. A Study of Closing Costs for FHA Mortgages - Urban Institute (2008)**

This section summarizes key results related to the origination costs and yield spread premiums from a study of FHA closing costs by the Urban Institute (2008). The study, entitled “A Study of Closing Costs for FHA Mortgages”, will be referred to as Urban Institute (2008). The report was written by Susan Woodward with the assistance of Urban Institute staff -- Signe-Marry McKernan, Caroline Ratcliffe, Doug Wissoker, and William Margrabe.

Readers not interested in the first section subsection, which is a background section on YSPs should proceed to the next section, which describes the data set. The third subsection summarizes the analysis of the data. An important focus of this study was to determine whether there is evidence that disclosures for mortgage borrowers could be improved. The answer is “yes”, for the following reason: the Urban Institute found that charges vary significantly by the race and education of the borrower, and the complexity of the loan. This section concludes by dealing with the question of where potential saving in yield spread premiums and direct origination fees will come from if this industry is competitive.

##### **IV.E.1. Background: Direct Fees and Yield Spread Premiums**

To understand the analysis done in this analysis of FHA loans, it is helpful to see how the rate-point tradeoff works from a mortgage lender’s perspective. About 20 percent of the loans in this study were done through mortgage brokers<sup>58</sup>, others were made by direct lenders. The main distinction is who owns the loan at the time it is closed: if the party arranging the loan owns the loan at closing, it is a direct loan. If a broker arranges the deal but a wholesale lender owns the loan at closing, it is a brokered loan.

Mortgage brokers are free-lancing middlemen. They have relationships with wholesale lenders who give them, at least daily, the terms on which they are lending at present. The mortgage broker finds borrowers, offers them a deal, and earns money potentially in two ways: first, as cash fees paid by the borrower to the broker, and second, as a fee paid by the lender that is tied to the rate paid by the borrower. The higher the rate, the higher the broker’s payment from the lender, other things equal. The broker’s payment from the lender is called a yield spread premium, or YSP.

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<sup>58</sup> These are brokers as HUD defines them (see earlier discussion).

A mortgage broker's fees can come from cash paid by the borrower, or from cash paid by a wholesale lender, or from a mix of the two. In principle there could be a one-for-one tradeoff, with the borrower choosing whether to pay closing costs in cash or to agree to a higher rate and in essence, roll the closing costs into the rate on her loan. Whether there is a one-for-one tradeoff is one of the important questions the research here addresses. If borrowers thoroughly understood how rates and points work, we would expect to see a one-for-one trade-off. In a previous study of brokered loans, (mainly conventional, with some FHA and some jumbos), Woodward found that for each dollar paid in YSP, borrowers saved 55 cents in cash closing costs.

The terms offered by wholesale lenders are detailed on a document called a rate sheet. The rate sheet shows the payments the lender will make to the broker for a loan of a given amount at a given interest rate. Because the rate sheets given by wholesale lenders to mortgage brokers make the rate-point tradeoff so clear, let's review the mechanics the rate sheets.

Below is a typical rate sheet for a day in the month of April 2000, for 30-year, fixed-rate, conventional loans<sup>59</sup>. Brokers usually have relationships with a dozen or so wholesale lenders who update their rate sheets at least daily. The wholesale terms on the rate sheet show the rate-point alternatives offered.

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<sup>59</sup> A rate sheet for FHA loans may not be identical to this rate sheet for conventional loans, but it will be functionally very similar.

**Exhibit: A typical rate sheet:**

<b>Rate</b>	<i>lock period</i>			
	15 days	30 days	45 days	60 days
<b>9.750%</b>				
<b>9.625%</b>				
<b>9.500%</b>				
<b>9.375%</b>				
<b>9.250%</b>				
<b>9.125%</b>	103.375	103.250	103.125	103.000
<b>9.000%</b>	103.000	102.875	102.750	102.625
<b>8.875%</b>	102.625	102.500	102.375	102.250
<b>8.750%</b>	102.375	102.250	102.125	102.000
<b>8.625%</b>	102.000	101.875	101.750	101.625
<b>8.500%</b>	101.500	101.375	101.250	101.125
<b>8.375%</b>	101.000	100.875	100.750	100.625
<b>8.250%</b>	100.625	100.500	100.375	100.250
<b>8.125%</b>	100.250	100.125	100.000	99.875
<b>8.000%</b>	99.750	99.625	99.500	99.375
<b>7.875%</b>	99.125	99.000	98.875	98.750
<b>7.750%</b>	98.625	98.500	98.375	98.250
<b>7.625%</b>	98.250	98.125	98.000	97.875
<b>7.500%</b>	97.625	97.500	97.375	97.250
<b>7.375%</b>				

The left-most column, in bold, shows the coupon rate on the loan, quoted in one-eighth increments or “ticks”. This is the interest rate that will be used to calculate the borrower’s payments. The top line indicates the length of time for which the lender will lock (guarantee) that interest rate, giving the lender and borrower the time needed to assemble the paperwork to complete the transaction. Sometimes brokers (and retail lenders as well) require an up-front payment of several hundred dollars from the borrower, often in an application fee, sometimes in an explicit lock fee, to provide a lock.

The figures in the grid indicate the amount of cash the lender will deliver at closing for a given rate and lock term per hundred dollars of mortgage loan amount. For example, the cell for a rate of 8.25 percent and a 30-day lock indicates that for a \$100,000 mortgage, the lender will deliver \$100,500 to the closing table, and that this offer remains good (locked) for the next 30 days. This choice will result in a mortgage with a principal balance of \$100,000, for which an interest rate of 8.25 percent will be used to calculate payments, and the lender will pay at closing, in addition to the \$100,000 mortgage loan amount, another \$500 in cash. This additional cash can be kept by the mortgage broker or credited to the borrower. In the mortgage business, this \$500 is called the *yield-spread premium* or YSP.

Consider another cell in the column for a thirty-day lock, at the 8.5 percent rate: for a loan of \$100,000 at 8.5 percent, the lender will deliver \$101,375 at the closing. By contrast, in order to get a rate of 7.5 percent on a thirty-day lock, the broker making a loan of \$100,000 notional value will have to *pay* \$2,500 cash at closing, that is, to pay 2.5 *points* (also called “discount points”) at closing, and the broker will likely charge the borrower for at least this amount. It makes sense to think of YSPs as negative “points” on loans with above-par interest rates.

Note that for the 45-day lock period there is an interest rate, in this instance 8.125 percent, for which the lender delivers exactly the mortgage amount at closing, and neither requires nor provides additional cash. This is called the *par* interest rate for the 45 day lock. Note also that there is no par rate for the 15, 30, or 60 day locks. Because mortgage interest rates are quoted on ticks of one-eighth of a percentage point, frequently no loan will be quoted exactly at par, as one will arise only if the par interest rate happens to fall on a tick. Sometimes it does, often it does not.

Loans with interest rates above par are called premium loans—those on which the lender pays a yield-spread premium. This payment is also sometimes called a “service release premium” a “broker’s premium”, “lender’s premium”, “deferred premium” and even “discount rebate”. The terminology used for this payment on HUD-1 settlement statements is far from uniform.

Borrowers do not have access to rate sheets. For loans originated through mortgage brokers, the YSP is required to be disclosed on both HUD Good Faith Estimate, and on the HUD-1 settlement statement. Despite this requirement, YSPs are often not disclosed.<sup>60</sup> Thus borrowers are frequently unaware of the existence of the YSP. Even when it is disclosed they may be unaware of it, as it is not easy to interpret HUD-1 settlement statements. All lenders have a functional equivalent of a yield-spread premium, but only mortgage brokers are required to disclose them.

In practice, the yield-spread premium is always paid to the broker, not the borrower. Sometimes the borrower’s cash closing costs are lower when she pays an interest rate that results in a yield-spread premium, and sometimes they are not. In Woodward (2003), where the majority of the loans studied are conventional, (with also some FHA and jumbo loans), borrowers’ upfront cash charges fell about 20 cents for each dollar paid in YSP.<sup>61</sup>

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<sup>60</sup> In Woodward (2003), a study of loans made 1996-2000, about one-third of YSPs were not reported on HUD-1s.

<sup>61</sup> Susan E. Woodward, “Consumer Confusion in the Mortgage Market,” Sand Hill Econometrics, July 7, 2003. Jackson and Woodward each examined the same data as part of the court case, *Glover v. Standard Federal Bank*. Jackson (2002a), serving as an expert witness for the plaintiffs, concluded that, for the most part, yield spread premiums are not being used to lower direct fees paid by borrowers. Based on his regression analysis, Jackson concluded that borrowers gain (as an offset to their closing costs) only about 25 cents on each dollar of YSP; the other 75 cents of YSP ends up as extra compensation for the broker. Woodward (2002), serving as an expert witness for the defendant, reached different conclusions based on analysis of the same sample, noting that Jackson’s analysis was incomplete because it failed to consider many factors that cause variation in broker compensation. In her initial regression analysis (as reported by Jackson and Berry, 2001), Woodward finds that 74 percent of the yield spread premium offsets borrowers’ closing costs. Woodward, however, has indicated to the Department that her

Direct lenders participate in the same wholesale market as do lenders who lend through mortgage brokers. They face the same wholesale rate-point tradeoff. Traditional direct lenders have not historically compensated their loan officers based on the size and interest rate on the loans they make. Instead, loan officers were salaried employees who likely received some bonus for volume and for the profitability of their book of business. More recently, lenders appear to be moving in the direction of compensating loan officers in ways more similar to how mortgage brokers are compensated.<sup>62</sup>

Total loan origination charges consist of two components: the direct loan charge and the yield spread premium (YSP). The direct loan charge is the fee charged directly by the lending loan originator in exchange for providing the loan. In the case of a brokered loan, the yield-spread premium is another payment received by the broker at the time the loan is made. The YSP is the present value of the higher monthly payments resulting from the higher interest rate the borrower will pay over the expected life of the loan. The borrower becomes committed to this higher monthly payment at the closing. For loans with relatively high coupon rates (above the market “par” rate), the broker receives the amount of the yield-spread premium upon selling the loan to the wholesaler. For loans with relatively low coupon rates (below the market “par” rate), the broker makes a payment to the wholesaler as part of the transaction selling the loan. These payments might well be called negative YSPs, but are commonly called discount points. YSPs are referred to as closing costs because the borrower gets committed to the stream of higher monthly payments at closing and the broker receives the YSP, the present value of the difference in the higher monthly payments at closing.

On the HUD-1, which is the source of the FHA data, only mortgage brokers receiving (positive) YSPs are required to report them. Those loan originators who are not HUD-defined mortgage brokers – that is lenders – are not required to report YSPs, despite the fact that a lender receives the same monetary reward for originating loans at an above-par interest rate. They can either sell the loan and get the equivalent of a YSPs from the wholesaler or they can keep the loan in portfolio and keep the higher monthly payments for themselves, where the YSP equivalent is the present value of the expected higher income stream. So brokers and lenders are treated differently with respect to the disclosure of YSPs or their lender-equivalent. Since YSPs are not reported by lenders, the yield-spread premium is predicted for the non-brokered loans.<sup>63</sup> The analysis is based on observed yield-spread premiums for brokered loans and predicted yield-spread premiums for non-brokered loans. Neither brokers nor lenders have to report discount points (negative yield spread premiums) with the precision required of brokers who receive YSPs.<sup>64</sup>

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recent work using the court-case data base suggests that 55 cents in each dollar of YSP results in extra compensation to the broker. The latter work is consistent with her analysis as reported in Woodward (2003).

<sup>62</sup> Most FHA mortgages are securitized through GNMA soon after origination.

<sup>63</sup> Yield-spread premium is imputed for non-brokered loans using the relationship observed between yield spread-premium, loan amount and interest rate for brokered loans with an interest rate at or above 7 percent.

<sup>64</sup> The HUD-1 data also does not indicate whether a loan is from a broker or a lender. Brokered loans are defined as loans for which a positive YSP was reported on the HUD-1. All other loans are considered non-brokered loans.

## IV.E.2. Closing Costs Data

The first goal of this research was to assemble a data set in order to provide HUD with descriptive information on closing costs. Information on the amount and variance of total closing costs and its components (direct loan origination fees, yield-spread premiums, title charges, and other third-party charges) are sparse. This data set fill that gap. These loans are from a sample of 7,600 FHA loans that were closed during a six-week period in May 2001 and June 2001.<sup>65</sup> All loans are 30-year fixed rate loans. The Urban Institute collected data on loan closing costs from the HUD-1 settlement statements associated with the loans.<sup>66</sup> The characteristics of the data set are reported in the table below.

### **Borrower Charges for All Loans and Title Services (nationally-weighted sample)**

	All Loans	All Non-subsidized loans	Non-subsidized loans with coupon rate > 7%
<b>Total Loan Charges</b>	<b>\$4,917</b>	<b>\$5,245</b>	<b>\$5,635</b>
Total Lender/Broker Charges	\$3,081	\$3,390	\$3,766
Up-front charges	\$1,454	\$1,450	\$1,348
Yield-spread premium*	\$1,628	\$1,940	\$2,417
Total title charges	\$1,329	\$1,349	\$1,364
Other third-party services**	\$507	\$506	\$505
Coupon rate	7.31%	7.38%	7.54%
Down payment	\$2,486	\$2,542	\$2,470
Loan Amount	\$108,237	\$110,439	\$108,704
<i>Number of Loans</i>	<i>7,560</i>	<i>6,366</i>	<i>4,603</i>

\*The Yield-spread premium is actual for brokers and estimated for lenders.

\*\*Third-party services consist of appraisal, credit report, flood certification, and tax service. These are only the charges paid by originators. Other services such as closing, survey, and pest inspection are not included here.

Closing costs are a significant portion of charges and, on average, are twice as great as the down payment. The above table presents the descriptive data for two sub-samples of the total data set: non-subsidized loans and non-subsidized loans with coupon rates greater than 7 percent. These sub-samples were used for the regression analysis. Non-subsidized loans are loans that have not received contributions to closing costs from state or local programs and thus are thought to better reflect the typical market loan. Loans with a coupon rate greater 7 percent are thought to be more likely to have been a premium loan in May and June of 2001 and thus have received a yield-spread premium. The loans were all closed between mid-May and the end of June, 2001, During that period, the Freddie Mac published weekly rate varied between 7.1% and 7.2%. For the full sample, average closing costs are slightly lower at \$4,917 than for non-subsidized loans and represent a smaller fraction (4.5 percent) of the loan amount than for the

<sup>65</sup> The loans dropped from the full 7,600 sample are those (1) identified as government subsidized on the HUD-1 form, (2) with interest rates that are not multiples of 1/8 (i.e., off tick), and (3) with interest rates less than 7 percent.

<sup>66</sup> The closing costs analyzed are those associated with loan charges (direct loan fees and yield-spread premiums), title charges (including title insurance), and other third-party fees (such as appraisal, credit report, survey, and pest inspection fees). Data to calculate these costs come largely from the 800, 1100, and 1300 series of the HUD-1 form. These charges comprise the bulk of total closing costs that must be paid at closing.

other two sub-samples described in the columns to the left. These loans are of modest size, not surprising since all are FHA-insured and FHA restricts the size of the loans it will insure.

Average closing costs for non-subsidized loans are \$5,245. The standard deviation, a measure of dispersion, of total charges is \$2,267. To understand the magnitude of the variability, statistical theory (Chebyshev's inequality) tells us that that as many as one quarter of the observations could be \$4,534 away from the mean of \$5,245. For the average loan (\$110,439), total closing costs are 4.7 percent of the loan amount. Total loan charges average \$3,390 (standard deviation of \$1,931) and account for the largest share of closing costs at 65 percent (and 3.1 percent of the loan amount). Of the two components of total loan charges, indirect loan fees paid through yield-spread premiums and direct loan fees, the yield-spread premium is larger. The magnitude and proportion of this difference increases in the sample (non-subsidized loans above 7 percent) that is likely to contain only premium loans. Total title charges average \$1,349, with a standard deviation of \$568, while the third category of costs (miscellaneous third-party settlement costs) average \$506, with a standard deviation of \$107.

### **IV.E.3. Regression Analysis of FHA Closing Cost Data**

**Introduction and Questions Addressed by Statistical Study.** The original goal of RESPA was to assure the mortgage market was competitive and to make it easier for borrowers to shop for mortgage loans by giving them better information. Since RESPA was enacted in 1975, and its amendments in 1983, new controversies have arisen about mortgage lending practices. As has already been discussed, one is the payment of yield-spread premiums by lenders to mortgage brokers. Race discrimination in lending continues to be an issue also. More recently, partly because of the YSP controversies, questions have arisen about whether our present mortgage disclosures help borrowers much and whether they could be better.

- How much do FHA borrowers pay in lender/broker closing costs and how much do costs vary?
- Are brokered loans more expensive than loans from direct lenders?
- Do borrowers receive any benefit from yield-spread premiums paid to mortgage brokers?
- Do borrowers receive any benefit from implicit yield-spread premiums when they borrow from direct lenders?
- Are there differences in charges to borrowers by credit score? By education? By race? Does loan counseling help borrowers?
- Are there differences in originator charges by State?
- How large are title charges, and how are they related to borrower and loan characteristics? (The answer to this question is provided later in the discussion of title fees in Section V..)

Each question is answered below. To answer these questions, comparisons need to treat direct loans and brokered loans similarly. Brokers are required to report yield-spread premiums, but direct lenders are not. Yield-spread premiums are without question a cost to the borrower, because the borrower pays a higher interest rate when the lender pays the broker a YSP. Rates vary on direct loans as well as brokered loans, and direct lenders have their functional equivalent of the YSP. Thus, for a proper comparison, YSPs need to be estimated for the direct loans.

**How much do FHA borrowers pay in lender/broker closing costs and how much do costs vary?** The answer to the first question is answered in table 5-1 above. Consumers pay approximately \$5,000 in closing costs, which vary considerably (approximately \$3,500 depending on the data set).

**Are brokered loans more expensive than loans from direct lenders?** The brokered loans are used to measure the relationship between yield-spread premium, the interest rate on the loan, and the loan amount. This measurement is then used to calculate estimated YSPs for direct loans. In this study, “total cost” always means the cash charges to the lender/broker plus the actual or estimated YSP.

Brokered loans are identified as those loans with a YSP reported. If the YSP fails to be reported, and other data suggests brokers often do fail to report them, too few of the loans here are classified as brokered loans and some brokered loans are mixed in with what we treat as direct lender loans. This tends to make the two sets of loans look more alike than they truly are. Despite this, the brokered loans are measurably different from direct loans.<sup>67</sup> Brokered loans are more expensive. But the customers brokers serve are, by all analyses in the data, more expensive customers. For example, a higher fraction of their customers have no credit score, and the loans they write are slightly larger than the non-broker average. Brokers on average charge \$714 more than direct lenders charge. Taking account of the different characteristics of customers served by mortgage brokers, the difference falls to \$422.

It is also possible to look at differences in how brokers vs. direct lenders “treat” their customers by measuring how loan terms relate to borrower characteristics for each group, then using that set of measures to calculate what brokers would have charged to direct-lender customers, and vice-versa, and to calculate what each type of lender would have charged to all customers of non-subsidized loans. The results of this exercise plus other summary figures appear in the table below:

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<sup>67</sup> A surprisingly large number of the loans in the study—nearly 16 percent—appear to be subsidized by some state or local program. The main analysis is restricted to the non-subsidized loans. In the FHA records, including the HUD-1 settlement statements, there were many signs showing which loans were subsidized. For some, contributions by various programs were clear. For others, the interest rate on the loan was far lower than any feasible market rate. For another group, the interest rate was off the “tick” (1/8, 1/4, 1/2, etc.) suggesting that the funds may have come from some state or local bond issues. These loans were all flagged as “subsidized”

***Comparison of Charges, Direct Lenders vs. Brokers, non-subsidized loans only (from Table 5-6a of Urban Institute 2008)***

All 6,366 non-subsidized loans	<i>Brokers</i>	<i>Direct Lenders</i>	<i>difference</i>
All non-subsidized loans	\$3,653	\$2,939	<b>\$714</b>
Upfront cash charges	\$1,481	\$1,266	\$215
YSP	\$2,171	\$1,673	\$498
Average coupon rate, percent	7.45	7.32	0.13
Percent of borrowers with no credit score	7.4	5.1	
Average loan amount	\$113,003	\$108,145	
Difference measured as a regression coefficient			<b>\$422</b>
standard error of this coefficient			\$52

While the differences between the charges of brokers and direct lenders are smaller when borrower characteristics are taken into account, brokered loans are still more expensive by more than 10 percent.

**Do borrowers receive any benefit from yield-spread premiums?** This question has been central in litigation over mortgage lending practices for the last decade. The answer is “Yes, but very little.” For the sample of premium loans (coupon rate above 7 percent), the answer is “No” for the average borrower. These results are stunningly bad for borrowers. Clearly, the average FHA borrower has no idea a higher interest rate can be used to reduce upfront charges.

The table shows the net loss to the borrower from paying an additional \$100 of yield spread premium. Borrowers who pay a higher yield spread premium should gain by paying lower closing costs. In the sample of all non-subsidized loans, borrowers see only \$18 of savings in closing costs for every \$100 of yield spread premium paid. This trade-off appears to vary by type of lender and is least advantageous for brokered loans: the reduction in closing costs is only \$7 per \$100 of yield spread premium for a net loss of \$93. The trade-off is more advantageous for loans from large mortgage banks, where the savings in closing costs is \$29 per \$100 of yield spread premium. While better, this exchange is not close to what is ideal: a one-to-one trade-off between the yield spread premium and high upfront charges. Note that for the smaller sample of loans with a coupon rate above 7% there is no gain to be had for the average borrower. The borrower who pays a higher yield spread premium pays *higher* closing costs (an additional \$10 of closing costs for every \$100 increase of the yield spread premium).

The other empirical research that has made a thorough study of data from HUD-1 settlement statements (plus lender’s electronic records, from which this FHA study does not benefit) found that borrowers saved about 55 cents for each dollar of YSP they paid (see the description above of Woodward 2003 in Section IV.D.3). The loans in the Woodward (2003) study were mainly conventional, with a small fraction of FHA and also jumbo loans. The FHA data shown in the table from the Urban Institute (2008) reveals a different picture. These trade-offs compare unfavorably to that faced by mainly conventional borrowers, who save on average

55 cents on cash fees for each dollar of YSP according to other studies. The trade-offs compare even more unfavorably to the implicit trade-off on the rate sheets as measured between rate and YSP among the brokered loans, or on actual rate sheets. Service providers are expected to make a profit on a deal, but it appears that they make an extra profit when the deal is made more complicated for the borrower.

In reading the table, keep in mind that the distinction between brokers and lenders in this study is imprecise. It is reasonably certain that all loans designated as brokered are indeed brokered, but there are likely some brokered loans for which YSPs were not reported among the direct lenders. Thus, the figures for direct lenders may be on the high side. In Woodward (2003), about one third of the YSPs were not reported. Total charges were no higher on the loans with unreported YSPs.

***Borrower Losses from YSPs (from Table 6-1 from Urban Institute 2008)***

Loss is measured per \$100 of YSP	<i>all non-subsidized loans</i>		<i>&gt; 7% only</i>	
	<i>Net loss</i>	<i># of loans</i>	<i>Net loss</i>	<i># of loans</i>
<b><i>Type of lender</i></b>				
<i>all lenders</i>	\$82	6,366	\$110	4,603
<i>Depositories</i>	\$78	913	\$76	494
<i>Large mortgage banks</i>	\$71	1,745	\$67	1,324
<i>Smaller mortgage banks</i>	\$81	2,275	\$120	1,611
<i>Mortgage brokers</i>	\$93	1,433	\$116	1,174
<i>From Woodward (2003)</i>	\$45	2,624		

In sum, the borrowers are getting a small benefit from the YSP: 7 cents on the dollar from brokers; 22 cents per dollar from depositories; 29 cents per dollar from large mortgage banks; and 19 cents on the dollar from smaller mortgage banks. The difference between the measures of the YSP benefit here versus the other study of mainly conventional loans may arise because FHA borrowers are in many ways disadvantaged borrowers, less well prepared to make their way in complex financial transactions.

**Are simpler loans less expensive?** The answer is “yes” It appears that when a loan is simpler, it is easier for consumers to compare different loans and choose the least expensive. Features such as discount points and sellers’ contributions to closing cost increase the cost of a loan. Overall, borrowers see a benefit of only \$20 for each \$100 of points paid, for a net loss of \$80. Those who borrow through mortgage brokers see no benefit at all from paying benefits while customers of depositories realize \$65 for every \$100 of discount points. When sellers contribute to closing costs, there does not appear to be a one-for-one trade-off between costs paid by the seller and costs paid by the borrower. On average borrowers pay \$50 less themselves for every \$100 of contribution from the seller. This is not an even trade. As described in the previous section, the yield-spread premium, which is a function of a complex market, is of little or no benefit to the benefit to the borrower (7 cents for every dollar).

Just as increasing the complexity of a loan makes it harder to figure out which loan is the cheapest, reducing the complexity of loans makes it easier. This effect is most dramatic for “No-Cost” loans. When sellers want to avoid up-front fees for loan origination, they can do so by rolling these up-front charges into a higher interest payment. The advantage of shopping for a “No-cost” loan is the ease of comparison with other offers. Instead of comparing interest rates and settlement charges, the borrower can focus on finding the loan with lowest interest rate. No-cost loans in the sample are cheaper than other loans by **\$1,200**. In addition, the race and education premium found for other loans (described below) do not exist for “No-cost” loans. This result is important one because it gives HUD an estimate of the potential economic gains for consumers of simplifying the process of obtaining a loan.

**Do settlement charges vary by the characteristics of the borrower?** The answer is “yes.” The cost of a loan depends on a borrower’s credit score, race, education, and whether the borrower has received loan counseling.

Credit Scores. FHA borrowers who are not part of a local or State subsidy program have credit scores averaging about 600 points. Just under 6 percent of non-subsidized FHA borrowers lack a credit score. In order to measure differences on both the level of credit score and whether borrowers had one or not, credit scores for borrowers lacking them were estimated from the data for borrowers with them using methods that account for bias in the data. Whether we measure the impact of credit scores on loan terms with or without State effects, the measured impact is very close, so the results with States effects are reported here.

Good credit is worth more to borrowers who get their loans through brokers than those who get their loans through direct lenders. Brokers’ customers save \$604 for each additional 100 points of credit score on a \$100,000 loan, and they pay an extra \$534 for not having a credit score at all. The customers of direct lenders save \$376 for each additional 100 points of credit score and they save \$207 for having a credit score (see Table 4-2, Urban Institute 2007b).

Borrower Education. The differences in amounts charged to borrowers with different levels of education are one of the most compelling reasons to revise and improve mortgage disclosures. Taking account of all of the other borrower differences which can be measured, education differentials are very large by any metric. They are about three times the size of race differences. This is especially striking given that borrower education is measured with noise: we do not know actual borrower education, but only the average educational attainment of the adults in the borrower’s census tract. In addition, taking account of the factors that generally explain mortgage defaults (loan size, credit score, whether borrower has a credit score, and more), borrower education is unrelated to defaults.

The results below show the education differential (which represents how much more borrowers with only high school are charged, other things equal, compared to college-educated borrowers) measured both with and without State-level effects. The differential is lower taking account of State effects. This suggests that borrowers with less education tend to live in more expensive States.

***Differences in Lender/Broker Charges Related to Education***  
***(Table 5-4 from Urban Institute 2008)***

<i>Differential Charges, High School vs. College</i>	<i>Measured with State effects</i>	<i>Measured without State effects</i>
All non-subsidized loans	\$1,091	\$1,699
Non-subsidized loans with rate > 7%	\$1,271	\$1,882

These very large differences in mortgage costs for borrowers with different levels of education should give regulators concern. The differences are measured taking account of just about all the borrower characteristics we can measure—loan amount, credit scores, income, whether borrowers were counseled, by whom, metropolitan area incomes, borrower race, and more. Borrower education, taking account of other factors, is unrelated to differences in default likelihoods. The education differential is measured with high precision (the effect is five to seven times its standard error, depending on which measurement) and is within \$100 (without State effects) of that found by Woodward (2003). This result is not a fluke, but something very systematic in the functioning of our mortgage markets.

Borrower Race. There are measurable differences in the loan charges to borrowers of different races in the FHA data. Looking at only the non-subsidized loans, the differences can be approached in several different ways. First, the easiest is to compare the averages of the different population. On average, African-American borrowers are charged \$756 more (\$3,671) and Latinos are charged \$1,043 more (\$3,958) than non-minority borrowers (\$2,915) in this sample. A simple comparison of the means could be misleading. Minorities tend to have smaller loans, which would reduce their charges, but worse credit, which would increase them. Consider also State effects, which have an especially large impact on the measured differential for Latino borrowers because Latinos tend to live in the States with the most expensive lending. The estimates taking all characteristics into account will give a more accurate measure of how differently groups are treated. Thus, when measuring the race differential, it is desirable to control for borrower and loan characteristics by treating race as a categorical variable in a regression equation. The race differential is then the regression coefficient on the race categorical variable, which is an additional \$563 for African-Americans and \$489 for Latinos.

***Differences by Race: all non-subsidized loans***  
***(from Table 5-3a, Urban Institute 2008)***

<i>Measure of Race Difference</i>	<i>African- American</i>	<i>Latino</i>
Difference in simple means	+\$756	+\$1,043
Regression coefficient	+\$563	+\$489
Actual minus forecast	<b>+\$414</b>	<b>+\$365</b>

The last assessment of race differences does something different: it measures how loan costs are related to borrower characteristics using only non-minority borrowers, and then asks

what the minority borrowers would have been charged using this set of parameters. These measurements include neighborhood-level race effects because non-minority borrowers sometimes live in neighborhoods with minority residents. These are the last figures in the table above. They indicate that African-American and Latino borrowers would have been charged, respectively, \$414 and \$365 more than white borrowers if the same standards applied to whites had been applied to them. All of these measurements are done using only the non-subsidized loans.

Loan Counseling. Loan counseling does help borrowers. Counseling data identifies borrowers who were counseled by their lenders, counseled by third parties, declined counseling, and those for whom data was lacking. The only group that stood out as different from the others was the group that received third-party counseling, who saved \$306 taking into account loan and borrower characteristics. The savings indicated, combined with the low frequency of third-party counseling (there were only 101 non-subsidized loans), suggests that additional investigation is in order before dismissing the value of counseling. Again, these measurements were done using only the non-subsidized loans above 7 percent.

**Are there differences in originator charges by State?** If the differences across States were just random noise, among 50 States only one or two would be more than two standard errors from the average. Instead, after taking account of the variety of borrower and loan characteristics, there are many States whose average costs to borrowers are outside of two standard errors. The lowest-cost State is Alaska, and the highest is Nevada. High property values (and larger loans) do not explain why Nevada is the highest cost state: these differentials are measured taking property values into account. The source of these differentials is not clear. One possibility is state law. A categorical variable controlling for the eight states where a mortgage loan is a nonrecourse loan shows that such a legal regime the cost to consumers by \$550 per \$100,000 of loan amount. This does not explain why borrowers in Nevada, Michigan, and Utah pay a premium of \$2,500.

#### **IV.E.4. Sources of Potential Savings in a Competitive Market**

One question that arises is where the savings in yield spread premiums and direct origination fees comes from if this industry is, in fact, competitive. This brings up the issue of how the conditions in the loan origination market might differ from the classic conditions of perfect competition and allow for these savings.

On the demand side, borrowers do not have perfect information. Most borrowers are not professional loan applicants. It would be so costly to obtain perfect information relative to its expected benefits that virtually no applicants would obtain it. But, most loan originators are professionals in their field and typically do have excellent information at their fingertips. Loan prices offered by originators to borrowers are often the result of one-on-one negotiations and every borrower need not pay the same. Borrowers with poor information facing loan originators who are willing to exploit the borrowers' poor information may well be offered and accept loans with higher prices. So asymmetric information may lead to some borrowers paying higher prices for their loans than other borrowers do for loans that are otherwise identical, even if there are a large number of loan originators and low barriers to entry.

But even if there were not uniform pricing, it would seem that there would still be entry until economic profit were zero, that is, only normal profit would exist. We would expect entry would eliminate economic profit in the long run.

Another potential explanation is that all resources may not be equally productive. Take the salesperson, the person who is the loan originator, for example. Some might be better than others in getting the borrower to accept more costly loans that result in higher revenue for the firm originating the loan. But that skill may be easily identified as the salesperson's and the salesperson may recognize this and look for better pay. The owners of the loan origination firms might recognize this as well and be willing to pay more for it. Thus, the market forces might lead to higher pay to the owners of this more effective resource. Labor market competition will eventually lead to the superior salesperson capturing the market value of this skill rather than the owner of the firm retaining it as profit. And without profit, there is no incentive for new firms to enter the industry. And to the extent that this skill is innate, potential new entrants with this skill are limited and the return to this special skill can persist in long run equilibrium. The higher prices borrowers pay and the higher compensation paid to more effective employees can persist in long run equilibrium.

A variation on this theme is the superior skill that the manager of the loan origination firm may have. The manager might enhance the ability of all the loan originators who work there to get borrowers to agree to higher-priced loans. But the same rationale that applied above would apply here and the manager would capture the value of that skill rather than the owner of the firm. It would generate higher labor compensation rather than higher profit. Borrowers could pay different prices with some of them paying high prices, but the firms would earn zero economic profit in the long run.

What if this superior manager were also the owner of the firm? Would this lead to the firm earning positive economic profit? No. The owner could use this skill as the manager of somebody else's firm and earn higher wages there. This skill would warrant higher pay regardless of which firm utilized it. Analytically, its use by the owner in the owner's own firm has a opportunity cost equal to its value in the market. Thus, this skill's value is reflected in the opportunity cost of its use rather than as economic profit going to the owner. As before, this higher return goes to the resource's owner as a cost to the firm and does not generate economic profit that stimulates entry. But the owner has a choice. The owner could elect to keep the firm's books in such a way that this return is recorded as accounting profit rather than wages. If so, the firm could have high accounting profit and earn that in the long run. But there is no economic profit that results from this accounting choice, and therefore no entry would result. If the superior manager skill is innate or difficult to replicate, all this could persist in the long run.

The poorly informed borrower might well accept a higher-price loan. Firms could react to these opportunities by expending resources in the attempt to make these borrowers the firms' profitable customers. These marketing expenses will be incurred until, at the margin, the costs of obtaining these borrowers equal the additional revenue to be obtained. Firms will enter until the expected profit of entry is zero, but this could exist with the firms still expending marketing dollars to obtain the poorly informed,- more profitable borrowers.

How does all this fit into the effect of the new RESPA rule? All of these profitable scenarios rely on the borrower being poorly informed. The new rule and its new GFE are designed to give the borrower better information. This better information will reduce the extent to which borrowers will accept higher prices in the market for loans. So the first effect is on demand.

The superior salesperson will face less of an opportunity to charge higher prices. Attempts to do so will result in less success than before. Prices will fall and the return to the superior resource will fall. The salesperson will earn less money per loan but could wind up originating the same number of loans. The profit of the loan origination firm will be unaffected by this. In the long run, it will earn zero economic profit.

The manager of the firm who enhances the ability of the salespeople he manages faces the same fate. His compensation will fall but the profit of the firm will be unaffected in the long run. The owner who is the manager faces the same fate as well. And the long run effect will be no change in the zero economic profit the firm earns. But there may be a drop in accounting profit if the owner had foregone higher wages and recorded the higher return as accounting profit. Once the higher wages disappear, the accounting profit will fall.

In the case where the higher marketing expenses were incurred to capture the more poorly informed borrowers who would accept higher prices, the reduction in the borrowers' willingness to accept higher offers will result in lower expenditures to capture these borrowers. Fewer resources will be expended to pursue these borrowers because they will not be worth as much as they used to be.

Thus, the savings mentioned in connection with this rule come at least in part from the higher returns earned by those who excel in getting borrowers to agree to higher prices. That return is currently going as economic rent to those who possess and exercise those skills, not as economic profit to the owners of loan origination firms. They could also result from lower marketing expenses aimed at those poorly informed borrowers who are more likely to accept higher prices, capturing poorly informed borrowers. Both these can serve as sources of savings, even in a market in long run equilibrium where firms earn zero economic profit. And we would expect that both of these to be sources of savings to be tapped as borrower information improves and the prices paid by those who formerly had been poorly informed fall.

## **V. Title and Settlement Services: Background Analysis and New Studies**

Chapter 3 discusses features of the proposed rule that are intended to reduce consumer costs of third-party settlement services. Some of the commenters on the 2002 proposed rule raised questions about whether HUD's proposals, particularly packaging, would lead to any reduction in the fees charged by third-party settlement service providers. According to these commenters, there is no evidence of "fat" (excess fees) in the system; or if there were any reduction in third-party fees, lenders would not pass the reduced costs through to consumers. In addition, these same commenters predicted that large providers of third-party services (e.g., settlement agents and independent title insurance agents) would replace small providers of these services, thus reducing options available to consumers.

This section provides background analysis of issues concerning third-party services and reports the results of some new empirical analyses of title and settlement fees by the Urban Institute and HUD. These latter studies are important because to date there has been little hard, statistical evidence on title fees. Most information on the title industry was through anecdotes, court cases, industrial organization studies, and a few small surveys. Now more comprehensive data are available from the Urban Institute and HUD.

**Organization of Section.** The remainder of this introductory section provides a brief discussion of consumer shopping for title and third-party services. Subsection V.A provides an extensive literature review of the title industry. Subsection V.B examines whether title fees can be reduced -- most observers believe that third-party fees are too high and can be reduced. This section reports findings from a major HUD-sponsored study of title fees by the Urban Institute. Subsection V.C examines the question of whether lenders will pass through any fee reductions to consumers -- there is substantial evidence that competition will ensure that any cost reductions will be passed through to consumers, rather than retained by lenders. As discussed in Chapter 3, the proposed rule includes many provisions that assist in bringing about savings in third-party costs. In addition, the increased ability of consumers to shop under the new GFE, combined with the competitive nature of mortgage lenders, will ensure that any cost savings are passed through to consumers.

**Consumer Shopping for Title, Settlement, and Other Third-Party Services.** In their comments on the proposed rule, ALTA noted that title agents typically market their services directly to consumers, as well as to real estate brokers, builders, and lenders. There is much evidence that homebuyers rely on their real estate agent for recommendations of third-party providers (e.g., closing agents) as well as lenders. Chapter 3 makes the argument that consumers may not be the best shoppers for third-party providers, and that one of the potential savings from the limited tolerances and discounting provisions of the GFE is that lenders (with more expertise than consumers) will be encouraged to shop for third-party services and drive down the prices for consumers. These provisions of the proposed rule will encourage competition among third-party settlement services providers, leading to lower costs for these services.

There are other problems with today's methods for delivering third-party services, in addition to lack of consumer expertise in this arena. These problems were identified by FTC staff, who examined the issue of consumer shopping for third-party settlement services (for their insights into consumer shopping for lender services, see subsection IV.D.5). As noted above, consumers may directly shop for settlement services or may rely on recommendations from the real estate broker (in the case of a home purchase) or the broker/lender (in the case of a refinance as well as a home purchase). The following quote (a continuation of the earlier quote in subsection IV.D.5) from the FTC staff highlights issues when the consumer relies on referrals in today's market:

Borrowers must also purchase various settlement services, such as appraisal, title search, and title insurance, to obtain a mortgage. It can, therefore, be time consuming and costly for borrowers to search for all features of a mortgage transaction, including all aspects of the loan and settlement services. Some borrowers may do so; others may choose to rely on referrals, for example, from their loan originator for settlement services. Originators, however, may not always have strong incentives to refer

borrowers to low-cost settlement providers. Savvy borrowers may ask for information about settlement service costs when contacting potential originators and may consider these costs when they select a lender, but other borrowers may not. In addition, settlement services are likely not the primary products for which borrowers search. Rather, borrowers may devote more search time to a loan, which itself may be a secondary consideration if the borrower is also searching for a home to purchase. (page 11)

Thus, one concern is that there may not be any incentive for the referring party (e.g., the loan originator) to direct the consumer to the lowest cost provider, and because settlement services may be a secondary consideration to the consumer (rather than the primary one of buying a home), the consumer may not closely monitor settlement costs, much less engage in some intensive search for them. As the FTC staff note, consumers may not obtain low-cost settlement services:

Settlement service providers can, of course, also compete to attract consumers. But, to the extent that some borrowers rely on referrals from lenders and those referrals do not depend mainly on price, inefficient producers of services may survive if they are able to attract referrals, thorough other means. As a result, borrowers may not necessarily obtain low-cost services, and the current situation may not be fully efficient. (page 11)

In his comments on HUD's 2002 proposed rule, Jack Guttentag echoed similar sentiments when he stated:<sup>68</sup>

Under existing arrangements, competition in the markets for settlement services is "perverse" -- it tends to drive up prices, or prevent them from falling in response to deployment of more efficient technology. Perverse competition arises when one party selects the seller of the service and another party pays for it. (page 9)

In the case of "perverse competition", the loan originator selects the settlement service provider but the consumer pays for the service. In this situation, according to Guttentag, the settlement service providers compete for the favor of the loan originator, rather than competing for customers (i.e., consumers) by lowering prices.

As explained in Chapter 3, the limited tolerances and discounting provisions under the enhanced GFE are intended to improve on today's current practices where consumers rely on referrals that may or may not be in their best interests.

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<sup>68</sup> Jack Guttentag, "HUD's Proposals For RESPA Reform," submitted to Rules Docket Clerk at HUD, regarding Proposed Rule on *Real Estate Settlement Procedures Act (RESPA): Simplifying and Improving the Process of Obtaining Mortgages to Reduce Settlement Costs to Consumers*; Docket No. FR-4727-P-01; (July 29, 2002), October 18, 2002.

## V.A. Literature Review of Market Issues in the Title Industry

**Introduction.** With exception to the discussion of Eaton and Eaton (2007), This literature review was written for HUD by Bob Feinberg of American University. While there is some overlap with the earlier background discussion of the title industry, it was decided to present this literature review in its entirety since it focuses on important market issues.

This section discusses recent research on the workings of the U.S. market for title services; this market includes both title insurers and title agents, as well as closing (settlement) and escrow service providers. The exact role of each of these participants varies from state to state and even by metropolitan area within states, however the basic structure of the services provided remains the same. The economic importance of title costs is shown by the fact that they account for almost 73 percent of the third-party fees included in this analysis. In addition, as reported in GAO (2007), they account for almost thirty percent of total loan origination and closing fees on a typical real estate transaction (though a much smaller percentage of all closing costs, including real estate broker commissions and escrow payments).

These services involve searching the history of legal and tax documents pertaining to the real estate in question (the title search), evaluating the likelihood of “defects” in the title (e.g., liens against the property), arranging for a title insurance policy to be written (either on the value of the mortgage – a lender’s policy – or on the total value of the property (with the possibility of this covering appreciation as well), and providing the actual insurance.<sup>69</sup> Beyond this, as discussed by Lipshutz (1994, p. 7), “[t]he expense component of title insurance is expanded even further by the fact that the title insurer is frequently also responsible for the closing of the real estate transaction, a responsibility that encompasses correction of any really serious title problems prior to closing; drafting , or at least collecting, all the relevant documents, including deeds and mortgages; maintaining the escrow account; conducting the settlement itself; and recording the documents establishing the new ownership, releasing the mortgage liens of lenders who have been repaid, and recording the lien interests of the new lenders.”

The title search itself traditionally involved a time-consuming investigation through documents at a county courthouse, but larger title insurers and agents developed and “maintained their own title plants – a physical housing of title-related documents. Over the past few decades, title plants have become, to a large extent, computerized and title insurers have merged title plants into joint title plants. These joint title plants provide access to other title insurers and underwritten title companies – non-owners – for a subscription fee. Title plant information comes from individual counties as the title-related information – such as property sales, liens, and tax information – is filed initially within the county (Birnbaum 2005, p. 12).” The 2007 GAO report details considerable variation across states in methods (and efficiency) of title searching: in New York, title agents send employees to various county offices to conduct document searches manually and a “typical title insurance issuance took 90 to 120 days for a purchase and 30 to 45 days for a refinance”; in contrast, for an automated title plant in Texas,

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<sup>69</sup>Lipshutz ( 1994, p. 1) states: “Title insurance is unique in that it is insurance against ignorance of the past, that is, whether some unknown past event has clouded the ownership interest or lien interest in a parcel of real property that the insured believes to exist when the title insurance policy is issued.”

“typical turnaround time for a completed title search, examination , and commitment for a title examiner simultaneously working on several titles was 2 to 3 days” (p. 17).

The rationale generally provided by the industry for premiums far in excess of losses is that title search is costly, both in fixed (maintenance of title plants) and variable (labor expenses, primarily) costs.<sup>70</sup> Title insurers argue that it is this extensive search which keeps losses low. Of course, there is a classic principal-agent problem here in that the ultimate purchaser of title insurance has no idea how much search is really required to bring expected losses to a reasonable level and must rely on the title agent to do the optimal amount of search.<sup>71</sup> While Baker et al (2002, p. 148) state that “...title insurers have a strong interest in ensuring that the search is optimal,” they give no explanation for why title insurers’ interests would be the same as society’s. They find (on p. 153), in a cross-state analysis, that a higher risk of defects is a determinant of longer – and presumably more expensive search – and interpret this as consistent with efficient search. But their empirical proxy for this higher defect risk is simply the average title insurance premium in a state. So, the finding of a positive partial correlation between premium and search can be interpreted in a more cynical way as suggesting that the title industry simply uses more search as a justification for higher rates.

**Structure of fees.** Title insurance fees vary considerably across states. Lewis (2006) reports – based on a 2005 Bankrate.com survey of closing costs on a \$180,000 loan to urban buyers -- that these costs ranged from \$439 in North Carolina to \$1451 in New York. However, in discussing title insurance fees, there are several factors which make comparisons difficult. The first is that the services covered by a title insurance premium may differ from state to state – in some covering title search by an agent (and possibly additional paperwork and settlement expenses), while in others only the actual insurance is covered and separate charges are made by the title agent for the title search.<sup>72</sup> A second is that different rates apply to owners (covering buyers on the value of the property as long as they own the particular property) and lenders policies (covering lenders up to the value of the loan only until the loan is paid off, either through sale of the property or refinancing). Finally, there are also generally discounts available (though -- as noted below – not always offered to homeowners), “reissue rates,” on refinancings.

Birnbaum (2005, p. 17) reports: “The bulk of the title insurance premium goes to expenses as opposed to claim payments. A.M. Best reports that title insurers paid an average of 4.6% of premium for claims and claim settlement expenses from 1995 to 2004 compared to around 80% for the property casualty industry.

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<sup>70</sup> The 2006 GAO report (2006, p. 3) notes that “the amount of premium paid to or retained by title agents, generally to pay for title search and examination costs and agents’ commissions, accounted for approximately 71 percent of title insurers’ total premiums written in 2004.”

<sup>71</sup> In fact, GAO (2007) reports that title insurers themselves do little analysis of actual costs incurred by agents and that the percentage of premium retained by agents was negotiated based on a variety of factors but not generally the agent’s actual costs.

<sup>72</sup> Lewis (2006) attributes this explanation to James Maher, executive vice president of ALTA. Indicative of a lack of cost basis for title insurance rates is the discussion in GAO (2007; p. 39) reporting that insurers “generally share the same percentage of the premium with their agents, around 80 to 90 percent, regardless of whether those agents were in states where consumers were to pay for agents’ search and examination services within the premium rate ... or whether they were in states where agents can charge consumers separately for these services....”

The title insurance premium is split between the title insurance company and the underwritten title company, when an underwritten title company is involved in the title transaction. The typical premium split in California is 8% to 12% for the title insurer and 92% to 88% for the underwritten title company ...[comparable to a title agency in other states]... The percentage of gross title premium retained by title insurers in California – a bit less than 10% on average – is much less than the percentage retained by the same title insurers in other states.”<sup>73</sup>

Commission rates (or split of premiums between title insurers and agents) are generally unregulated and simply reflect negotiations between insurer and agent. Exceptions are Florida, New Mexico, Texas, Connecticut and South Carolina (Lipshutz 1994, p. 38). The agent can be an employee, an affiliated agency, or an independent agent. According to Lipshutz (1994, pp. 35-36), more than half of all title insurance premiums are written by independent agents; the agent often does more than just marketing, and serves an underwriting function (producing “a fully examined and insurable title”). Even on the marketing side, the agent’s efforts are directed not to ultimate consumers but to local real estate professionals. “... customer loyalty runs primarily to the producer, not the insuring company as such, and so competition among insurers for established producers is intense. In some cases, established title producers can be induced to become employees of an insurer branch office. But many very effective producers prefer to conduct business as independent agents, and in the competition to attract these agents, the primary competitive tool is the commission rate. As institutional loyalties throughout the economy have eroded, switching among insurers by agents has become more common and has led to the perception that prevailing commission rates have crept upward.”

**Rate determination.** Fay (2005) provides a summary of the current mechanisms of regulation of title insurance rates, which varies considerably from state to state. There are 36 “file and use” states, in which title insurers must file rates with the state regulatory body (and often wait for a short time – often 15-30 days – for either regulatory approval or lack of objections) before using them. Insurers in Alaska, Arizona, Nevada, New Jersey, New York, Oregon, and Pennsylvania can avoid separately filing by joining a licensed rating bureau. Three states (Florida, New Mexico, and Texas) directly promulgate rates for insurers within their jurisdictions. Three others (Hawaii, Vermont, and Wisconsin) ask insurers to file or make rates available for inspection, but do not require them to wait for approval. Iowa does not allow the sale of title insurance. The remaining states have no rate filing requirements for title insurers.

Roussel and Rosenberg (1981), an article written by two lawyers with strong ties to the title insurance industry, is essentially a defense of title insurance price-fixing via rating bureaus. They state (p. 646) “[t]itle insurance rating bureaus at present provide rate computation for all of their members, based upon consolidated industry data.” Lipshutz (1994, p. 53) notes that the dominant price scheme in the 1972-1985 period was the rating bureau mechanism – voluntary associations of title insurers to file joint rates for members in “file and use” states -- but that this largely ceased in 1985 due to an FTC antitrust complaint (which argued that the McCarran-Ferguson exemption did not protect them). Nyce and Boyer (1998, p. 227) discuss the case -- “[o]n June 12, 1992, in *FTC vs. Ticor Title Insurance Co. et al.*, the U.S. Supreme Court sided with the FTC in finding that rate bureaus were guilty of horizontal price fixing for title searches

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<sup>73</sup> Lipshutz (1994, p. 37) gives an estimate of 80% for the average agent commission.

and examinations.” While the decision provided some guidance on how rate bureaus could be reformed – essentially, to make them less industry cartel and more directly state regulated – they have become less important since the decision (though they remain in the seven states mentioned above).

Birnbaum (2005, p. 15) explains that in California, “[t]he price a consumer pays for title insurance is based on rates filed by title insurers with the California Department of Insurance. Rates for title insurance are typically a function of the amount of liability. The liability is the amount of coverage, which is the amount of the loan for the lender’s policy and the purchase price of the house for the owner’s policy. The filed title insurance rates typically do not vary within the state. However, because title rates are a function of sales price or loan amount, the average title premium varies considerably by county.

Similarly, Arrunada (2002, p. 9) states: “Premiums differ substantially across states. They usually increase in a lower proportion than the amount insured. According to a 1997 survey, for a property valued at 50,000 US dollars, the owner’s policy costs on average 3.55 per thousand, but this falls to 2.44 per thousand for properties valued at one million dollars. These premiums do not include the costs of search (estimated between \$192.72 and \$519.03), closing services and document preparation.”

Roussel and Rosenberg (1981, p. 645) agree on the basic pattern of pricing: “...the cost of production of a policy does not vary consistently with the exposure for loss; the same cost may be incurred on a policy for a \$1,000,000 industrial project and a \$50,000 single-family residence. However, the single most important variable in the price of a title insurance policy is its face amount: the typical price structure is ‘x’ dollars per thousand dollars of coverage. Because of the relatively constant cost of production, the result is a substantial cross-subsidization of purchasers of small, single-family, residential policies by purchasers of large facilities, typically commercial, industrial, or large residential developments.<sup>74</sup> The 2007 GAO report notes (p. 34) disagreement among industry officials and state regulators as to whether this subsidization was intentional or not.

**Price Discrimination by Title Service Providers.** Price discrimination is defined by economists as pricing differences to different consumers not justified by cost differences. The discussion above makes clear the systematic price discrimination present in the industry. As both title insurance premiums and escrow fees generally rise with loan value (while costs, if they rise at all, do so only modestly), owners of higher-valued properties are discriminated against relative to owners of lower-valued properties.<sup>75</sup> Whatever one may think of the equity (fairness)

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<sup>74</sup> Lipschutz (1994, p. 50) agrees this pricing pattern results in a cross-subsidization for small consumers (as “cost per transaction was not strongly dependent on the amount of liability insured”). Birnbaum (2005, p. 22) notes that (for California at least) “[l]ike title insurance rates, escrow fees vary by the size of the transaction. Unlike title insurance rates, escrow fees also vary by county.”

<sup>75</sup> Woodward (2003b), however, in an econometric study of the determinants of title insurance fees fails to find this relationship; while these fees do increase with loan value, the effect is not statistically significant once other factors – in particular yield spread premiums on the loan – are included. This is a puzzling result which deserves further exploration, considering that the monotonic relationship between title fees and loan size is accepted as truth by virtually all who have written on the industry.

aspects of this price discrimination, it does strongly suggest an element of market power present in the market (this is discussed in more detail below).

In addition there are less systematic aspects of price discrimination present as well in favor of better informed consumers. Reissue rates with discounts of 50% or more (Harney 2002) on refinancing transactions are not always offered to consumers – those who ask get them.<sup>76</sup> But given the limited title searching required on refinancings, it is likely that the costs associated with these policies fall by much more than the premiums, implying price discrimination against refinancers (despite the discounts). Similarly purchasers of properties recently sold would seem to be discriminated against given the limited amount of search required to find title defects since the previous sale.

Both the Woodward (2003a) and Courchane et al (2004) papers deal with broker fees and yield-spread premiums, with no separate discussion of title services and fees. But they do both suggest that homebuyers can be segmented into types by degree of sophistication and that this translates into different fees paid. From the perspective of title fees, this strongly supports the ability to price discriminate by title insurers and agents as well.

**Reverse Competition, Referral Fees, and Controlled Businesses.** A feature of the market for title services which is often the focus of discussion is “reverse competition.” Birnbaum (2005, p. 2) describes the basics well:

“Title insurance and escrow markets are characterized by reverse competition where the marketing of the products is directed at the real estate agents, mortgage brokers and lenders who steer and direct the home purchaser or borrower – the consumer who actually pays for title and escrow services – to particular title insurers, underwritten title companies and escrow companies. Residential consumers have little, if any, market power because title insurance and escrow services are required for the closing of a real estate transaction, resulting in inelastic demand. In a reverse competitive market, expenses are inflated as title insurers compete for the producers of title business – the real estate agents, mortgage brokers and lenders and others involved in real estate settlements.”

However, Birnbaum (2005, p. 33), goes on to refer to a 1980 Peat Marwick study for HUD: “Peat Marwick’s study found that ‘the combination of reverse competition and prices set by historical and customary practices has led to excess revenues which either are used to obtain referrals or contribute to underwriter profit.’ The study also concluded that excess profits may not accrue to title insurers, but rather to the producers of the title business. The underwriter may be forced to bid away the excess profits to acquire the business from the real estate settlement entity.”

Referral fees (otherwise known as kickbacks, rebates, bribes) result, despite being illegal under RESPA, section 8. However, enforcement of RESPA has led to the growth of “controlled

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<sup>76</sup> Harney (2002, p. H1) quotes James R. Maher, executive vice president of ALTA acknowledging that the association is “aware that not all of our members disclose” the possibility of these reissue discounts.

businesses” or what the 2007 GAO report refers to as “affiliated business arrangements” (ABAs); Owen and Grundfest (1977, p. 943) noted that the potential for collusive profits combined with anti-rebate laws have prompted entry by these “controlled firms” – title insurers and/or title agencies owned by real estate brokerages (and sometimes lenders).

ALTA’s 1979 paper, *The Controlled Business Problem in the Title Insurance Industry*, argues, referring to controlled title insurance agencies as ones owned or affiliated with a broker or lender, that a controlled title insurance agency faces little competition and therefore is unlikely to worry about keeping prices low. They also note that these arrangements create entry barriers for new title insurance service providers into the market.

Lipshutz (1994) has a concise discussion of the relevant issues. Referring to Owen and Grundfest (1977), he states (p. 68) that it can be argued “the payment of kickbacks [or referral fees] is an efficient way to market, the profits earned through kickback mechanisms are applied by the kickback recipient to reduce the prices it charges for its other services, and any misbehavior on the part of the kickback recipient is forestalled by the recipient’s regard for its business reputation.” And, when in response to RESPA, real estate businesses have opened title insurance agencies – controlled businesses -- Lipshutz reports (p. 66) that some argue [referring here to White (1984)] “the profits earned on title insurance agency business are used to subsidize the cost of the other real estate activities of the controlled business agent, and thus reduce the price for other services related to real estate transfer, if not the title insurance rate itself.”

However, Lipshutz (p. 66) goes on to note that others “maintain that controlled business agents extract monopoly rents from their control of customers by charging a higher than necessary commission, or by extorting special concessions from their insurer. With respect to ultimate consumers, they maintain that controlled business agents exploit their monopoly of information by failing to alert purchasers to the existence of lower title insurance rates offered by insurers for whom they do not act as agents, or even from their active insurer through available discounts for special conditions...”

But the latter point is important. It is only because of monopoly power in related services, especially by brokers that these rebates or referral fees are not translated into lower prices to consumers. White (1984, p. 313) claims that even successful enforcement of Section 8 simply reallocates rents between the various real estate service providers with no change in the price of title insurance to homebuyers. “Instead, the title insurers would keep a larger share of the potential profits that the large price-cost margins promised; referrers would receive less.”

Furthermore, he claims that if there was competition among the referrers of business to title insurers (brokers, lenders, lawyers), the ability to get referral fees (reverse competition), by lowering their cost, would push them to lower prices on their services to consumers. Even without price competition among these providers, they might still compete on non-price measures to the benefit of consumers. Sec. 8 of RESPA limits this and thus likely makes consumers worse off. With respect to controlled businesses, White (pp. 317-318) sees these as a 2<sup>nd</sup>-best response to Section 8 of RESPA. Controlled businesses will still need to compete (either in price or non-price ways) to attract consumers, though he does acknowledge that there may be inefficiencies in combining the various providers into a single entity.

More recently, Martin and Ludwick (2006) conclude that title agents within ABAs do not charge higher fees to consumers than those who are independent. Nevertheless, the 2007 GAO report finds (p. 33) that “the concerns expressed by regulators and some industry participants over ABAs raise questions about the potential effects of some ABAs on consumers.”

**Recent Developments Involving Allegations of Title Insurance Kickbacks and Captive Reinsurance Arrangements.** The 2006 GAO report (p. 14) discusses state and federal investigations of these activities, in particular the practice of captive reinsurance deals. “In such arrangements, a home-builder, real estate broker, lender, title insurance company, or some combination of these entities forms a reinsurance company that works in conjunction with a title insurer. The title insurer agrees to “reinsure” all or part of its business with the reinsurer by paying the company a portion of the premium ... for each title transaction.” Given the minimal level of risk involved in title insurance, with less than 5% of premiums going to pay losses on average, regulators have questioned the need for reinsurance.<sup>77</sup>

That same report (on pp. 14-16) describes recent settlements involving HUD as well as cases brought by state insurance regulators in California, New York, and Colorado. It describes the “typical fraudulent business arrangement” as one involving “a shell title agency that is set up by a title agent but that generally has no physical location, employees, or assets, and does not actually perform title and settlement business. In cases we examined, regulators alleged their primary purpose is to serve as a vehicle to provide kickbacks by being a pass-through for payments or preferential treatment given by the title agent to real estate agents and brokers, home-builders, attorneys, or mortgage brokers for business referrals. Investigations have alleged that the arrangements in these cases violate RESPA (p. 15).”

One example of a recent settlement involves two leading title insurers – Fidelity National Financial and First American – who each agreed to pay \$2 million and reduce rates by 15 percent. New York Attorney General Eliot Spitzer claimed “the insurers drove up rates for homeowners by providing developers free or discounted insurance in other states in exchange for client referrals in New York (Washington Post, 2006, p. D-2).”

The 2007 GAO report identifies “13 [state and HUD] investigations [from 2003 to 2006] involving 37 entities that were related to captive reinsurance arrangements, with 1 multistate settlement agreement involving activities in 26 states” (p. 30). “On the basis of details provided in a multistate settlement, insurers were allegedly giving away [to reinsurers] as much as one-third or more of the premiums consumers paid in order to obtain consumer referrals” suggesting to state regulators that these ABAs led to consumers being overcharged relative to competitive levels (p. 31).

**The Nature of Competition in the Market.** Birnbaum (2005) is a recent discussion of competition in the California title services industry. Using a traditional framework from the field of Industrial Organization – looking at the structure, conduct and performance of the market – he finds that there is not “a reasonable degree of competition” in the markets for title insurance and

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<sup>77</sup> Erin Toll, a deputy commissioner at the Colorado Division of Insurance, testified before the House Financial Services Subcommittee on Housing and Community Opportunity on April 26, 2006 that “there is no financial necessity to reinsure in a residential, single-family dwelling – there’s absolutely none.”

escrow services in California. The focus of the discussion below is on the aspects of this study of broader relevance nationally. There has been criticism of the Birnbaum report by other economists retained by the title industry, and these views will be considered as well.<sup>78</sup>

First, consider market structure. Birnbaum (p. 72) reports “significant consolidation and growth in concentration in the title insurance industry on a countrywide basis and in California. The American Land Title Association web site lists 46 mergers or acquisitions of title insurance companies that appears to cover the period 1987 through 1999. Between 1986 and 1991, three of the seven largest title insurers were acquired by two of the remaining four. Chicago Title acquired Safeco Title and Ticor Title and Commonwealth Land Title acquired Transamerica Title (now Transnation Title). ...The top three title insurers in 2003 wrote 72.5% of the market, up from 53% in 1996 and the top five title insurers in 2003 wrote over 90% of the market compared to 74% in 1996.”<sup>79</sup>

Stangle and Strombom (2006), in a report prepared for the First American Title Insurance Company, acknowledge consolidation in the industry but note (p. 3) that “there is no necessary connection between the number of firms and price competition.”

Another important consideration in judging competition, from a market structure perspective, is the role of entry barriers. Three possibilities considered by Birnbaum are: (1) fixed costs of maintaining title plants; (2) the monoline nature of title insurance; and (3) availability of skilled personnel. At least in larger local markets in California Birnbaum finds (pp. 67-68) that “title insurers and underwritten title companies that do not own their own title plant can gain access to joint plants for a relatively small fee. In 2004, underwritten title companies reported title plant rent and maintenance expenses of about 5% of gross title premium” and thus do “not represent a significant fixed cost for underwritten title companies or title insurers.”<sup>80</sup>

However, Birnbaum (p. 66) states that “[t]he fact that title insurance is a monoline product means that other property casualty insurers cannot enter the title insurance market without first creating a new title insurance company. And while creating a new title insurer and obtaining a license to do business is not impossible, it is not a trivial undertaking. It requires millions of dollars in capital and a detailed application and approval process. In other property

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<sup>78</sup> For example, Vistnes (2006), critiquing the study on behalf of the California Land Title Association, rejects the analyses in the Birnbaum report.

<sup>79</sup> GAO (2007) provides similar figures for 2005 and points out that concentration is even higher than this in individual states, with two or three insurers generally dominant.

<sup>80</sup> Nyce and Boyer (1998, p. 228) do suggest that requiring title plants may be a barrier to entry. They present some data suggesting that in states not requiring title plants (15 states) there are more title insurers, and a lower Herfindahl index (a measure of market concentration) -- even after controlling for differences in state size. They do, however, expect that technology will lessen this barrier.

and casualty lines of insurance, an existing insurer licensed to sell insurance in one line can enter another line of insurance without a new insurance company application and approval.”<sup>81</sup>

Finally, while Birnbaum concludes (p. 69) that the available pool of skilled personnel to perform title searches and escrow services is sufficient, “the availability of established relationships to the referrers of title insurance business is a barrier to entry. Because of reverse competition in the California title insurance and escrow markets, existing firms with established relationships to the referrers of title insurance business have a significant competitive advantage over new entrants who do not possess such relationships. In our view, that is why the new entrants are either acquiring existing firms with such relationships and controlled business arrangements owned, in whole or in part, by the referrer of title insurance and escrow business.”<sup>82</sup>

Adding to the market power of title insurers, according to Birnbaum (p. 69) is that “[t]here are no substitutes for title insurance. . . . Lenders require assurance of title before agreeing to make a loan and, in 49 states and the District of Columbia, the only acceptable method of providing title assurance is title insurance.” Furthermore, Birnbaum notes (p. 70) – as many others have as well – that “[c]onsumer demand for title and escrow services is inelastic, meaning that changes in the price for title insurance and escrow services have very little or no effect on the amount of these products purchased. . . the demand for title insurance and escrow services is derived from the demand for real estate purchases and real estate loans. The cost of title insurance and escrow services is relatively small in comparison to the size of the underlying real estate or loan transaction and are often financed as part of the larger transaction or paid for by another party to the transaction. Even though the cost of title insurance and escrow may be thousands of dollars, a consumer – who generally has little knowledge of title insurance and escrow because he or she infrequently uses the services – is unlikely to stop a real estate or loan closing because of concerns about the cost of title or escrow.”<sup>83</sup>

On the last point, White (1984, p. 312) notes that it is standard to assume that consumers are unfamiliar with title insurance and will just rely on recommendations from other professionals, so that title insurers cannot compete directly for business from home buyers. “This reluctance to approach consumers directly is quite consistent with the insurers’ reluctance to compete on the basis of price. There have been sporadic instances of title insurers approaching consumers directly, but these have been the exception rather than the rule. We would expect a more competitive industry to advertise in the real estate sections of newspapers, along the lines

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<sup>81</sup> Jaffee (2006) does suggest that there may be efficiencies associated with the monoline insurance requirement.

<sup>82</sup> Nyce and Boyer (1998, pp. 230-231) agree that controlled business arrangements may discourage new entry by requiring partnerships with existing producers of business (affiliations short of ownership raise same issue).

<sup>83</sup> In a similar vein, the 2006 GAO report (pp. 10-11) states that “while consumers are the ones paying for title insurance, they generally do not know how to ‘shop around’ for the best deal, and may not even know that they can. Meanwhile, the potential exists for real estate or mortgage professionals to recommend – not the least expensive or most reputable title insurer or agent – but the one that is most closely aligned with the professional’s best interest.”

of ‘To protect your home and to get the best price, insist on XYZ title insurance when you buy your home.’ Even in states in which regulation makes price competition impossible, one would expect to see ads along the lines of ‘For the best way to protect your home, insist on XYZ title insurance when you buy your home.’ Normal homeowner’s insurance is sold in this manner, despite the fact that it too is a complicated instrument. One suspects that adequate advertising by title insurers could go a long way toward educating consumers.” The 2007 GAO report continues to find that “title agents market to those from whom they get consumer referrals, and not to consumers themselves, creating potential conflicts of interest where the referrals could be made in the best interest of the referrer and not the consumer” (p. 25).

Turning to the issue of market conduct, Birnbaum (2005, p. 3) “found numerous examples in California of illegal rebates and kickbacks where the title insurer or the underwritten title company provides money, free services or other things of value to a real estate agent, a lender or homebuilder in exchange for business referrals. These illegal rebates and kickbacks – a consequence of reverse competition – show that title insurance and escrow charges are excessive and that some portion of the overcharge is passed from the underwritten title company or title insurer to the referrer of business.” On the reverse competition issue, Birnbaum comments (p. 26): “the vast majority of title insurance and escrow business is generated by local referrals. ...the key point of competition among underwritten title companies and title insurers is for referrals from the real estate professionals who can steer the ultimate consumer – the buyer or seller of a property or the consumer borrowing money secured by real estate – to the escrow company, the underwritten title company and the title insurer. In most cases, this competition for referrals is quite local and focuses on escrow and title sales staffs who have established relationships with the real estate professionals who are able to steer title and escrow business. In other cases, the competition is at a national level, characterized by the largest title insurers seeking a countrywide relationship with lenders or others who are able to steer business on a nationwide basis.”

Consistent with a lack of competition in pricing towards ultimate consumers, Birnbaum (p. 3) “found a remarkable absence of rate changes by title insurers over the past five years, despite declining costs of production, increased number of transactions and increased revenue per transaction. During a period when costs per unit of production declined significantly, underwritten title companies and title insurers maintained excessive rates. The prices charged by title insurers and underwritten title companies were not and are not responsive to the changing costs of production or increasing revenue per transaction at a given set of rates.” Much earlier, Owen and Grundfest (1977, p. 940) had noted uniform and stable prices (despite the cyclical nature of demand) as an indicator of a lack of competition among title insurers; the requirement imposed by most state regulators for posting prices with the state and sticking with these (preventing discounting to consumers) facilitates this. They noted, as does White (1984), that price discrimination (higher rates on more expensive homes relative to cost) also indicates a lack of competition, or market power.

The views of Roussel and Rosenberg (1981) should be noted, as they essentially reject the notion that rate competition among title insurers could lower prices or in any way benefit consumers. Their main points (p. 644) are that rating bureaus (and lack of rate competition more generally) subsidize low-value residential transactions (by forcing title insurers to stick to premium formulas based on loan value), reduce costs of insurers by allowing sharing of data –

helping to keep smaller (possibly less efficient) title insurers afloat, and “by mitigating the effects of reverse competition they lower costs [to consumers, presumably], especially for residential real estate transactions.” They argue that, with the introduction of rate competition, small residential purchasers will have to pay more for title insurance if the insurers “reverse compete” by offering rebates to brokers or lenders or lawyers to get the business, but that large purchasers will be able to shop around and not pay more. In contrast, Baker et al (p. 157), in one of their econometric specifications, do find that the title insurance premium “is smaller in states in which pricing was judged to be relatively competitive” where the latter judgment is based on an admittedly old survey published in a 1973 law review article (Stephen J. Quiner, Title Insurance and the Title Insurance Industry, 22 Drake L R. 711 (1973)).

Stangle and Strombom (2006) argue that prices in California (the focus of their study) are highly competitive. They compare (one-time) title insurance premiums to the much higher total homeowner’s premiums paid over the expected 14 year period of ownership (though they fail to take the present discounted value of the latter, which would provide a more appropriate comparison); this shows little as costs and risks associated with the two types of policies are quite different. Similarly their comparison of California title insurance premiums to those in other large states says little about the state of competition either in California or nationally. Stangle and Strombom focus on premiums per dollar of coverage to argue that California title insurers have dramatically lowered prices over time: for example, they note (p. 3): “in 1962, the price of First American’s CLTA Standard Coverage owner’s policy for the median priced home in California of \$15,100 was \$6.89 per thousand dollars of coverage... By 2005, the price of coverage for the median priced home of \$548,400 had fallen to \$3.06 per thousand dollars of coverage.” However, the cause of this trend was not reduced premiums but the tremendous appreciation in the value of California real estate over this period; in fact, over the 1962 to 2005 period, the premium for that median-priced California home increased from \$104 to \$1678, by more than 1500 percent, while the consumer price index over that period increased by just under 550 percent.

On the issue of reverse competition, Owen and Grundfest (1977) claim that rebates and referral fees may actually lower costs, and that the main reason for high closing costs is the lack of competition in the real estate transactions industry – in particular price fixing by local real estate broker associations, facilitated in large part by participation in Multiple Listing Service organizations (p. 948). Similarly, White (1984, pp. 308-309) states “that the absence of price competition in title insurance is the fundamental problem of the industry and that reverse competition and controlled business arrangements are symptoms of that problem, rather than being problems themselves. Indeed, reverse competition and controlled business arrangements represent *ameliorations* of the problem of the absence of price competition and should be *encouraged* rather than discouraged, so long as true price competition remains absent.”

Both Owen and Grundfest (1977) and White (1984) use the analogy of the airline industry under CAB regulation to describe an oligopolistic industry where competition in marketing practices occurs because of the combination of monopoly rents and the lack of other means of competition. Owen and Grundfest (p. 942) suggest that the inability of title insurers to stop this form of competition among themselves has led the industry to call for government to make referral fees (and other forms of “reverse competition”) illegal. Owen and Grundfest argue for deregulation of title business and antitrust action against brokers (noting that antitrust against

title insurers themselves may be blocked by the McCarran-Ferguson Act). They (p. 952) claim that if brokers were competitive, rebates and kickbacks and referral fees would be bid away in lowering prices to final consumers.

White (1984, p. 310) emphasizes that the direction of causality often drawn between high settlement costs and “reverse competition” is the wrong one: “...the *conclusion* that it is the kickbacks and fees that would cause the high prices of title insurance is simply *incorrect*. Instead, proper analysis will show that it is the high price of title insurance (relative to the basic costs of title searches, claims payments, etc.) that lead to the referral fees. The model that should be applied to this situation is that of non-price competition in concentrated or regulated industries... the competitive instincts of the firms are likely to be channeled into non-price dimensions. If the margin between price and the basic costs of producing the product or service is large, each extra sale is quite attractive to the firms in the industry, and substantial sums are likely to be spent on non-price competition; this non-price competition could exhaust a large part of the potential profits which would otherwise be present.”

White argues (pp. 318) that “[c]ontrolled business arrangements with respect to title insurance largely represent an imperfect way of referrers reestablishing referral fees... In this sense, these arrangements are a loophole in Sec. 8 of RESPA, but they are a loophole that should be encouraged rather than discouraged, as long as Section 8 itself is not repealed. To the extent that there is competition among real estate brokers, builders, lenders, and attorneys –and this is likely to increase, since added antitrust attention is being paid to real estate brokers and attorneys and relaxation of economic regulation of banks and savings institutions should bring more competition among these institutions – controlled business arrangements will allow benefits to flow through to consumers.”

Finally, a major indicator of exploited monopoly power is profits. While difficult to measure precisely, in a competitive market sellers should be earning a reasonable return. Birnbaum found (2005, p. 76) countrywide profitability of title insurers licensed to conduct business in California (profitability measured as after-tax net income divided by mean policyholder surplus) to average 27.2 percent over the 2001-2004 period. He also examined (p. 78) the profitability of the publicly-traded parents of the four largest insurer groups – First American, Fidelity National Financial, LandAmerica and Stewart. For the latter two virtually all revenues were generated from title insurance premiums, and their average profitability (here net income divided by stockholder equity) over the 2001-2004 period was 16.4 percent – well above any reasonable notion of a normal rate of return.<sup>84</sup> The 2007 GAO report found that the industry’s financial performance has been strong since as far back as 1992 (with return on equity above that of the property-casualty insurance industry in every year since then but one).

How were title agencies doing during this period? In the California market, the underwritten title companies – again, comparable to title insurance agencies in other states--realized after-tax net income as a percentage of stockholder’s equity (as calculated by Birnbaum,

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<sup>84</sup> Average profitability was even higher for the other two holding companies during the same period, but a significant part of revenues for these companies was generated from non-title insurance sources. Stangle and Strombom (2006) make a different comparison, title company net income margin and operating profit margin vs. property/casualty insurers, homebuilders and the S&P 500, to claim title insurers have comparable or lower profits.

p. 82) of 49.0% and 32.3% respectively in 2003 and 2004. Furthermore, Birnbaum notes that these figures “almost certainly understate the actual profitability because many owners of underwritten title companies were also paid salaries, commissions and bonuses as employees of or contractors to their underwritten title companies. In some cases, the salaries, commissions and bonuses paid to owners were in the millions of dollars.” White (1984), writing more than 20 years ago, observed potentially large rents available to be shared by players in the real estate transaction market. Birnbaum’s recent results suggest that these rents remain. White argued that (p. 319) “public policy should encourage the maximum amount of competition – price and non-price – at all levels and among all types of real estate settlements services. Restrictions on competition in this area, as in virtually all other areas of the U.S. economy, must inevitably mean reduced overall economic welfare.”

Eaton and Eaton (2007) present arguments that the American title insurance operates as a cartel and enjoys excessive profits. The authors demonstrate that the American title insurance industry has induced laws granting itself special benefits, such as mandated price floors in most states in U.S. and being exempt from federal antitrust liability. As a result, consumers are generally overcharged for title insurance policies, and the “wealth poor” Americans’ chances of homeownership are also hurt (P.6).

Unlike industries for other forms of insurance against casualty losses, the companies in the title insurance industry do not compete for market share in an open market, the industry enjoys a government-enforced minimum price in most states, and title insurance is mandatory for purchasing a property with a mortgage in U.S. Also, “title insurance premiums are set by regulators without actuarial details on how closely premium levels reflect the industry’s overhead costs” (P.51). All are evidence that this industry operates in outside the market economy.

Price discrimination suggests that overpricing for title insurance exists. For example, title insurance premium rates vary significantly from state to state. “No state has published regulatory operational guidelines ... on how to set title insurance premiums that are both cost-effective for consumers and provide sufficient income to the industry” (P.34). The authors argue that, if it were not because “title insurance companies earn much more than required to meet their costs and make a reasonable profit” (P.51), then the industry could not sell the same ALTA policy in some states for much less than in other states.

Comparing the cost of insuring a property through a for-profit private enterprise with lower-cost governmental programs in Iowa and in Canada sheds more light on this issue: the for-profit title insurance agencies in the United States reported losses and loss adjustment expenses much higher than those of Iowa, with Iowa’s loss experiences much more in line with the actual statistics inferred from mortgage default rates of Fannie Mae and Freddie Mac. And in Canada, several American title insurance companies prosper while charging only a small fraction of what the same services cost across the border in U.S.. As an additional piece of evidence, the Iowa Title Guaranty Division reinsures itself against any loss in excess of \$500,000, for a fee of 0.35 cents per \$1,000 of coverage, much lower than the prevalent premium rates charged by the title insurance industry.

Eaton and Eaton (2007) present five additional arguments that there is evidence of noncompetitive behavior. The fact that the cost of title insurance premiums has risen much faster than the rate of inflation for decades suggest the monopolistic privileges of the industry.

Although there probably are significant differences in loss rates due to location variations or property types, “in all but a few jurisdictions, title insurance policies on all properties are charged according to a single premium schedule, varying only with the size of the mortgage and the price to be paid for the property” (P.25). The authors suggest that this fact may imply that excessive premium charges exist.

The authors state that “title insurance prices are not based on evidence of actual losses” (P.6). The current loss minimization process against a defected title is working well, and not all title defects result in covered losses. Also, the risk of a faulty title decreases every time a property is sold. No actuarial statistics are available to the public “to check whether mandatory fixed-price premium schedules are reasonable and to review the fairness of the legal provisions in the standard title insurance contract forms” (P.19).

A large proportion of the premium is retained by the title abstract and settlement agency (from 60 to more than 90 percent), which title insurance industry officials argue is justified by the alleged high cost of title searching back into the distant past. However, “in fact, a high proportion of noncommercial properties are searched only through the most recent transaction” (P.15). The cost of title search does not seem to be high, and has been declining with technological advances.

There may be “double coverage” (P.25) premium income generated when owner policies are purchased simultaneously with a lender policy.

## **V.B. Title and Settlement Fees -- Can They Be Reduced?**

The improved shopping, limited tolerances, and volume discounting provisions in the proposed rule are intended to drive third-party settlement costs down. However, some believe that there is no “fat” or excess in third-party fees, although others believe that more effective shopping and competition have the potential to significantly reduce third-party costs. This subsection examines these different viewpoints about third-party settlement costs, paying particular attention to title fees. While many of the comments were directed at packaging, the market dynamics being addressed by the comments are also important for the changes in this proposed rule as well.

In their 2002 comments, the American Land Title Association (ALTA) says there is no comprehensive study (or indeed, no responsible study at all) that supports the conclusion that packaging will reduce “fat” or unnecessary charges in the title industry.<sup>85</sup> They go on to say:

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<sup>85</sup> See comments from James R. Maher, Executive Vice President, ALTA, to Rules Docket Clerk, HUD, regarding “Proposed Rule on Real Estate Settlement Procedures Act (RESPA); Simplifying and Improving the Process of Obtaining Mortgages To Reduce Settlement Costs to Consumers; Docket No. FR-4727-P-01; 67 Fed. Reg. 49134 (July 29, 2002),” October 4, 2002.

Indeed, other than some potential savings in marketing costs and modest operational efficiencies, there are no significant savings in the title-related or closing-related work that has to be performed in 1000 transactions involving 1000 different properties whether those transactions involve a single mortgage lender or multiple mortgage lenders. (page 28)

Ann Schnare, who prepared a report for the National Association of Realtors entitled “The Downside Risks of HUD’s Guaranteed Mortgage Package” (dated October 24, 2002), expressed similar sentiments. According to Schnare, “there is no theoretical or empirical evidence to suggest that mortgage packaging will lead to lower settlement costs. In fact, one could easily argue just the opposite” (p. 22). Schnare notes in the case of “no closing cost” mortgages, lenders already “have an incentive to seek out low cost service providers in order to keep their offerings as competitive as possible” (p. 11). However, in the same paper she suggests that third-party service fees are overpriced when she comments on HUD’s enhanced GFE:

HUD’s proposed changes to the GFE should make these incentives [to seek out low cost service providers] even stronger. The new GFE should make consumers more aware of closing costs, thereby increasing the incentives of lenders to seek out low cost service providers as a way of competing for market share. (p. 11)

While ALTA and Schnare believe that settlement fees cannot be reduced, other industry observers believe they can. In fact, title service providers, who levy the majority of third-party fees, are increasingly criticized for charging excessive fees. This criticism has been leveled by private industry, consumer advocate groups, and scholars. Charges that title fees are too high are increasingly common in the popular press and also have led to several court cases. Many of the comments received by HUD in response to the 2002 proposed rule suggested that title fees are excessive and can be reduced. Although many of the charges are not fully substantiated, or provide only anecdotal evidence, there is substantial evidence that fees can be reduced.

The remainder of this section discusses the various types of information available on this issue. As noted above, HUD has available new information on title fees from the HUD-1s of FHA borrowers. When looked at in combination, the anecdotal, industry, and data analyses reported below suggest that there is substantial potential to reduce title and settlement fees.

### **V.B.1. Anecdotal and Industry Evidence on Title Fees**

When commenting on HUD’s 2002 proposal Wells Fargo, a large mortgage lender, made it clear that they believe settlement costs are too high.<sup>86</sup> These points are made in the following three quotations.

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<sup>86</sup> They further argue that with packaging, prices will decline for three reasons: (1) unnecessary services will be eliminated; (2) the purchasing leverage of packagers will result in more negotiation of prices, volume discounts, and other techniques for reducing costs; and (3) competition will increase because consumers will be more knowledgeable of prices.

Cumbersome and overpriced settlement services that have been the tradition for generations of consumers will begin to evolve. Settlement services that are deemed to be unnecessary or overpriced will be eliminated. (p. 2)

Significantly, the [HUD] proposal removes restrictions in RESPA that have effectively prevented loan originators from using their purchasing leverage to offer consumers lower, guaranteed closing costs. (p. 2)

With more reliable information about interest rates and closing costs, consumers will be able to shop more effectively for loans and free market dynamics will result in a reduction in closing costs. (p. 2)<sup>87</sup>

Other mortgage lenders and mortgage industry observers share Wells Fargo's position. In discussion with HUD, the large mortgage lender ABN-AMRO noted costs in title and settlement fees are excessive and savings of up to \$400 are possible. Lenders that held discussions with HUD, such as ABN-AMRO, emphasized that there was little negotiation in today's market to reduce title and other third-party fees. Based on these comments, it appears that incentives to negotiate prices, such as offered by tolerances and volume-based discounting, have the potential to significantly reduce closing costs. Too often in today's market, increases in title and closing costs, as well as other third-party costs, are simply passed through to the consumer with little effort on the part of the originator to contain these costs.

Wholesale Access Mortgage Research & Consulting, Inc. also sees a potential for savings in title fees. In their letter commenting on the proposed rule, they write,

Perhaps total savings might be as much as \$5 billion, but that assumes states allow average pricing of title insurance.<sup>88</sup>

Of course, this proposed rule does exactly that – allows average cost pricing.

Fannie Mae's vice president for credit policy, Joe Biegel, also saw a potential for reduced fees. Speaking in reference to title insurance premiums Biegel states, "it's safe to say that prices, in many respects, are higher than they ought to be."<sup>89</sup> Forbes magazine takes the editorial position that the title insurance industry is a "racket" and a "cartel."<sup>90</sup> In its analysis of the title

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<sup>87</sup> See comments from Peter J. Wissinger, President and Chief Executive Officer, Wells Fargo Home Mortgage, Inc., to Rules Docket Clerk, HUD, regarding "Proposed Rule on Real Estate Settlement Procedures Act (RESPA); Simplifying and Improving the Process of Obtaining Mortgages To Reduce Settlement Costs to Consumers; Docket No. FR-4727-P-01; 67 Fed. Reg. 49134 (July 29, 2002)," October 28, 2002.

<sup>88</sup> See comments from Tom LaMalfa and David Olson, Wholesale Access Mortgage Research & Consulting, Inc., to Rules Docket Clerk, HUD, regarding "Proposed Rule on Real Estate Settlement Procedures Act (RESPA); Simplifying and Improving the Process of Obtaining Mortgages To Reduce Settlement Costs to Consumers; Docket No. FR-4727-P-01; 67 Fed. Reg. 49134 (July 29, 2002)," September 30, 2002.

<sup>89</sup> Ruth Simon, *Wall Street Journal*, December 18, 2002, p. 1.

<sup>90</sup> Ira Carnahan, *Forbes Magazine*, September 2, 2002.

industry, Standard and Poor's concludes that HUD's proposed 2002 RESPA rule "could place downward pressure on title rates."<sup>91</sup>

A 2004 industry article concludes that title fees are excessive and can be cut. An article "Cutting A Better Title Deal: Money-Back Settlement Programs Put Cash in Buyers' Pockets" by Kenneth R. Harney<sup>92</sup> indicates the potential for cutting title fees in the Washington D.C area. According to Harney, at least two title insurance agencies are now offering substantial credits or rebates to home purchasers at closings. The money-back programs rely on cash that otherwise would go to little-publicized joint venture arrangements between real estate brokerage companies and title insurance agencies. These joint ventures funnel hundreds, and sometimes thousands, of dollars from homebuyers' settlement fees to the real estate brokerage firm owners, according to Harney. Industry executives say that consumers rarely understand that their payments are flowing back to the realty company. Harney reviews the programs of two firms that are giving the money back to consumers. For example, First Savings Mortgage Company and Monarch Title Inc are jointly offering a program that guarantees closing cost credits of anywhere from \$500 to \$5,000 to homebuyers who obtain their mortgages from First Savings and their settlement services from Monarch Title. Jerry Boucher, president of Monarch Title, says the money paid to homebuyers would otherwise have been paid from the title premiums to a real estate brokerage firm through a joint venture agreement; Boucher says his firm avoids such deals with real estate firms. A similar program, called "1Roof Credit," is offered by Federal Title & Escrow Co. in Washington, D.C. This program, which offers a credit with or without the use of Federal Title's mortgage lender partners, pays credits back to homebuyers ranging from \$525 to \$1,525 on a \$300,000 house. In announcing the program, Federal Title said also said that the settlement credit paid to buyers would have otherwise gone to a real estate company.

The lenders involved in these programs provide some insights into the types of cost savings that can result from discounting arrangement and RESPA reform. The title firms taking part appear to be cutting their own net fees in exchange for expected higher volumes of business from individual buyers and their realty agents. Larry Pratt, president and chief executive of First Savings Mortgage said there are two separate levels of cost reductions built into his firm's program: First Savings is reducing or putting lids on cost items such as appraisals, credit reports and other origination services, and then guaranteeing home buyers that the costs will not exceed a specific amount at settlement. A second level of savings is the lower total fee for title and settlement services by virtue of not having to split the money with a real estate broker via an affiliated business relationship.

Pratt notes that the bulk of the title insurance premium goes to the title agency that does the closing, as only a fraction goes to the title insurance company that provides the insurance coverage against title problems. Harney reports that industry officials say that title agents get 70-85 percent of the title premium, depending upon the amount of business the agents direct to a specific title insurance underwriter. Those same title agents may have joint venture arrangements with large real estate brokerage firms and share with the real estate brokers the

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<sup>91</sup> Standard and Poor's, *Industry Report Card: U.S. Mortgage and Title Insurers*, 2003, page 2.

<sup>92</sup> Kenneth R. Harney, "Cutting a Better Title Deal: Money-Back Settlement Programs Put Cash In Buyers' Pockets," *The Washington Post*, January 24, 2004, p. F01.

total fees generated by every client the firm brings in for a settlement transaction. Monarch Title's Boutcher reported a case of a settlement company paying a brokerage \$800 to \$1,000 per transaction. Boutcher notes "We are talking about a lot of money that is coming out of the home buyer at the settlement table and going to the broker" (Harney, 2004). Boutcher goes on to say "...this is a very sensitive subject for the big [real estate] brokers. They have exclusive arrangements to direct as many settlements as they can to their [joint venture] partners. Boutcher said most of the joint venture agreements are tightly held proprietary deals, with no information available to the public about them.

An article on the practice of lenders creating vendor management companies as subsidiaries expressed similar sentiments about the title industry (Shenn, 2004a). A big reason vendor management subsidiaries have been lucrative for their lenders is that they are created as title agencies; Shenn (2004a) notes that "title premiums, which often are set by states, are among the most expensive pieces of the settlement pie, and are often split on a negotiated basis between title agents and insurers." In these cases, Terry Wakefield, president of a Wisconsin consulting firm, notes that "the ability to make some extra money on each loan as a title agent is a big benefit"(Shenn, 2004a).

Several consumer advocate groups believe title and closing costs are excessive. Consumers Union and the National Community Reinvestment Coalition (NCRC) have been especially critical of the title insurance industry for regularly overcharging consumers that refinance their homes. Refinancing borrowers are generally eligible to pay lower title insurance premiums than purchase money borrowers.<sup>93</sup> These lower premiums are widely known as "reissue rates." Title insurers and agents regularly fail to offer refinancing borrowers the discounted reissue rates. The difference between reissue rates and standard issue rates can easily amount to several hundred dollars. Paying the standard rate instead of the reissue rate confers no benefit on the refinancing borrower, but confers substantial benefit to title insurance agents and carriers. In testimony presented before the California state legislature, NCRC director Kelly Brinkley questioned the sincerity of title insurers who claim to be working for the best interest of consumers. Specifically she asked: "If title insurers are truly interested in what is best for the consumer why is it necessary for consumers to specifically ask for a cheaper rate? Why is the rate not automatic?"<sup>94</sup>

An article by Ken Harney also focused on reissue rates, which are the discounts off standard premiums charged on title insurance policies.<sup>95</sup> As noted above, the idea behind

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<sup>93</sup> One reason that title insurance rates can be lower for refinancing borrowers is that because a title search was done recently, when the home was purchased, it is relatively simple to do a new title search and establish title merchantability. Thus, the discount reflects the fact that when there has been no change in ownership of the property, and the title for that property was examined earlier (when the person bought the property), there is less need for another comprehensive search of the records.

<sup>94</sup> Kelley Brinkley, Director – Legislative and Regulatory Affairs of the National Community Reinvestment Coalition, testimony before the Insurance Committee of the California Legislature, April 30, 2003 (available at <http://www.ncrc.org/>).

<sup>95</sup> See Kenneth R. Harney, "How to Save 50 to 60 Percent on Title Insurance When Refinancing," *Realty Times*, June 17, 2002.

discounted reissue rates for title insurance on a refinancing is that there may be no need to pay the full price for a complete title search on a property that received such a complete title search only a few years earlier as part of the initial home purchase or an earlier refinancing. Harney gives the following hypothetical example -- rather than paying \$1,200 for a new title policy, why not take advantage of a reissue rate at \$500-600. While the discounts vary from State to State and from title insurer to title insurer, Harney reports that they average 50-60 percent.<sup>96</sup> While reissue rates are normally available on refinancings, in some areas they can be obtained on home resales where a title search was performed relatively recently. Harney's article focuses on the issue raised above by Brinkley -- why this concept of discount pricing is not widely known to consumers nor is it widely promoted by the industry. Harney quotes James R. Maher of the American Land Title Association (ALTA) as saying he is aware that "not all of our [ALTA] members disclose" the existence of reissue rate discounts. Harney also notes that while some mortgage brokers routinely ask the title or closing agent for reissue rates on refinancings, others admit that unless an applicant asks, they don't mention the reissue rate option. With respect to title agents or closing attorneys disclosing reissue rates, some do, but Harney notes there are financial incentives against them doing so. This is because the title agent or attorney receives most of the insurance premium back from the insurance company; thus, the smaller the premium that is charged for the insurance coverage, the smaller the compensation to the title agency or settlement attorney. Harney quotes Maher as saying the average national "split" of the premium charged at closings is 70-72 percent to the title or settlement agency, and the balance to the title insurance company. The splits go as high as 92.5 percent to the agent or attorney and just 7.5 percent for insurance, according to Maher.

Further evidence of variation in settlement service costs is presented in a 1996 Media General study.<sup>97</sup> Media General surveyed 489 settlement service providers in Virginia. The survey revealed that some settlement service providers charged substantially more than others. Specifically, settlement service providers that were attorneys charged an average of \$451 for title examination and closing, while those that were not attorneys charged an average of \$272, or nearly 40% less.

**Radian Lien Protection.** Some private sector financial institutions believe title insurance premiums are too high. Against considerable opposition from existing title insurers, Radian Guaranty introduced a title insurance alternative called Radian Lien Protection (RLP). RLP is a form of mortgage guaranty pool insurance with additional coverage for mortgage defaults involving undisclosed liens. If a loan in a mortgage pool protected by RLP is found to have a title defect, RLP will reimburse the loan owner, up to certain limits. RLP is designed to take the place of traditional lenders' title insurance. Radian claims its lien protection product is comparable to traditional title insurance, but costs several hundred dollars less. Specifically, Radian states

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<sup>96</sup> According to Mike Finnerman, a senior title officer with the American Title Company, deeply discounted reissue rates are usually available on refinances, typically ranging from 30-50 percent of the normal premium fee. Finnerman also notes "these discount opportunities seem to be a deep, dark secret in today's marketplace." See "Trimming the Cost of Title Insurance," *South Coast Today: The Standard Times*, June 29, 2002, page T3.

<sup>97</sup> Media General, "Residential Real Estate Closing Cost Survey," September 1996.

Radian Lien Protection was developed as an innovative, cost-saving product that can reduce closing costs by more than 50 percent on refinances, second mortgages and home equity loans. A mortgage insurance pool policy, Radian Lien Protection is designed to provide coverage for a range of losses arising from defaults, including losses due to undisclosed liens.<sup>98,99</sup>

Radian believes its lien protection product can save consumers an estimated \$3 billion per year.<sup>100</sup> After selling its product for a brief period prior to receiving explicit regulatory approval from any state insurance commissioner, Radian suspended sales pending explicit regulatory approval.<sup>101</sup> Prior to its suspension, about half a dozen lenders have used RLP and the investment banking firm Lehman Brothers accepted RLP as an alternative to title insurance on asset-backed and mortgage-backed securities. Fannie Mae is reportedly “looking at” alternatives to traditional title insurance.<sup>102</sup> Both the Community Financial Resource Center and the National Community Reinvestment Coalition support Radian’s efforts to reduce the cost of title insurance.

RPL proved to be quite controversial and the subject of two expert, technical analyses. One of these analyses is very much in favor of RPL; the other is very much against it. Liu finds that RPL could save refinancing borrowers in California an average of \$272 dollars. He estimates that for mortgages under \$650,000 the average refinancing title insurance was \$548 in 2001, and the average RLP fee would have been \$276.<sup>103</sup> Applying the average saving of \$272 to certain assumptions regarding future mortgage activity in California, Liu estimates that RPL could increase consumer surplus in the state by at least \$1.38 billion. In sharp contrast, Lipshutz argues that consumers would actually pay more for RPL than they would for traditional title insurance.<sup>104</sup> He also contends that the integrity of American title records would deteriorate if RLP became widely used. (See Chapter 5 for further details.)

Fidelity National Financial, the nation’s largest title insurance carrier, is planning to offer a new insurance product that essentially mimics RLP and costs as little as \$275 per

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<sup>98</sup> [http://www.radiangroupinc.com/RadianGroup/MortgageInsurance/RadianGuaranty/products/mi\\_products\\_radianlien.asp](http://www.radiangroupinc.com/RadianGroup/MortgageInsurance/RadianGuaranty/products/mi_products_radianlien.asp)

<sup>99</sup> Unlike traditional title insurers, Radian will not attempt to correct any title problems that it discovers.

<sup>100</sup> *The Legal Description*, April 1, 2002.

<sup>101</sup> The Radian Group Inc. failed to get regulatory approval to sell Lien Protection in California. In July, 2003, the head of California’s Department of Insurance, John Garamendi, upheld a ruling barring Radian from offering the product in California. See Jody Shenn and Erick Bergquist, “Clearer Signs of Shakeout in the Mortgage Business,” *American Banker*, January 5, 2004, pp. 1, 18.

<sup>102</sup> *The Legal Description*, May 16, 2002.

<sup>103</sup> Paul Liu, “The Increase in Consumer Surplus From Radian Lien Protection: The California Market”, 2003.

<sup>104</sup> Nelson Lipshutz, “Consumer Impacts of Substituting Radian Lien Protection Coverage For Refinance Lender’s Title Insurance,” 2003.

transaction.<sup>105</sup> This suggests that when confronted with the possibility of competition, title insurers can indeed reduce the cost of their products. Fidelity's action is interesting given the vigorous resistance the title industry has exhibited towards Radian's product. While Fidelity's co-chief operating officer Ernest Smith believes the firm's new product is not suitable in every situation, according to Jody Shenn of American Banker, Smith believes that the new product makes sense for certain lenders, particularly those planning to self-insure against title risk or refinancing existing loans.<sup>106</sup>

## **V.B.2 HUD Actions, Court Cases, and Government Reports Involving the Title Industry**

Title and closing costs have been the subject of investigation and litigation across the country by HUD and by the courts. HUD and state regulatory agencies have initiated many investigations identifying allegedly illegal activities in which realtors, lenders and builders have been compensated for consumer referrals to title agencies in apparent violation of provisions of RESPA. While many of these cases do not establish liability, taken as a collection they are a strong indication that consumers and state officials are often dissatisfied with title and closing fees.

**HUD Investigations.** Among the real estate settlement service businesses under RESPA's jurisdiction, title insurance companies are the nexus for a disproportionate number of RESPA violations. HUD has identified and addressed a number of illegal activities related to the marketing and sale of title insurance. Although title insurance is required in the vast majority of residential real estate transactions, title insurance companies almost always market their services to potential referral sources (real estate agents, real estate brokerages and lenders), not to consumers.

In recent cases, the Department has entered into settlements with a number of title insurance companies for operating affiliated businesses that were solely designed to ensure a stream of referrals by paying kickbacks to potential referral sources.

HUD continues to coordinate with state and federal regulatory agencies. For example, HUD is presently pursuing RESPA enforcement cases with the states of Pennsylvania, Florida, Minnesota, Alabama, and Texas. HUD has recently coordinated RESPA regulatory and enforcement efforts with the states of Alaska, Arizona, Colorado, New Mexico, and Tennessee. Captive reinsurance cases have been a strong area of cooperation between HUD and state regulators working through the National Association of Insurance Commissioners (NAIC). Similarly, HUD continues to coordinate RESPA enforcement activities with various federal agencies including the Federal Deposit Insurance Corporation, Federal Trade Commission, Office of the Comptroller of the Currency and the Department of Justice.

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<sup>105</sup> According to *Inside Mortgage Finance*, unlike RLP, the Fidelity National Financial product will not require the borrower to certify that no liens have been placed on the financed property and will not require the borrower to be sufficiently creditworthy. *Inside Mortgage Finance*, June 6, 2003, page 9.

<sup>106</sup> Jody Shenn, "Title Insurer Transforms Debate Over Lien Policies", *American Banker*, June 18, 2003, page 1.

Finally, the Department has developed a memorandum of understanding with a state insurance commissioner that HUD hopes will form the basis of additional information sharing agreements. HUD believes these agreements will expand the Department's outreach to state regulators regarding enforcement of RESPA, and will assist in developing close working relationships with the states to enforce RESPA in the title insurance field.

**Examples of Allegedly Illegal Referral Fees Described in Investigations by HUD and State Insurance Regulators.**

- A title agent paid real estate agents' business training and printing expenses.
- A title agent provided trips, entertainment, and catering for entities involved in real estate transactions.
- A title agent contributed to a pool of funds that was given away in a drawing among real estate agents.
- A title agent paid an excessive rate to rent a conference room from a real estate company.
- Title agents provided free or below-cost marketing services to real estate agents.

In captive reinsurance arrangements, a home builder, real estate broker, lender, title insurance company, or some combination of these entities forms a reinsurance company that works in conjunction with a title insurer. These arrangements have been used as a means of paying referral fees.

**Other Cases.** Examples include:

As of April 2003, there were eight class-action lawsuits pending in New York State alleging that title agents intentionally overcharged homeowners who were refinancing their loans.

The State Insurance Commissioner in California ordered an investigation of the title and escrow rates of five of the state's largest title insurance sellers; this came after the Consumers Union surveyed the rates of six major title insurers, which sell 84 percent of all title policies in the state (see below).<sup>107</sup> In October 2002, the California Attorney General reached a \$50 million settlement in a consumer protection lawsuit brought against six major title companies and their affiliates. The companies were charged with deceptive advertising and unfair business practices regarding their escrow services.<sup>108</sup> They were charged with deceiving Californians with hidden fees and costs while providing routine residential escrow and title services.<sup>109</sup>

The court case *Lane V. Residential Funding* revealed that title insurers do offer significant discounts to certain customers. Specifically, Chicago Title offered a

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<sup>107</sup> Broderick Perkins, "Title, Escrow Firms Gear Up to Give Borrowers Discounts," *Sacramento Business Journal*, June 30, 2003.

<sup>108</sup> Office of the Attorney General, State of California, Press Release dated October 8, 2002.

<sup>109</sup> Perkins, *op. cit.*

25% price reduction on title services offered in conjunction with mortgage loans originated by Residential Funding Corporation. This suggests that title fees can indeed be reduced through volume discount pricing and other business arrangements.<sup>110</sup>

**Government Reports.** The GAO<sup>111</sup> examined in more detail issues which had been previously raised (in an earlier GAO report) as worthy of further study, concerning the nature of competition in the title insurance industry and the impact on consumers. While examining national data and contacting government and industry sources familiar with the title insurance industry more generally, the focus of this report is on the performance of the industry and regulatory regimes in six states – California, Colorado, Illinois, Iowa, New York, and Texas. These states were chosen because they appeared to display a wide range of variation in size, industry practices and federal/state regulatory oversight.

The report finds the title insurance market to be highly concentrated nation-wide at the level of insurers, with 92 percent of premiums written by the top 5 companies (as of 2005); within particular states the degree of concentration is generally higher. There is variation across the six states in business practices. For some examples: (1) the method title agents employ to conduct searches is highly automated in some, much more labor-intensive in others; (2) affiliated business arrangements (ABAs) among lenders, real estate agents, and title agents (and sometimes “reinsurers”) are more common in some states than in others; (3) services included in what is viewed as the title insurance premium varies across states. For this reason it is quite difficult to determine with precision the nature of price variation across states and across consumers within the same state.

The GAO study notes that the nature of the market for title insurance makes it difficult, if not impossible, for consumers to comparison shop for this service – which in turn makes it less likely that they tend to pay a competitive price for title insurance. Consumers generally do not choose their title agent (and title agents make no effort to market directly to consumers), and most likely are unaware that they are able to make this choice. The fact that title insurance is a very small share of all closing costs (estimated to be 4% of these costs in California), and that the title fees are not disclosed until the settlement process has started moving along adds to the reluctance of consumers to seek an alternative title agent and/or insurer which may delay their closing. Attempts by GAO to closely relate title fees to costs of activities performed were frustrated by a lack of data; however, there seems little evidence that variations in title fees (for example, as the size of the mortgage loan increases) can be reasonably explained either by variations in risk or by effort required for title searching.

The fact that title agents market to real estate agents and mortgage brokers, and are sometimes in ABAs with these parties, can lead to conflicts of interest with benefits received by these real estate and lending professionals but no guarantee that these benefits are passed on to

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<sup>110</sup> U.S. Court of Appeals for the Ninth Circuit. No. 01-16798 D.C. No. CV-96-03331-MMC.

<sup>111</sup> U.S. General Accountability Office, *Title Insurance: Actions Needed to Improve Oversight of the Title Industry and Better Protect Consumers* (Report to the Ranking Member, Committee on Financial Services, House of Representatives), April 2007.

consumers. The report discusses recent investigations by HUD and state regulatory agencies identifying allegedly illegal activities in which realtors, lenders and builders have been compensated for consumer referrals to title agencies in apparent violation of provisions of RESPA. However, state and federal regulators are seen as being limited by resources, the complexity of many ABAs, lack of coordination between different agencies within the states (each focusing on a particular sector of the real estate industry) and between federal and state agencies, and limited enforcement penalties available to them.

The GAO report makes several recommendations to promote price competition both at the title insurer and title agency level, to require more detailed cost data be provided to state regulators by title agents and insurers, and to better enforce existing rules relating to potentially illegal marketing practices in the industry. At the federal level, the study proposes providing HUD with increased authority to penalize violators of section 8 of RESPA, to clarify regulations on ABAs and referral fees, to better coordinate with state regulators in enforcing RESPA, and to require consumers be better informed (and earlier in the process) about options for purchasing title insurance, warnings about dealing with title agent ABAs, and discounts available – especially on refinancings. Also recommended is strengthened state-level regulation of title agents, increased collection and auditing of title agent costs and revenues, and improved methods of publicizing title insurance price information to consumers.

## **V.B.2. Surveys and Other Industry Data on the Title Insurance**

**Consumers Union Survey.** A Consumers Union study found evidence that borrowers were paying too much for title insurance when they refinance their homes. Consumers Union surveyed California title agents and found they consistently are not offering refinancing borrowers the discounted reissue rates. Norma Garcia, a senior attorney for Consumers Union’s West Coast Regional Office declared, “Californians are paying too much for title insurance. We believe the high cost of a refinance title insurance policy would be substantially lower if there were more competition in the industry.”<sup>112</sup> As noted above, as a result of the Consumers Union survey, the California Attorney General reached a \$50 million settlement against six major title companies and their affiliates, charging them with deceiving Californians with hidden fees and costs while providing routine residential escrow.<sup>113</sup>

Analysis of the Consumer Union survey data also suggests wide dispersion among fees offered by settlement and title service providers. The Consumer Union data indicate the fees quoted by escrow agents for the same sized loan vary widely within the same metropolitan area. For example, quoted fees for title insurance and all other closing expenses for a \$250,000 refinancing in the Los Angeles metropolitan area ranged from \$1,000 to \$1,464, placing the highest price quote almost 46 percent higher than the lowest quote. The average quoted price in the Los Angeles area, \$1,286, was \$286, or 28.6 percent, greater than the lowest quoted price. There are four possible explanations for the variation in prices. First, the firms that are quoting lower prices may not be accurately representing the actual prices that they will eventually

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<sup>112</sup> Norma Garcia, Consumers Union news release, April 2, 2003.

<sup>113</sup> Office of the Attorney General, State of California, Press Release dated October 8, 2002.

charge. Second, the firms that are quoting higher prices may have uncompetitive cost structures. Third, the firms that are quoting higher prices may have cost structures similar to those of the firms that are quoting lower prices, but price their services higher and earn excess profits. Fourth, some firms may provide different title and closing services, which would call for different fees. While there will always be some dispersion in prices (reflecting the specifics of each transaction),<sup>114</sup> it is not clear that differences in services explain the price dispersion observed here. Whatever the explanation, some consumers appear to be either deceived or paying more than they have to.

The Consumer Union data reveal similar pricing practices across California. Among surveyed areas, prices varied the least in the San Diego metropolitan area; however, even there they ranged from \$1,079 to \$1,338, placing the highest quoted rate 24% higher than the lowest quoted rate. In San Francisco quoted prices ranged from \$1,110 to \$1,370, placing the highest quoted rate 24% higher than the lowest quoted rate. In Sacramento quoted prices ranged from \$1,136 to \$1,475, placing the highest quoted rate 30% higher than the lowest quoted rate. In Fresno quoted prices ranged from \$940 to \$1,512, placing the highest quoted rate 60% higher than the lowest quoted rate.<sup>115</sup>

**Data from ABN AMRO.** ABN AMRO provided HUD with information on loans it originated during the period February 2002 through April 2002. The data included information on 8,771 loans, all of which were conforming. About half of the loans were funded through a program that used traditional title insurance, and about half of the loans were funded through a program that used Radian Lien Protection. The average loan amount for loans with traditional title insurance was \$145,667; the average loan amount for loans with Radian Lien Protection was \$132,024. The data are interesting for two key reasons. First, they demonstrate how widely title insurance and closing costs vary across states. Second, they demonstrate that borrowers benefit from RPL through lower costs and quicker processing times.

The ABN AMRO data show title insurance and closing costs vary widely across states. Specifically, ignoring the states where ABN AMRO did little business, title insurance and closing costs ranged from 0.5% to 1.3% of the loan amount.<sup>116</sup> While the existence of this variation may not be news to most mortgage market insiders, it is still somewhat surprising.<sup>117</sup>

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<sup>114</sup> The Consumers Union telephone survey sought quotes for the same loan amount within a single metropolitan area, thus controlling for two important factors that might affect title fees. This is why the dispersion in quotes is suggestive of excess fees.

<sup>115</sup> The average quoted prices in San Diego, San Francisco, Sacramento, and Fresno were \$1,190, \$1,246, \$1,323, and \$1,182, respectively. Thus the percentages by which the average price exceeded the lowest price are as follows: San Diego (10.3), San Francisco (12.3), Sacramento (16.4), and Fresno (25.7).

<sup>116</sup> States where ABN AMRO originated less than fifty loans in the period February 2002 through April 2002 are excluded from this analysis. Including them would further increase the cross-state variation in title insurance and settlement costs.

<sup>117</sup> HUD staff observed title insurance prices, one component of title and settlement costs, across the country. All prices are for a \$130,000 loan. The price is less than \$400 in several states and above \$1,000 in several others. The others are spread out all over between \$400 and \$1,000. Different claims rates cannot warrant these differences because claims are only a small percent of total title insurance premiums. While different legal requirements could explain some of the settlement cost differences observed among states, the very large differences in the regulated

All the settlements in the ABN AMRO data, regardless of location, result in the same thing: the closing of a loan. Given this homogeneity, why do costs vary so much? Indeed settlement practices vary across states, as does the cost of doing business, but can this variation explain the huge variation in title insurance and settlement costs? Not likely. The Department believes that title insurance and closing costs can be reduced in states where they are currently especially high.<sup>118</sup>

### **V.B.3. Recent Statistical Studies of Title Insurance**

This section reviews recent studies showing substantial variation in title fees. Earlier, Section IV.E provided background discussion of the data used in these studies by the Urban Institute and HUD.

#### **V.B.3.a. Urban Institute's Analysis of Title Fees**

The statistical study of FHA closing costs by the Urban Institute (2008), described in Section IV.E., includes a brief analysis of title fees. This statistical study sought to answer the following questions: how large are title charges and how do they vary? For example, are they related to borrower characteristics?

**How large are title charges?** Total title charges include the cost of title insurance and other fees associated with getting title insurance. Total title charges are captured by the total of all fees in the 1100 series (excluding lender's and owner's coverage premium 1109 and 1110) on the HUD-1 form as well as any courier delivery fees from the 1200 and 1300 series. Total title charges for the non-subsidized loans studied here are \$1,349 per loan and vary substantially across homebuyers (standard deviation of \$568). This amount approximately half of the average down payment.

**Do title charges vary by race and education of borrower?** Race effects are present in title charges roughly in proportion to those in lender/broker fees. African-Americans pay an extra \$123 in title fees (other things equal) compared to others, and Latino borrowers an extra \$106, both measured including State effects. These race differentials are related only to the

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title insurance prices among states would still be a prime suspect as at least part of the explanation for the difference in overall title and settlement costs among states.

<sup>118</sup> In addition to demonstrating wide variations in title insurance and closing costs, the ABN AMRO data reveal that borrowers can benefit from using Radian Lien Protection instead of traditional title insurance. Borrowers benefit because Radian Lien Protection costs less than traditional title insurance. On average borrowers saved nearly \$600, or just over 50 percent, by using Radian Lien Protection. Borrowers further benefited from the shorter time period it takes to settle a mortgage with Radian Lien Protection compared with traditional title insurance. On average, Radian loans closed twenty-one days faster than loans with traditional title insurance. This shorter time period yields two benefits, one of which is psychological and the other of which is financial. First, there is simply less waiting – nobody likes waiting. Second, it costs money to lock a rate. A rate quote for a 60-day lock is more expensive than a rate quote for a 30-day rate quote. Each 15 days in lock duration typically costs at least a eighth of a point, or nearly \$200 on a \$150,000 loan. Since loans that have Radian Lien Protection closer sooner than loans with traditional title insurance, they can provide borrowers better rates.

racial composition of the borrower's neighborhood, not to the race of the individual borrower. Borrowers with a college education pay \$200 less than borrowers with a high school education. Note that the education differentials are larger than race differentials, which is the same relationship found with origination fees. The signs of price discrimination present in lender/broker fees are present in title charges as well.

**Do title charges vary with loan amount?** Title charges rise with loan amount but the strength of the relationship depends on the state. In some states, the relationship is strong while in others it is not significant. The cost of providing title services should not be a function of the value of the property. Thus, variation in title charges by loan amount is evidence of price discrimination. The analysis finds that title charges also rises with the down payment. This suggests there is some discretion exercised in determining charges. When the borrower is more strapped for cash, the charges are lower. When the borrower has more cash, the charges are higher.

**Do title charges vary by state?** Average title charges vary significantly by state—from a low of \$668 in North Dakota to a high of \$2,094 in California (see Table 10-1, Urban Institute 2008). Across the 50 states and the District of Columbia, seven states have average title costs of over \$1,500 twelve and seventeen have title costs that average less than \$1,000. The variation by state remains after controlling for loan and borrower characteristics. There is a \$1,000 difference between the highest premium and the lowest. New York, Texas, California, and New Jersey emerge as the highest-cost states (premiums greater than \$1,000) while North Carolina is the lowest-cost state (a premium of \$0). Attempts to explain the differences with the type of title insurance regulation used by different States succeeded in explaining only a small portion of additional variation. Nonetheless, it seems that many State title insurance regulation regimes are not serving their citizens very well.

**Do title charges vary with other fees paid by the borrower?** There is one more finding of concern in title charges: title charges are higher when the fees to the broker/lender and the real estate agent are higher. These effects are present even when all of the other loan and borrower characteristics are also taken account of, and they are measured with high precision. With respect to lender/broker fees, title fees are higher by 2.5 percent of the cash fees to lender/brokers, and higher by 1.2 percent of the YSP. This elevation of fees does not reflect merely that all fees are higher on larger loans, because loan amount (as well as down payment and neighborhood property values) is already accounted for as part of the same measurement. Although title charges rise with both lender/broker charges and realty fees, there is no relationship between the fees paid to lender/broker and fees paid to real estate agents once loan and borrower characteristics after taking account of loan and borrower characteristics. In other words, when either the lender or the real estate agent makes more on a deal, so does the title company. The fees of lender/brokers and real estate agents have no similar relation. Title fees rise faster with lender/broker and realty fees when only non-subsidized loans are analyzed.

The implication of a fee elevation of 2.5 percent is substantial and the Urban Institute (2008) includes the following example: “lender/broker fees on non-subsidized loans average about \$3,100 per loan among these FHA loans. The variation is large, and the 25<sup>th</sup> and 75<sup>th</sup> percentiles are roughly \$1,950 and \$4,350, a difference of \$2,400. If these fees are split into half cash and half YSP, the title company makes an additional \$100 on the 75<sup>th</sup> percentile loan as

compared to the 25<sup>th</sup> percentile loan. This extra amount is in addition to the fees related strictly to loan amount, down payment, and neighborhood property values.”

### **V.B.3.b. HUD’s Analysis of Title and Settlement Charges by State and Metropolitan Area**

HUD used the same FHA data base of approximately 7,600 HUD-1’s (see earlier discussion of Urban Institute Study) to examine the distribution of title and settlement fees across and within States. Title and settlement fees include title insurance, title search, attorney fees, and any other fees (e.g., binder fees) associated with obtaining title insurance and closing a mortgage. For each State, Table 2.11 provides the mean loan amount, the mean title and settlement fee, the first (25%) and third (75%) quartiles, and the standard deviation. Also provided in Table 2.11 are: title and settlement fees expressed as a percentage of the loan amount; the inter-quartile dollar difference (third minus first quartile); the inter-quartile difference expressed as a percentage of fees; and the standard deviation expressed as percentage of fees.

**Interstate Variations in Title and Settlement Fees.** The FHA data show substantial variation in title and settlement fees across states. Some of the main points from Table 2.11 include the following:

- Title-settlement fees are substantial in some states. Fees are over \$1,600 in the States of Texas (\$1,717), New York (\$1,789), New Jersey (\$1,931), California (\$2,063), and Connecticut (\$1,752), to name a few. This compares with fees less than \$900 in 12 States; for example \$732 in North Carolina.
- The large interstate differences in title and settlement fees are not simply due to differences in the average loan amount across States. Title and settlement fees express as a percentage of loan amount are as follows in these high-cost states: Texas (1.82%), New York (1.67%), New Jersey (1.54%), California (1.49%), and Connecticut (1.37%). In 20 States, title and settlement fees are less than one percent of the loan amount. For example, title and settlement fees are only 0.67% of the average loan amount in North Carolina.

It is implausible to think such large interstate differences are due to differences in actual costs. Why does it take 1.82% of the loan in Texas to obtain title insurance and close a loan, as compared with only 0.67% in North Carolina?

**Within State Variations in Title and Settlement Fees.** Title fees not only vary across States but they also exhibit substantial variation within States. As noted above, several measures of within State variation are provided in Table 2.11. Some of the main points are as follows:

- In four States, the inter-quartile dollar difference is approximately one thousand dollars: New York (\$1,119), New Jersey (\$999), California (\$1,010), and Illinois (\$959). This compares with inter-quartile differences of less than \$225 in 16 states; for example, only \$138 in North Carolina.

- Large within State variations in title and settlement fees are not explained by differences in the absolute magnitude of title and settlement fees. The inter-quartile dollar difference expressed as a percentage of title and settlement fees were as follows in these selected states: Illinois (69.1%), Utah (68.3%), New York (62.6%), New Jersey (51.7%), Virginia (49.6%), California (49.0%), Ohio (44.4%), and Florida (37.9%). In 8 States, the inter-quartile dollar difference was less than 20% of title and settlement fees. For example, the inter-quartile dollar difference was 19% of the average title and settlement fees in North Carolina.
- The same within State information is shown by expressing the standard deviation of title and settlement fees as a percentage of the average fee in each state. Selected States with a high percentage (indicating highly variable fees) include: New York (52.5%), West Virginia (48.9%), Wyoming (47.6%), Illinois (47.3%), Nebraska (43.9%), Maine (40.9%), Ohio (37.6%), Florida (34.2%), Michigan (33.9%), Utah (33.8%), New Jersey (32.5%), Virginia (31.6%), and California (30.9%). In 9 States, the standard deviation was less than 20% of title and settlement fees.

The individual State charts in the Appendix A to this chapter also indicate the wide variability in title and settlement fees for given loan amounts.

**Individual Metropolitan Area Table and Charts.** The data were also analyzed for selected metropolitan areas. Table 2.12 provides data on title fees for 16 metro areas in the same format as the State data in Table 2.11. In addition, Appendix B to this chapter plots title fees against loan amounts for each of these 16 metropolitan areas areas. The advantage of looking at title costs within a metro area is that there will be fewer potential reasons for costs to differ as compared to across an entire state. Nevertheless, just as above with States, there are many examples of huge variations. As shown in the Appendix charts, Albuquerque varies between \$800 and \$1600, Chicago between \$800 and \$2,500, Dallas-Fort Worth between \$1,100 and \$2,300, Las Vegas between \$600 and \$1,800, and Washington, DC between \$1,000 and \$2,500, just to mention a few. Most of the rest show similar large variations for title and settlement work. As shown in Table 2.12, the standard deviation is more than 20 percent of the average fee in several metro areas, including Chicago, St. Louis, and Hartford.

The metropolitan area data reinforce the above State data, the findings of similar surveys (e.g., the Consumer Union survey showing wide variation in California title charges), the anecdotal information about overcharging by title companies that has appeared recently in the press, the numerous recent court cases involving kickbacks among title and other real estate service companies, and the recent reports (such as that by GAO) concluding that the title industry is characterized by non-competitive conditions. Like other borrowers, cash-constrained FHA borrowers are paying a wide range of fees to our nation's title and closing companies. Claims by ALTA and others that there is "no fat in title fees" do not carry much weight in light of these data.

### V.B.3.c. Other Analyses of Title and Third-Party Fees

Additional evidence suggesting third-party settlement costs can be reduced is provided by analysis of mainly conventional loans supplied to HUD by Susan Woodward (these are the court-case loans analyzed in Woodward, 2003). The analysis shows that, even after controlling for factors that are expected to affect the price of third-party settlement service, prices are extremely variable having a standard deviation of \$726 around a mean of \$1,229. The laws of statistics suggest that third-party settlement services costs will be reduced in concert with the reduced variability in prices brought about by consumers increased ability to meaningfully compare prices under the new rule. This is separate from any other influences that may result in a lowering of costs.

The total of third-party settlement service costs in a mortgage loan transaction can be described as a random variable from a lognormal<sup>119</sup> distribution. Estimates of the parameters ( $\mu$ ,  $\sigma$ ) of the lognormal distribution of third-party settlement services costs from a sample of 2,726 loan transactions from 8 states are 6.963685 for  $\mu$  and 0.592342 for  $\sigma$ . This implies that third-party settlement services costs have a mean of \$1,260 and standard deviation of \$817<sup>120</sup>. After using a model to control for various aspects that should have a bearing on third-party settlement services costs such as State, loan size, and whether or not the loan was a refinancing, the estimator of  $\sigma$  is reduced to 0.547760. Since the parameter  $\mu$  is unchanged by the model, the price of third-party settlement services after controlling for known factors has a mean of \$1,229 and standard deviation of \$726. Thus there is a large amount of variability, or price dispersion, that remains unaccounted for – this variability in third-party prices is similar to the variability found in lender and broker prices found by Jackson and Berry (2001) and Guttentag (2002).

Assuming the RESPA rule changes the distribution of third-party settlement services prices to one where the parameter  $\sigma$  is 25 percent lower (0.41082), the standard deviation of third-party settlement services costs after controlling for known factors would be \$493 and the mean would be \$1,151, \$78 or about 6.4 percent lower than before the rule. If the new distribution had  $\sigma$  half as large as the old distribution ( $\sigma = 0.27388$ ) the new standard deviation would be \$306 and the new mean \$1,098, \$131 or about 10.6 percent lower than before the rule. The reductions in average price and in price dispersion will benefit consumers by reducing their expenses and assuring them they have received a fair deal. Note that this reduction in average prices is simply the result of third-party settlement services prices coming from a post-rule distribution, created by consumers' increased ability to shop, with less variability than the pre-rule distribution. It is apart from any general price reductions achieved through increases in efficiency brought about by new business arrangements possible under the rule.

Woodward (2003b) has conducted her own analysis of title charges. She studies a unique set of data compiled from the entries in the 1100 lines of approximately 2800 HUD-1 settlement

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<sup>119</sup> A lognormal random variable always has a value greater than zero. The natural logarithm of a lognormal random variable with parameters  $\mu$  and  $\sigma$  has a normal distribution with mean  $\mu$  and standard deviation  $\sigma$ . See Mood, Alexander M., Franklin A. Gaybill, and Duane C. Boes, *Introduction to the Theory of Statistics*, McGraw-Hill, 1974.

<sup>120</sup> The mean of the lognormal distribution with parameters  $\mu$  and  $\sigma$  is  $\exp[\mu + \frac{1}{2}\sigma^2]$ , and the standard deviation is the square root of  $\{\exp[2\mu + 2\sigma^2] - \exp[2\mu + \sigma^2]\}$ . See Mood, et al., op cit.

statements for loans made over the period 1996-2001, all either funded (if brokered) or made (if retail) by a single large national wholesale lender. The basic findings are that for brokered loans, the cost of title insurance averages \$910 with a standard deviation of \$550, an enormous amount of variability. The total amount paid to the title insurer is systematically (and directly) related to only three measurable features of the transaction: 1) the number of individual line items payable to the title insurance company, 2) the amount paid to lawyers involved in the closing, and 3) the yield spread premium on the loan. That is, the total *amount* of title charges increases with the *number* of separate title charge line items, the amount paid to lawyers in the transaction and the size of the yield-spread premium. These factors explain about 20 percent of the variation in title charges. Retail loans have title charges that average \$200 less than those for brokered loans. Neither the amount of the loan, nor the value of the house, nor any geographic or socio-economic status variables bears any statistical or economic relation to title insurance charges. Title charges *do not* vary systematically by state where States with more requirements and more complex requirements (and possibly poorer property ownership records) might cause there to be higher charges or a larger number of charges for more individual items, and thus for the State in which the house is located to be important in determining total title insurance costs. In fact, the number of charges is unrelated to the State in which the property is located. The number of charges is significantly related to title costs in and of itself. In another test of transaction complexity, title insurance costs for purchase and refinancing loans were compared and found to be statistically indistinguishable.

### **V.C. Will Savings in Third-Party Costs Be Passed Through to Consumers?**

Subsection II.C explained that the mortgage origination market became more concentrated during the 1990s with the growth of large lenders that not only originated loans themselves on a retail basis but also purchased loans from brokers and loan correspondents on a wholesale basis. LaMalfa (2002), the Joint Center for Housing Studies (2002), Woodard (2003), and others have concluded that these lenders operate in a highly competitive market environment. Several of the commenters on the 2002 proposed rule had a different view about the competitiveness of the mortgage market, arguing that any third-party savings might be retained, rather than passed through to consumers. While many of the comments focused on packaging, the same market dynamics are for this proposed rule.

ALTA, for example, argued that HUD's proposals would increase concentration in the mortgage industry and would allow larger lenders to retain any price discounts obtained from third-party providers (p. 28). Similarly, the National Association of Realtors (NAR) said that HUD's packaging proposal "can lead to increase concentration with the industry and reduce competition" and lenders will have "no obligation to pass along discounts to borrowers" (NAR, 2002, p.4). The NAR-funded paper by Ann Schnare, entitled "The Downside Risks of HUD's Guaranteed Mortgage Package" (dated October 24, 2002) reached conclusions exactly opposite to those reached by LaMalfa (2002) and the Joint Center for Housing Studies (2002). Schnare identifies the same concentration trends as these studies:

[T]he mortgage industry is increasingly characterized by the dominance of a few large national originators. In 2001, for example, the top ten lenders accounted for over 50 percent of total loan originations and 48 percent of total servicing. The

degree of concentration within the lending industry has been increasing steadily over time, reflecting a wave of mergers and acquisitions that have transformed the financial service industry as a whole (page 15).

Schnare goes on to say the HUD's packaging proposal will accelerate this concentration trend and that gives her "some reason for concern" that packagers will not pass through any savings to consumers but rather retain any savings for themselves. She writes, "more important, perhaps, there is no reason to conclude that any cost savings that do arise [from packaging] will be passed through to consumers" (p. 10). Schnare asserts that the mortgage market has become less competitive over the last ten years, a conclusion that is soundly contradicted by most industry observers (Olson, LaMalfa, the Joint Center, Morgan Stanley, etc.). Schnare assumes that the above-mentioned trends in concentration are associated with changes in pricing dominance. But, LaMalfa (2002) disputes this view:

[H]owever--and let us underscore this point--market "dominance" is not market power, in the sense of pricing power, of which a perfectly competitive market like mortgage banking has none. (p. 58)

Commenters such as Schnare, NAR, and ALTA contend that increasing the concentration ratio (say from 50 percent to 55 percent in her example) would directly reduce the competitiveness and adversely influence pricing behavior in the market. But according to Inside Mortgage Finance (January 24, 2003), the share of the top five (25) originators increased from 28 percent to 47 percent (from 54 percent to 79 percent) between 1998 and 2002. By all evidence, firms are competing today as fiercely as they competed in 1998, not less so. Commenting on these trends, the Joint Center for Housing Studies (2002), which views larger lenders as competing in a highly competitive environment, noted that these trends will persist with continued technological change and that low marginal costs will spur competition "as large firms seek to identify and exploit competitive advantage in their pursuit of customers in an increasingly competitive marketplace"(p. 17). Woodward (2003a) echoes the same sentiments, when she states "the wholesale lending market is highly competitive" (p. 38) and "competing wholesale lenders are surely setting rate sheets so as to leave themselves indifferent as to which rate/point cells the broker and/or borrower select. It would not be profit maximizing for the wholesale lender to do otherwise" (p. 39).

The structure of nearly all sectors of the impacted industries (see Chapter 5 of this Analysis for details on the structure of these industries) suggests that there are few barriers or costs to successful entry so that exit involves little loss of sunk costs; and that average costs of production are constant over a wide range of output including quantities below market equilibrium. These are the necessary conditions for a "perfectly contestable" market as defined in Baumol, et. al. (1988)<sup>121</sup>.

In a contestable market, even a monopoly will produce output at the socially optimal (perfectly competitive) level where price equals marginal (equals average) cost because any attempt by the incumbent to raise prices will be met (contested) by the entry of a competitor who

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<sup>121</sup> William J. Baumol, John C. Panzar, and Robert D. Willig, *Contestable Markets and the Theory of Industry Structure*, 1988, Harcourt Brace Jovanovich, Inc.

can profitably undercut the incumbent's price. Today, if one "dominant" lender raised prices in its local market, then one or more other lenders would immediately enter the market and take market share away from the price-increasing lender. As LaMalfa (2002) states, "'dominance' is not pricing power." Today's wholesale mortgage lending market is highly contestable, and most of the other settlement services industries are highly competitive, for reasons that have nothing to do with current RESPA rules. There is no reason to expect RESPA reform to change these conditions. Even large players in the mortgage market will have to pass on savings to consumers in order to maintain market share. Any exertion of "monopoly" power by attempting to keep reduced costs from being passed to consumers would not be sustainable in the market without illegal collusive agreements among providers. Schnare's concern (p. 17) about some lasting monopoly power that allows lenders to increase their prices (after initially lowering their prices to gain market share) is simply invalid in today's mortgage market.

It is interesting that a year prior to her report for NAR, Schnare expressed a completely different view of the effects of consolidation. In a June 2001 report associated with the Standard-Heartland YSP case, she described the market trend toward consolidation and then stated:

Despite this consolidation both lending and servicing are industries in which no firm is sufficiently large enough to have market power, and thus are well described by what economists call "perfect competition." (p.5)

Schnare goes on to note that the movement to larger lenders "has helped to reduce the average homeowner's mortgage costs" (p. 5). In this report, she also notes:

Intense competition in the mortgage market makes mortgage funds flow to the low cost provider. This occurs at all points in the value chain. Mortgage brokers...actively compete for borrowers. Mortgage wholesalers...actively compete in the origination and servicing of loans. (p. 10)

In this case, Schnare concludes that intense competition tends to lower mortgage interest rates by putting downward pressure on origination fees. These views about the competitive nature of our mortgage market are similar to those expressed by LaMalfa (2002), the Joint Center for Housing Studies (2002), Woodward (2003) and others.

## **VI. Subprime Market**

The subprime market provides loans to borrowers who can not qualify for prime loans because of their poor credit records and high levels of debt. Subprime loans are defined as loans made to borrowers with impaired credit, typically with credit ratings of A-minus to D, whereas prime loans have a credit rating of A.<sup>122</sup> The problems discussed above regarding complex mortgage transactions and barriers to consumer shopping are only heightened in the subprime market.

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<sup>122</sup> Often a FICO score of 620 corresponds to the dividing line between prime and subprime, though the use of automated underwriting models have blurred the dividing line.

**Trends in Subprime and Non-Traditional Markets.** As shown in the table below, total residential mortgage originations increased from \$2,215 billion in 2001 to \$3,945 in 2003 as the drop in interest rates and strong house price appreciation spurred a wave of refinancing. But as the refinancing wave receded and increases in housing costs continued, the conventional conforming and government-insured market shares declined sharply, while the subprime, Alternative A (Alt A) and home-equity loan (HEL) products greatly expanded. In particular, the subprime loan share more than doubled from 8.6 percent in 2001 to 20.1 percent in 2006, although most of these gains were lost in 2007 as its market share returned to its 2003 level of 7.9 percent.

The growth in the subprime market up until 2007 is often attributed to two major innovations: credit scoring and securitization. Credit scoring techniques, first developed in making subprime auto loans, provided a standardized way of assessing risks. Securitization had allowed for expanding credit for prime borrowers since the eighties, but required an additional innovation to make the subprime mortgage-backed securities attractive to investors. The collateralized debt obligation (CDO) is a derivative designed to protect investors against the risks of default. This innovation allowed firms to sell subprime mortgage-backed securities at prices that were competitive with the lower-risk prime mortgage-backed securities of the GSEs. The growth of the subprime market was fueled further by a global demand for high-yield securities. Subprime securities were perceived to be safe by many who assumed that housing prices in the U.S. would continue to grow faster than income.

This expansion of the subprime market reversed itself dramatically beginning in late 2006. Delinquencies among subprime adjustable rate borrowers rose to 15 percent in late 2007, a level three times that only two years earlier. Indeed, adjustable-rate mortgages originated in late 2005 and in 2006 performed the worst, with some defaulting after only or two payments (Bernanke, 2007). A slowdown in the housing market has and will motivate many other defaults as subprime borrowers, whose downpayments were lower than prime borrowers, find themselves “underwater.” In addition, borrowers with adjustable rate mortgages, who had planned to refinance before their rates reset, will find that option less attainable as the asset value of their home declines.

Besides housing market trends, there are structural aspects of the market that have contributed to the recent and dramatic collapse of the subprime market. Poor underwriting standards are often blamed as a root cause. Much, if not all of the risk of a loan is passed on to loan purchasers, so the incentive for ensuring loan quality is weak. According to Bernanke (2007), fees tied to loan volume, but not the long-run performance of the loans, contributed to the decline in underwriting standards. The consequences of easing credit standards were realized in early 2007 as delinquency rates on nonprime mortgages soared (DiMartino and Duca, 2007).

Enormous losses have been incurred by investors in the subprime market leading to the failure of Bear Sterns and Lehman Brothers, two of the most aggressive participants in the subprime securitization process. The rise in subprime mortgage defaults became a significant burden on those financial institutions that had invested heavily in the subprime market. Consequently, the cost of subprime loans has risen and the underwriting standards for subprime loans have become more rigorous. The result is a significant decrease in market share of the subprime market.

The product type with the greatest initial expansion over the last five years is Alternative A or “Alt A.” The Alt A product share increased by a factor of 5, from 2.7 percent in 2001 to 13.4 percent in 2006. Alt A are loans made to borrowers with limited income or asset verification, often preferred by self-employed workers and those with non-traditional circumstances. Alt A are sometimes referred to as non-prime or near prime in that they generally have higher credit ratings than the B, C and D loans in subprime, but do not qualify as prime loans, which require full documentation of income and employment. The low documentation is often offset by relatively higher credit scores and a higher interest rate on the loan. More recently, however, the Alt-A has been used increasingly by consumers for whom the loan is at the limit of their financial means. Lenders even have the incentive to encourage potential borrowers to exaggerate their income and wealth in order to receive a loan. The market has receded slightly from its 2006 share to 11.3 percent in 2007 as a result of higher interest rates in this market..

### Mortgage Originations by Product

#### A. Dollars (in Billions)

	<b>Conv/ Conf</b>	<b>FHA/VA</b>	<b>Jumbo</b>	<b>Subprime</b>	<b>Alt A</b>	<b>HEL</b>	<b>TOTAL</b>
2001	\$1,265	\$175	\$445	\$160	\$55	\$115	\$2,215
2002	\$1,708	\$176	\$571	\$200	\$67	\$165	\$2,885
2003	\$2,460	\$220	\$650	\$310	\$85	\$220	\$3,945
2004	\$1,210	\$135	\$515	\$540	\$190	\$330	\$2,920
2005	\$1,090	\$90	\$570	\$625	\$380	\$365	\$3,120
2006	\$990	\$80	\$480	\$600	\$400	\$430	\$2,980
2007	\$1,162	\$101	\$347	\$191	\$275	\$355	\$2,430

Source: Inside Mortgage Finance, 2008 Mortgage Market Statistical Annual (p. 4).

#### B. Percentage Shares

	<b>Conv/ Conf</b>	<b>FHA/VA</b>	<b>Jumbo</b>	<b>Subprime</b>	<b>Alt A</b>	<b>HEL</b>	<b>TOTAL</b>
2001	57.1%	7.9%	20.1%	7.2%	2.5%	5.2%	100.0%
2002	59.2%	6.1%	19.8%	6.9%	2.3%	5.7%	100.0%
2003	62.4%	5.6%	16.5%	7.9%	2.2%	5.6%	100.0%
2004	41.4%	4.6%	17.6%	18.5%	6.5%	11.3%	100.0%
2005	34.9%	2.9%	18.3%	20.0%	12.2%	11.7%	100.0%
2006	33.2%	2.7%	16.1%	20.1%	13.4%	14.4%	100.0%
2007	47.8%	4.2%	14.3%	7.9%	11.3%	14.6%	100.0%

Another product with substantial increase during the last five years is the home-equity loan (HEL), which holds a junior position relative to the first mortgage. HELs are frequently piggyback loans in which the second lien is taken out at the same time as the first and allows the borrower to avoid payment of mortgage insurance, and so has contributed to the decline in market shares for conventional conforming and government insured loans. HEL loan share has increased from 4.6 percent in 2001 to 14.4 percent in 2006.

As noted above, the subprime market allows borrowers who can't qualify for conventional loans (or even FHA loans) to receive a loan by paying a higher interest rate to offset their higher credit risk; essentially, the growth in subprime lending has represented the first real expansion of risk-based pricing in the mortgage market. Without the subprime market, many lower-income, credit-impaired borrowers would not have been able to obtain funds during the 1990s (Gramlich, 2002). Because they face higher interest rates and origination fees due to questions about their creditworthiness, borrowers in the subprime market are precisely the people who need the simplification and shopping advantages offered by the types of reform outlined in the proposed RESPA rule. As noted below, there exists some inefficiency in the subprime market, which places a premium on consumers shopping in order to obtain useful information regarding mortgage options and prices.<sup>123</sup>

**Concerns About Market.** The joint HUD-Treasury report, *Curbing Predatory Home Mortgage Lending* (2000), explains the origins of this market, the factors behind its substantial growth, and the characteristics of borrowers served by that market. The report also discusses some of the concerns that have come with the growth in this market. First, there is evidence of inefficiency in pricing, which is not entirely surprising given the heterogeneous nature of borrowers served by this market and the rapidity with which the market has grown. Analysis by Freddie Mac economists suggests that some borrowers in this market are paying higher interest rates than would be predicted by their credit scores and other loan characteristics.<sup>124</sup> Both Fannie Mae and Freddie Mac have said that a significant number of subprime borrowers could qualify for conventional prime loans. This points to the importance of consumers shopping their qualifications among a number of lenders so as to gain information about the full range of mortgage options available to them.<sup>125</sup>

Second, HUD studies have documented that minority borrowers and neighborhoods rely heavily on subprime lenders for their refinance mortgages.<sup>126</sup> In 2000, subprime lending

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<sup>123</sup> The largest channel in subprime is the broker channel, which increased from 47.6 percent in 2003 to 59.3 percent in 2005 before shrinking to 54.9 percent in the first half of 2006.

<sup>124</sup> See Howard Lax, Michael Manti, Paul Raca, and Peter Zorn, "Subprime Lending: An Investigation of Economic Efficiency" (unpublished paper), February 25, 2000. Also, analyses by Fannie Mae and Freddie Mac suggest that some portion of subprime lending is occurring with borrowers whose credit would qualify them for loans sold to the GSEs. Freddie Mac staff estimate that 10-35 percent of subprime borrowers meet Freddie Mac's purchase guidelines for conventional loans. Fannie Mae has stated that half of all mortgage borrowers steered to the high-cost subprime market are in the A-minus category, and therefore are prime candidates for Fannie Mae. See "Fannie Mae Vows More Minority Lending", Washington Post, March 16, 2000, page EO1.

<sup>125</sup> Consumer advocates have also highlighted many cases in which the loan pricing appears to go far beyond the risk of the loan. Opportunity pricing means the lenders or brokers takes advantage of their greater familiarity with the market to set loan prices much higher than the borrower's risk would warrant. Through yield-spread premiums, the broker can turn the overage pricing into broker profit at the expense of the borrower. Profit-based pricing recognizes that pricing is not based on costs or risks, but rather set to maximize the profit of the lender. The key distinction is that borrowers with inelastic demand should be charged a higher price. From the borrower's perspective, inelastic demand means the borrower has few alternative offers, either because other lenders are unwilling to make offers or the borrower has not sought out alternatives. This may be the situation in the subprime market.

<sup>126</sup> The Unequal Burden report published by HUD (April, 2000) reported data on a neighborhood basis -- subprime lending accounted for 51 percent of the refinance loans in predominantly black neighborhoods, compared to only 9

accounted for 50 percent of refinance loans in majority African American neighborhoods – compared with only 21 percent in predominantly white areas (less than 30 percent of population is African American). It does not seem likely that these high market shares by subprime lenders in low-income and African-American neighborhoods can be justified by a heavier concentration of households with poor credit in these neighborhoods. Calem, Gillen and Wachter (2002) examined neighborhoods in Chicago and Philadelphia and concluded that about half of the increase in subprime lending could be explained by differences in neighborhood measures of credit quality. However, even after controlling for differences in neighborhood measures of credit quality and a variety of other neighborhood effects, there still was a strong concentration of subprime loans in African American neighborhoods.<sup>127</sup> <sup>128</sup> It appears that subprime lenders may have attained such high market shares by serving areas where prime lenders do not have a significant presence. Belsky and Calder (2003) discuss other factors besides credit quality that affect the types of financial services available in low-income neighborhoods and state that the lack of mainstream lenders in lower-income communities is also related to the actual or perceived differences in the profitability of mortgage lending in lower-income communities.<sup>129</sup>

Finally, there is evidence that predatory lending has been an unfortunate part of the growth in the subprime market. Predatory lending is characterized by several abusive and horrendous lending practices – excessive interest rates, extraordinary origination fees and points rolled into the mortgage, pressure tactics to refinance so that another set of high upfront fees can be charged, and so on. Predatory lenders target the elderly, women, and minorities who need money quickly to pay for medical expenses, pay off credit cards or make needed house repairs. There is no quantitative information on the magnitude of predatory lending (i.e., the number of loans with predatory characteristics), and there are questions about how exactly to define it. However, there is ample anecdotal information from victim testimonies and various court cases to indicate the seriousness of this problem and the variety of forms it can take. There is also evidence that the growing incidence of abusive practices has been stripping borrowers of their

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percent in predominantly white neighborhoods. The Unequal Burden work is updated in Scheessele (2002), which is the source of the 2000 data reported in the text.

<sup>127</sup> Paul Calem, Kevin Gillen, and Susan Wachter. “The Neighborhood Distribution of Subprime Mortgage Lending.” Zell/Lurie Real Estate Center at Wharton, Working Paper 404. 2002.

<sup>128</sup> Similarly, Pennington-Cross, Yezer and Nichols (2000) estimated the probability that an individual borrower selected a subprime mortgage and concluded that while borrower income, debt, credit history, and neighborhood factors significantly influence whether a borrower receives a subprime loan, race and ethnicity were also key factors in explaining why minorities are less likely to have prime loans than white borrowers. Anthony Pennington-Cross, Anthony Yezer, and Joseph Nichols. *Credit Risk and Mortgage Lending: Who Uses Subprime and Why?* Arlington, VA: Research Institute for America. 2000.

<sup>129</sup> Eric Belsky and Allegra Calder. *Credit Matters: Low-Income Asset Building Challenges in a Dual Financial Service System*. Presentation at Joint Center for Housing Studies Conference: Building Assets, Building Credit: A Symposium on Improving Financial Services In Low-Income Communities. November 18-19, 2003. See also John Caskey. *Bringing Unbanked Households into the Banking System*. Report for the Brookings Institution. 2002; Michael S. Barr. *Banking the Poor*. Report for the Brookings Institution. 2003; and Constance R. Dunham. “The Role of Banks and Nonbanks in Serving Low- and Moderate- Income Communities,” in J.L. Blanton, S.L. Rhine, and A. Williams, eds., *Changing Financial Markets and Community Development: A Federal Reserve System Research Conference*. Federal Reserve Bank of Richmond, pp. 31-58. 2001.

home equity, threatening families with foreclosure, and destabilizing neighborhoods.<sup>130</sup> The problems associated with home equity fraud and other mortgage abuses are not new ones, but the extent of this activity seems to be increasing. The expansion of predatory lending practices along with subprime lending is especially troubling since subprime lending is disproportionately concentrated in low- and very-low income neighborhoods, and in African-American neighborhoods.

**Shopping in Subprime Market.** Courchane, Surette, and Zorn (2004) found that subprime borrowers are less likely to shop for a mortgage than prime borrowers. For example, approximately 49 percent of prime borrowers in their survey searched for the best rate compared to approximately 32 percent for subprime borrowers. The authors concluded after controlling for underwriting factors, that borrowers who search less are more likely to obtain a subprime loan.<sup>131</sup> There are a number of reasons that subprime borrowers are not as likely to shop for the best mortgage rate.

First, subprime borrowers are not as financially sophisticated as prime borrowers.<sup>132</sup> Courchane, Surette, and Zorn (2004) found that prime borrowers were more likely to be very familiar with mortgage types, rates and costs, and how to qualify for a mortgage than subprime borrowers.<sup>133</sup> The state:

We find that subprime borrowers are less knowledgeable about the mortgage process, are less likely to search for the best mortgage rates, and are less likely to be offered a choice among alternative mortgage terms and instruments – possibly making them more vulnerable to unfavorable mortgage outcomes.

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<sup>130</sup> In fact, high foreclosure rates for subprime loans provide the most concrete evidence that many subprime borrowers are entering into mortgage loans that they simply cannot afford. HUD and others have documented the high rate of foreclosures in the subprime market in recent research studies. For an overview of these studies, see Harold L. Bunce, Debbie Gruenstein, Christopher E. Herbert, Randall M. Scheessele, “Subprime Foreclosures: The Smoking Gun of Predatory Lending,” 2000.

<sup>131</sup> See Marsha J. Courchane, Brian J. Surette, and Peter M. Zorn, “Subprime Borrowers: Mortgage Transitions and Outcomes,” *Journal of Real Estate Finance and Economics*, Forthcoming, 2004.

<sup>132</sup> A United Kingdom research study found that financial sophistication limited shopping for a mortgage. See Financial Services Consumer Panel, “Mortgage Research Study,” United Kingdom, August 1999.

<sup>133</sup> According to the Joint Center for Housing Studies, “even the most sophisticated borrower will find it difficult to evaluate the details of a mortgage since the essence of mortgage pricing reflects decisions concerning repayment of debt over time.” The Joint Center report cites research that concludes that many borrowers use short-cut methods to comparison shop and these methods allow some brokers to exploit the weaknesses of these short-cut methods. Subprime borrowers are more vulnerable than prime borrowers because they have less financial sophistication, fewer resources to seek professional help, and because subprime loans may have features that are not characteristic of prime mortgages. See “Credit, Capital and Communities: The Implications of the Changing Mortgage Banking Industry for Community Based Organizations, Joint Center for Housing Studies, Harvard University, March 9, 2004.

The authors also determined that subprime borrowers are less satisfied with the terms of their loans.<sup>134 135</sup> Similarly, a recent Joint Center for Housing Studies report found that areas with high shares of college-educated individuals have higher proportions of prime conventional loans even after controlling for neighborhood and family income.<sup>136</sup> Second, subprime borrowers are more likely to have obtained loans through aggressive marketing by a mortgage broker. Mansfield (2003) observes that one feature of the subprime market that distinguishes itself from the prime mortgage market is brokers' "push marketing" of loan products. Subprime borrowers are more likely than prime borrowers to obtain a mortgage from brokers who use telephone solicitation, direct mail, or door-to-door solicitation to seek out customers.<sup>137</sup> A Fannie Mae Survey of credit-impaired borrowers also found that subprime borrowers were more likely to obtain a loan from lenders who used these marketing techniques.<sup>138</sup> Among other reasons, push marketing is effective because it promises guaranteed loan approval or convinces homeowners to obtain a mortgage even though they were not searching for one.<sup>139</sup>

Third, the typical subprime borrower does not have as many resources to shop as the typical prime borrower. As stated in the last section, even after controlling for neighborhood credit measures, subprime lending is concentrated in low-income and minority neighborhoods.<sup>140</sup> Low-income and minority may not shop for a mortgage for a number of reasons. For example,

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<sup>134</sup> Ultimately, however, the authors could not decide whether the subprime borrowers were made better off or worse off by their loans. On the one hand, the subprime market did make it possible for them to get a loan, but, on the other hand, the expensive terms of the loan and higher rates of default meant that some subprime borrowers were worse off having received the loan.

<sup>135</sup> In a borrower satisfaction survey by J.D. Power and Associates in November 2005, subprime borrowers were the least satisfied. The survey asked 4,498 recent borrowers about the application process, loan officer and closing process. ABN AMRO Mortgage got top marks with quick processing and ease of closing, followed by SunTrust, Wachovia, Countrywide and Wells Fargo. The highest volume subprime lenders, Ameriquest and Option One, both scored well below the industry average. Most of the respondents (61 percent) said they rely on word-of-mouth recommendations from family and friends, so reputation is important for future business. A common problem for subprime closings was a surprise increase in their monthly payment. "Borrowers may feel somewhat deceived when their monthly payment does not match what was quoted in the good faith estimate," according to Jeremy Bowler, senior director of J.D. Power's finance and insurance practice (Inside B&C Lending, 2/17/2006).

<sup>136</sup> See Joint Center for Housing Studies, *op. cit.* Also see Paul Calem, Kevin Gillen, and Susan Wachter, "The Neighborhood Distribution of Subprime Mortgage Lending," Zell/Lurie Real Estate Center at Wharton, Working Paper 404, 2002.

<sup>137</sup> Cathy Lesser Mansfield, "Consumer Choice and Risk in Society," Remarks for the 9<sup>th</sup> International Consumer Law Conference, Athens, Greece, April 10-12, 2003.

<sup>138</sup> See Fannie Mae, "Examining the Credit Impaired Borrower: 2001 National Housing Survey," Washington DC, 2001.

<sup>139</sup> See Eric Belsky and Allegra Calder, "Credit Matters: Low-Income and Asset Building Challenges in a Dual Financial Service System," *Building Assets, Building Credit: A Symposium on Improving Financial Services in Low-Income Communities*, Joint Center For Housing Studies, Harvard University, November 18-19, 2003.

<sup>140</sup> For example, see Paul Calem, Kevin Gillen, and Susan Wachter, *op. cit.*; and Anthony Pennington-Cross, Anthony Yezer, and Joseph Nichols, "Credit Risk and Mortgage Lending: Who Uses Subprime and Why?" Arlington, VA, Research Institute for America, 2000.

low-income borrowers do not have as many resources to devote to shopping for a mortgage.<sup>141</sup> Also, borrowers rely on informal contacts for most of their information on mortgages and low-income and minority borrowers may be less likely to have contacts that are as familiar with mortgage markets.<sup>142</sup> Finally, households in low-income and minority neighborhoods may perceive that there are fewer opportunities to find a mortgage because of a lack of prime lenders in their neighborhoods. Belsky and Calder state, “Similarly, if there are few available choices in an area, family or peer referrals may continue to send new borrowers to the same institutions, regardless of their price structure.”<sup>143</sup>

Fourth, subprime borrowers may be more likely than prime borrowers to have different attitudes and objectives that contribute to less mortgage shopping. Belsky and Calder conclude that consumers often choose subprime mortgage lenders because they create a welcoming environment, have representatives that speak their language, and easier loan approvals.<sup>144</sup> Subprime borrowers may be more likely than prime borrowers to remain with the same lender because he understands their credit and financial circumstances.<sup>145</sup> Subprime lenders may provide more help than prime lenders in completing the mortgage application. Subprime borrowers may need money more quickly, which limits their mortgage search. Subprime borrowers are more likely to believe that they have fewer opportunities because of their credit circumstances and brokers may reinforce these perceptions. In many cases the borrower is happy to be approved.<sup>146</sup> The broker can reinforce the perception that the borrower may not be approved elsewhere by suggesting that the loan is hard to make and they are the only lenders who will make it.<sup>147</sup>

Finally, there are differences in the amount of information that subprime and prime lenders provide publicly which may limit the amount of mortgage shopping by subprime borrowers. Prime loan rate quotes can be easily found in newspapers, on the Internet, and

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<sup>141</sup> Mortgage research conducted by the Financial Services Consumer Panel highlighted that “consumers stretched by the house buying process are less likely to shop around or withdraw from a mortgage application at a late stage even if it is not a good deal; this made them more reliant on advisers and susceptible to poor advice.” See Financial Services Consumer Panel, “Financial Services Consumer Panel Warns That Stronger Protection Is Needed Now For Housebuyers,” United Kingdom, October 11, 1999.

<sup>142</sup> See John Caskey, “Keynote Speech for Alternatives Federal Credit Union,” May 16, 2002; Joint Center for Housing Studies, op. cit.; and Financial Services Consumer Panel (August 1999), op. cit.

<sup>143</sup> Eric Belsky and Allegra Calder, op. cit. See also Randall M. Scheessele. “Black and White Disparities in Subprime Mortgage Refinance Lending,” Working Paper No. HF-014, Housing Finance Working Paper, April 2002; and Daniel Immergluck and Marti Wiles, “Two Steps Back: The Dual Mortgage Market, Predatory Lending, and the Undoing of Community Development,” Chicago, IL, November 1999.

<sup>144</sup> Eric Belsky and Allegra Calder, op. cit.

<sup>145</sup> Financial Services Consumer Panel (August 1999), op. cit.

<sup>146</sup> A Fannie Mae survey finding that nearly one-third of credit-impaired borrowers did not care if they received the lowest cost loan led Belsky and Calder to conclude “getting a yes is often the most important consideration.” See Eric Belsky and Allegra Calder, op. cit.; and Fannie Mae, op. cit.

<sup>147</sup> David Reed, “It Pays To Shop Around,” [www.realtytimes.com](http://www.realtytimes.com), October 10, 2003.

directly from the lender. But subprime lenders typically don't quote rates until after a consumer applies for a loan and the lender gets his or her credit score.<sup>148</sup> Mansfield states, “The result of all of these realities taken together is that in the subprime mortgage market it is almost impossible to get accurate information about pricing and loan product features. This is true at almost any phase of the transaction – from direct marketing or advertising to closing of the loan.”<sup>149</sup>

While RESPA reform will not eliminate the fraudulent practices that take place in the predatory lending market, it does have the potential to help borrowers in the high-cost and subprime markets. The proposed rule will simplify the process of obtaining a mortgage loan by allowing the consumer to shop based on a few summary numbers: the interest rate (or monthly payment) and the information on the summary page 1 of the GFE. Consumers who are less informed may be better off under the proposed rule since it is easier to understand a few numbers rather than a detailed list of charges.<sup>150</sup>

## VII. Comments by the NAMB Relating to Literature Review

**Comment.** The June 12, 2008 comment letter from the National Association of Mortgage Brokers (NAMB) states, on p. 49 that: “the Proposed Rule fails to give proper consideration to much of the most relevant and authoritative research relating to the operation of mortgage markets, including but not limited to, the 2004 FTC study; the 2006 GAO Report; the 2007 GAO Report; the Broker Regulations Analysis prepared by a staff member of the Federal Reserve Bank of Minneapolis and a professor at the University of Minnesota; the Mortgage Pricing Study prepared by researchers at George Washington, Georgetown, and Oklahoma State Universities; the Harvard Mortgage Markets Study; and other government and academic studies.” In the section that follows, HUD briefly discusses each one of those, how the NAMB feels that the results should be taken into consideration; and HUD’s conclusions.

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<sup>148</sup> See <http://www.in.gov/dfi/education/applycr.htm>. See also Joint Center for Housing Studies, *op. cit.*, Subprime lenders argue that subprime credit is priced on an individual basis but Mansfield (2003) argues that subprime lenders have rate sheets that easily categorize borrowers and these rate sheets can be made available to consumers. See Mansfield, *op. cit.* Others argue that not providing information is one way to prevent shopping around. For example, Consumers Union suggests that subprime lenders require that you pay an application fee, which tends to lock consumers into a relationship before they provide mortgage information. See Consumers Union, “Tips for Consumers To Avoid High-Cost Loans,” [www.consumersunion.org](http://www.consumersunion.org), October 2002.

<sup>149</sup> Mansfield, *op. cit.* Findings from Courchane, Surette, and Zorn also support this conclusion. They found that prime borrowers were twice as likely as subprime borrowers to have the opportunity to make choices about mortgage features. See Courchane, Surette, and Zorn, *op. cit.*

<sup>150</sup> This sentiment is reflected in the following comments by staff for the Federal Trade Commission (FTC). “Indeed, we believe that some of the problem practices in the high-cost loan market take advantage of the current complexity of mortgage transactions and the difficulty that consumers face in this market when shopping for a loan. Thus, the FTC staff believes that HOEPA loans should qualify for the guaranteed package safe harbor. This approach would enable HOEPA consumers to benefit from cost savings that may result from packages of settlement services. (page 13) “Comments of the Staff of the Bureau of Economics, the Bureau of Consumer Protection, and the Office of Policy Planning of the Federal Trade Commission,” October 28, 2002.

**Response. 2004 FTC Study:** The FTC concluded that the disclosure of the YSP on GFE forms had two drawbacks. First, the disclosure of the YSP impaired the ability of borrowers to comparison-shop, leading many to choose the more costly alternative. Second, the disclosure of the YSP introduced bias in the selection process that favored lenders over brokers. Neither of these outcomes is a policy goal of the Department. Thus, with the help of a communications firm, HUD developed new forms and has performed two further rounds of testing since the publication of the 2004 FTC Study. The 2004 FTC study was informative but their 2004 test examined an incomplete and now obsolete version of the GFE form, which has been significantly revised and tested<sup>151</sup>. By being fully responsive to the FTC’s criticism, HUD has developed a form with which borrowers consistently identified the cheapest loan 90 percent of the time or *more* regardless of whether the broker or the lender was cheaper.

**2006 GAO Report:** The only mention of the GAO (2006) report in the NAMB letter (p. 44) refers to a comment made by the Federal Reserve concerning “how disclosures can be revised to reduce complexity and information overload (GAO, p. 47).” The advice that the Fed offers in achieving this goal is to “use design consultants to assist in developing model disclosures that are most likely to be effective in communicating information to consumers,” which HUD has done. HUD hired Kleimann Communications to help HUD design a form that provides critical information on the terms and settlement costs in an organized, easy-to-compare, and illuminating fashion.

**2007 GAO Report:** The NAMB contends (pp. 19-20) that according to the 2007 GAO report, the recent foreclosure crisis and other problems in the mortgage markets can not be attributed to mortgage brokers or inadequate mortgage disclosures or the disclosures of originator compensation. Given this, NAMB argues that HUD should address the factors that the GAO blames for the current real estate crisis in its 2007 report rather than imposing an unnecessary regulatory burden on mortgage brokers.

First, the GAO (2007) study should not be referred to as a study of whether effective disclosure has an impact on foreclosures because the GAO did not control for foreclosures. They statistically examined the correlation of state housing price appreciation and labor market conditions with foreclosures. For example, there are other issues that the GAO (2007) did not address, such as the impact of broker licensing laws (the costs of which are discussed at length by the NAMB elsewhere in their letter) but the fact that the GAO does not mention these laws does not imply that they would have no impact.

Second, HUD did not propose RESPA reform as a solution to the current foreclosure crisis. The goal of the proposed RESPA reform is promote consumer savings whether the markets are doing well or poorly. By making homeownership more affordable, HUD would create more new homeowners. But HUD believes that the proposed RESPA reform would also increase the net homeownership rate by reducing foreclosures.

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<sup>151</sup> Kleimann’s report, entitled *Testing HUD’s New Mortgage Disclosure Forms With American Homebuyers Rounds 4 & 5* (dated March 19, 2004, [http://www.huduser.org/Publications/PDF/GoodFaith\\_4and5vol1.pdf](http://www.huduser.org/Publications/PDF/GoodFaith_4and5vol1.pdf)), provides information on the specific characteristics of the consumers tested, revisions that Kleimann made to the form and the reasons for those revisions, the specific cities where the tests were conducted, the testing protocols, testing conditions, and the main results from each round of testing.

Third, despite the fact that the subject of the report is the effect of economic variables, the GAO mentions the following concerning complex loans: “Borrowers may not be well-informed about the risks of these products, due to their complexity and because promotional material by some lenders and brokers do not provide balanced information on the risks and benefits. (p. 44)” Thus, while HUD does not argue that effective disclosure would have had a greater impact on foreclosures than healthier labor and housing market conditions; it is not farfetched to argue that better informed consumers would have done a better job choosing more appropriate loan products for themselves.

Kleiner and Todd (2007): As mentioned by the NAMB, this NBER working paper appeared while the proposed rule was in clearance, at which time HUD’s own analysis would not have been altered. The study is an empirically rigorous attempt to measure the impact of mortgage broker regulations (state licensing requirements) on both mortgage brokers (employment and earnings) and the outcome for borrowers (subprime mortgages, foreclosure rates, and high-interest rate loans). The authors of the study acknowledge that there may be a need to regulate the mortgage brokerage industry: “as of 2007 it appears that market responses have not eliminated concerns about bad outcomes caused by asymmetric information and incentive conflicts in the mortgage broker market (p. 9).” However, they caution against regulations that would act as barriers to mortgage brokers in providing low-cost loans to consumers. To offer empirical guidance on this question, they perform regression analyses, using a panel data set, of the effects of a state regulatory index on mortgage market and broker employment variables.

Kleiner and Todd explore the effect of a dollar-valued measure of the bonding and net worth regulations. Note that “most aspects of mortgage licensing requirements, such as mandatory professional education, do not have a significant and consistent statistical association with market outcomes (p. 1)”. A higher measure of bonding and net worth regulation is associated with higher levels of earnings and a slight reduction in the number of brokers and subprime loans (from HUD-defined subprime lenders); which are phenomena consistent with the licensing requirement acting as a fixed cost of entry that would reduce the number of brokers overall as well as activity in the low-quality spectrum of the market. Better brokering should increase the quality of the matches. In fact, the authors find that regulations are associated with slightly higher foreclosure rates. The authors admit that the theoretical predictions of the effects of licensing requirements on the mortgage market when asymmetric information is present are less clear. However, a measure of the effectiveness of a regulation in protecting consumers would be whether the number high-priced loans are reduced because “brokers have short-term incentives to sell high-priced loans to consumers (p.28)” In their analysis, Kleiner and Todd find that the number of high-priced loans *increased* with the licensing requirement. It is evident that this type of regulation may not benefit consumers. The authors are cautious in interpreting their results and conclude that: “Without a deeper understanding of the causal linkages underlying our statistical associations, we cannot say that bonding requirements are a bad idea, but we think our results underscore the need for both more research on this topic and a cautious approach to imposing additional restrictions on entry into the mortgage broker business and occupation.

How does the NAMB want this study to inform HUD’s proposed rule? The NAMB’s first reference to this study is to a discussion of a quotation (of the NAMB) concerning the difficulty of distinguishing brokers and lenders. It should be noted that this is not a finding of the NBER

study but part of the study's literature review. The NAMB also cites the Harvard study and the Mortgage Pricing Study on this point. HUD understands there are different and reasonable definitions of what a mortgage broker is (see p. 2-14 of the RIA and Section II of Chapter 5 for a lengthier discussion). The difficulty of defining a broker is an issue of which HUD was very aware when developing its proposed rule. For example, on the proposed GFE, the distinction between "broker" versus "lender" never appears. Both are referred to as the "loan originator." Our goal was to produce a GFE that was unbiased and that allowed consumers to select the least expensive loan regardless of the loan originator. This was finally achieved after five rounds of testing the proposed GFE.

The second reference by the NAMB to the NBER study is on p. 2 where Kleiner and Todd are quoted: "Brokers have helped to shorten the loan process and to make it cheaper, and they have enabled the mortgage industry to meet the enormous fluctuations in demand (p.7)." These are not findings of the study, but part of the authors' literature survey. On p. 17 of their letter, the NAMB quotes all of the other sentences from the above paragraph extolling brokers except for the concluding sentence, which reads: "However, the transformation of the mortgage industry created some new problems, and mortgage brokers are also blamed for some of these." HUD agrees that mortgage brokers have performed a valuable role in expanding consumer credit. We also believe that if mortgage brokers continue to offer loans at a lower cost than other lenders, then the proposed rule should be a boon to mortgage brokers by making that information all the more transparent to consumers. The customer outreach function that mortgage brokers perform for wholesale lenders is not going to change with RESPA reform. Wholesale lending, which has fueled the rise in mortgage originations over the past ten years, will continue to depend on brokers reaching out to customers and supplying them with loans. Brokers play the key role in the upfront part of the mortgage process and this will continue with the proposed rule. RESPA reform is also not going to change the basic cost and efficiency advantages of brokers. Brokers have grown in market share and numbers because they can originate mortgages at lower costs than others. There is no indication that their cost competitiveness is going to change in the near future. Thus, brokers, as a group, will remain highly competitive actors in the mortgage market, as they have been in the past.

The third reference by the NAMB is on p. 8, where they reference a quotation by Kleiner and Todd discussing consumer satisfaction with brokers: "It seems likely that many if not most of them [consumers] found value in the brokers' services, which is what we would expect in honest, competitive markets (p. 3)." This is not a finding of the study but a part of their survey of the literature. The sentence following the one quoted above reads: "On the other hand, critics have argued that too many mortgage brokers or, more broadly, that market failures prevent competition from effectively disciplining brokers' profits and quality of service." The NAMB chose not to quote this particular finding of the literature review and many others like it. The main impact on brokers (both small and large) of the proposed rule will be on those brokers (as well as other originators) who have been overcharging uninformed consumers, through the combination of high origination fees and yield spread premiums.

The fourth reference to the study by the NAMB is their discussion of the empirical results on pp. 8-9 of their letter, which are also summarized above. HUD agrees with the NAMB's interpretation of the study that onerous regulation on mortgage brokers would have the end effect of hurting consumers. The proposed rule does not impose entry requirements on mortgage

brokers and is a different type of rule than what is analyzed by Kleiner and Todd. First, the proposed rule does not single out mortgage brokers. However, there is a concern expressed by brokers that the reporting of yield spread premiums would disadvantage them relative to lenders. HUD has redesigned the proposed GFE form to focus borrowers on the bottom-line numbers (while effectively communicating that choosing a higher interest rate should result in lower settlement costs, and vice versa) so that competition is maintained between brokers and lenders. The forms adopted in the proposed rule were tested on hundreds of subjects. The tests indicate that borrowers who comparison shop will have little difficulty identifying the cheapest loan offered in the market whether from a broker or lender. Thus, the problem of potential bias has been eliminated.<sup>152</sup> Second, one could argue that by imposing compliance, the proposed rule costs could have the same effects as other types of regulation. The proposed rule would have imposed adjustment costs of \$6,000 on every mortgage brokerage firm. This amount is much lower than the average bonding/net worth requirement for 2005, which is \$27,479. Another significant difference is that the one-time compliance cost of the proposed rule is a burden only during the year of implementation. Unlike the bonding/net worth requirement that remains present as a cost of entry, brokers that enter the market after the rule is in effect will not bear the one-time compliance costs. The recurring compliance costs of the proposed GFE should also be a concern to mortgage brokers. The cost of the new GFE in the 2008 proposed rule is estimated at between \$32.40 and \$55.40 per loan. Assuming 125 loans per year for the median firm<sup>153</sup> would imply an annual recurring compliance cost of between \$4,000 and \$7000 per broker firm. While not insignificant, this dollar figure is still much smaller than the average regulatory burden measured in Kleiner and Todd. More importantly, our estimate represents a worst case scenario and not what we expect to be the recurring compliance cost, which is closer to zero.

HUD agrees wholeheartedly with the NAMB's statement that: "if consumers have greater choice among vendors, and are given the tools to make informed choices about the relative merits of the products that vendors offer, consumers are certain to benefit. (p. 9). The goal of this RESPA reform is to produce substantial shopping and price reduction benefits for both origination and third-party settlement services by providing a GFE that increases transparency for consumers; including tolerances on final settlement costs; and allowing service providers to use average cost pricing for third-party services they purchase, making their business operations simpler and less costly. Competition among lenders will put pressure for these cost savings to be passed on to borrowers.

The Mortgage Pricing Study: An earlier April 2005 version of the cited July 2005 paper by Anshasy, Elliehausen and Shimazaki was mentioned in the Regulatory Impact Analysis of the 2008 proposed rule. Overall, the authors find that subprime borrowers using mortgage brokers save 53 basis points compared to those borrowing directly from lenders. HUD believes that this competitive advantage in the subprime market should be enhanced by the proposed rule that will encourage consumers to compare among different lenders.

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<sup>152</sup> For more information on these testing results, see the summary of the fifth round of testing of the GFE form in Chapter 3 of the Regulatory Impact Analysis (pp. 42-45).

<sup>153</sup> According to Wholesale Access, in 2004 the median broker firm originated 200 loans in 1998 and 125 loans in 2000 and 90 in 2004.

The Harvard Mortgage Markets Study: Apgar and Essene state four principal findings concerning the state of consumers in the mortgage market (pp. ii-iv). They are: 1) Consumer Preferences Are Malleable, Not Fixed; 2) Consumers Often Lack Awareness of Mortgage Prices; 3) Consumers Struggle with Choices that Involve Risks and Payments over Time; and 4) Consumers Often Struggle With Mortgage Shopping. HUD agrees with most of these characterizations of consumers and the mortgage market. The proposed rule is designed to increase mortgage pricing transparency and to assist consumers, for whom a mortgage purchase is a rare event, better understand complex loans. Apgar and Essene propose four recommendations for shaping policy directed at remedying this problem.

NAMB wants HUD to pay more attention to the fourth key policy recommendation (see p. 10 of their letter), which is to “Establish Minimum Standards and Apply Rules Equally to the Marketplace,” by which the authors mean that government should: “Create effective and adequately funded enforcement strategies to ensure that all mortgage brokers, loan officers, and mortgage originators play by the same rules.” There are three specific policy recommendations under this category: expand the “Interagency Guidance on Nontraditional Mortgage Product Risks” (by the GAO) to cover all lenders, not just federally regulated deposit taking institutions; encourage the Federal government to assist states that carry a significant responsibility for regulating the mortgage market; and adopt a federal mortgage broker licensing law. These three specific policy recommendations cannot be pursued through RESPA reform. However, the general spirit of this policy principle has been applied. For example, HUD has been conscious to apply this principle in crafting the GFE and has gone to much effort to develop a Good faith Estimate that is not biased against either brokers or lenders.

The Harvard Study contains some RESPA-specific policy discussions. The authors general view on the current state of affairs is that, while intended to be helpful; disclosures “do not ensure that the consumer receives the best price, nor does it overcome the lack of financial knowledge a consumer might have. Furthermore, the Good Faith Estimate is often not accurate and the TILA disclosure is typically not provided early enough for borrowers to easily change their mind (p. 17).” To address this specific concern, the authors propose their third principle for policy: “Enhance Information Transparency and Encourage Industry Self-Regulation.” One of their specific policy recommendations is that “the Good Faith Estimate be binding earlier in the application process. (p. vi)” By doing just that, through the addition of tolerances, the proposed rule would follow the recommendations of Apgar and Essene. In addition, the new GFE, by serving as an informative shopping document, would heighten borrowers’ financial knowledge and increase their chances of getting a better deal. HUD thanks the NAMB for suggesting that this study be included in our literature review, which supports the justification for our reform and the reform itself.

## CHAPTER 3

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## **I. Introduction and Main Findings**

This chapter discusses the economic effects of the primary aspects of the final rule: the new Good Faith Estimate (GFE); the revisions to the HUD-1 to make it track more closely with the new GFE; and the comparison page for the revised HUD-1, which will help ensure that consumers get the loan and closing costs they shopped for and selected on the GFE.

The rule changes the Good Faith Estimate settlement cost disclosure and related RESPA regulations to make the GFE simpler, firmer, and more usable to facilitate shopping for mortgages, to make mortgage transactions more transparent, and to help prevent unexpected charges to consumers at settlement. The new GFE includes a summary page that contains the key numbers for comparison-shopping. The new GFE includes a summary disclosure of the terms of the mortgage that will help consumers to ensure they are comparing similar loan offers, to let consumers know when they are being offered loans with potentially risky terms, as well as to know that the loan they were offered is the one they are getting at settlement. The new GFE also ensures that yield spread premiums are properly credited to borrowers in brokered transactions and includes a trade-off table that will assist consumers in understanding the relationship between higher interest rates and lower settlement costs. The new GFE includes a set of tolerances on originator and third-party costs that will encourage originators not only to lower their own costs but also to seek lower costs for third-party services.

To increase the value of the new GFE as a shopping document, HUD is implementing revisions to the HUD-1 Settlement Statement form that will make the GFE and HUD-1 easier to compare. The revised HUD-1 uses the same language to describe categories of charges as the GFE and provides reference-back numbers for the GFE form. This makes it much simpler to compare the two documents. In addition, the rule requires as an additional comparison page to the revised HUD-1, which would: (1) compare estimates on the GFE to the charges on the HUD-1 and show borrowers whether tolerances have been met or exceeded; and (2) verify that the loan terms summarized on the GFE match those in the loan documents, including the mortgage note.

To assist in reducing the costs of settlement services, the final rule encourages discounting and allows firms to use average cost pricing. This final rule will lead to cost reductions by clarifying that settlement service providers can seek discounts for settlement services, providing the price charged on the HUD-1 is no more than the price paid to the third-party settlement service provider for the discounted service. This should lead to lower third-party settlement service prices. In addition, settlement service providers will be allowed to use average cost pricing for third-party services they purchase so long as the average is calculated using a documented method and the charge on the HUD-1 is no greater than the average paid for

that service. This will make internal operations for the loan originator simpler and less costly and competition among lenders will put pressure for these cost savings to be passed on to borrowers as well.

**Organization of Chapter.** The remainder of this introductory section summarizes the chapter's main findings around the following topics – benefits of the final rule (subsection I.A), estimates and sources of consumer savings (I.B), and competitive and market impacts of the final rule (subsection I.C). The impacts on small business are highlighted throughout this discussion of the chapter's main findings.

Sections II-VIII of the chapter explain in more detail the anticipated consumer benefits and other impacts of the final rule. That discussion is organized as follows: the new GFE form and HUD-1 form (Section II); treatment of premiums and discounts (Section III); discounting and average cost pricing (Section IV); tolerances in settlement costs (Section V); additional topics and alternatives related to the GFE (Section VI); consumer benefits, market effects, and estimates of industry and small business transfers (Section VII); and competitive impacts, with a focus on the market effects on small businesses (Section VIII). Section IX summarizes estimates of the benefits, costs, transfers, and efficiencies of the final rule.

## **I.A. Main Findings: Benefits of the Final Rule**

### **I.A.1. Problems With the Mortgage Shopping Process and the Current GFE and HUD-1**

The current system for originating and closing mortgages suffers from several problems that have resulted in high prices for borrowers:

1. There are many barriers to effective shopping for mortgages in today's market. The process can be complex and can involve rather complicated financial trade-offs, which are often not fully and clearly explained to borrowers. Less informed and unsuspecting borrowers are particularly vulnerable in this market.<sup>1</sup>
2. Studies indicate that consumers often pay excessive fees for originating mortgages. Most observers believe that the market breakdown occurs in the relationship between the consumer and the loan originator -- the ability of the loan originator to price discriminate among different types of consumers leads to some consumers paying more than other consumers. The end result is that, on average, excessive fees are charged to originate loans.

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<sup>1</sup> But given the fact that a borrower may be more interested in the main transaction (the home purchase), even more sophisticated borrowers may not shop aggressively for the mortgage or may not monitor the transaction very closely.

3. There is rather convincing evidence that yield spread premiums are not always used to offset the origination and settlement costs of the consumer. Studies (Jackson and Berry, 2001; Jackson, 2002; Woodward, 2002, 2003a; and Urban Institute, 2008) find that yield spread premiums are often used for the originator's benefit, rather than for the consumer's benefit. These studies point to serious problems of excess fees and overcharging consumers.
4. The yield spread premium controversy has highlighted the fact that borrowers can be confused about the trade-off between interest rates and closing costs. It may be difficult for borrowers (even sophisticated ones but surely unsophisticated ones) to understand the financial trade-offs associated with interest rates, discount points, yield spread premiums, and upfront settlement costs. Available evidence suggests there are opportunities for unsuspecting shoppers to be taken advantage of by brokers and lenders – that is, they may be placed in a loan that not only has a high interest rate (which generates a yield spread premium) but also has high direct origination charges.
5. Borrowers may not be aware of the potential for reductions in closing costs at higher interest rates. While many originators explain this to their borrowers, giving them an array of choices to meet their needs, some originators may only show borrowers a limited number of options.
6. There is also evidence that third-party costs can be excessive and highly variable – there is much potential to reduce title, closing, and other settlement costs. There is not always an incentive in today's market for originators to control these costs. Too often, high third-party costs are simply passed through to the consumer. And consumers may not be the best shoppers for third-party service providers due to their lack of expertise. They often rely on recommendations from the real estate agent (in the case of a home purchase) or from the loan originator (in the case of a refinance as well as a home purchase).
7. The current GFE does not help the above situations, as it is not an effective tool for facilitating borrower shopping nor for controlling third-party settlement costs. The current GFE has no prescribed format. GFEs issued today typically contain a long list of charges that often overwhelms consumers and certainly does not inform them what the major costs are so that they can effectively shop and compare mortgage offers among different loan originators. Exhibits 1, 2, and 3 at the back of this chapter provide examples of the multitude of individual charges and fees that can be placed before consumers in today's market.
8. The current GFE does not provide information on important loan terms nor does it explain how the borrower can use the document to shop and compare loans. Also, the current GFE fails to make clear the relationship between the closing costs and the interest rate on a loan, notwithstanding that many mortgage loans originated today

adjust up-front closing costs due at settlement, either up or down, depending on whether the interest rate on the loan is below or above “par.”

9. Current rules do not assure that the “good faith estimate” is a reliable estimate of final settlement costs. There is little guidance and no meaningful standards for originators to adhere to in providing “good faith” estimates of settlement costs. As a result, under today’s rules, the estimated costs on GFEs may be unreliable or incomplete, and final charges at settlement may include significant increases in items that were estimated on the GFE, as well as additional surprise “junk fees” first appearing on the HUD-1, which can add substantially to the consumer’s ultimate closing costs.
10. The current HUD-1 can include a array of charges with names that may be entirely unrelated to anything in the GFE making the consumer’s task of judging whether their GFE told them anything useful nearly impossible.

## **I.A.2. Components and Benefits of the New GFE and HUD-1**

**Development of the GFE.** HUD conducted consumer tests over several years to develop the new GFE in this final rule. The new GFE is an easy to understand form that includes a summary page containing key information for shopping. In tests conducted by HUD, consumers found the summary page a useful addition to the GFE. The new GFE includes a trade-off table that tested consumers found particularly useful. To reduce consumer confusion, the new GFE consolidates settlement costs into a few manageable categories, and defines a set of tolerances that are aimed at controlling both originator fees and third-party settlement costs and at eliminating surprise charges at the settlement table. Consumers found the new GFE form to be clear and well written and, according the tests conducted, one that they can use to accurately determine the least expensive loan.

The forms improvement project was an iterative process of working on the presentation of the information to be conveyed on the form and testing to see how the changes worked. The first three rounds of testing utilized in-depth interviews. Once the improvements suggested by the results of the first round of testing were incorporated into the forms, borrowers generally identified the cheaper loan 90 percent of the time or more in the next two rounds of testing. The end result of two additional rounds of testing (involving 600 subjects per round) was that borrowers consistently identified the cheapest loan 95 percent of the time regardless of whether the broker or the lender was cheaper. The final round of testing, Round 7, tested the forms that were developed in response to public comments, which also achieved high success rates. The Department believes that the forms adopted in the rule perform well resulting with borrowers having little difficulty identifying the cheapest loan offered in the market whether from a broker or a lender. In other words, it is a shopping tool that is a vast improvement over today’s GFE with its long list of junk fees that can change (i.e., increase) at settlement.

More specifically, the rule with its new GFE form will address the problems of the current mortgage process in four ways. First, the rule will improve the existing RESPA

disclosure regime by establishing a new required format for the Good Faith Estimate providing greater simplicity, accuracy, and usefulness for consumers. This framework will better inform mortgage borrowers of the costs of obtaining a mortgage loan from any originator, and will better protect borrowers from unnecessary surprise charges at settlement. It also will provide firmer and more usable estimated cost disclosures so borrowers can more effectively shop and compare the cost associated with mortgages to lower settlement costs. Specifically, the new GFE will:

1. Inform the consumer that mortgage originators (brokers and lenders) cannot guarantee that their loan terms are the best in the market, and that the consumer is responsible for shopping for a mortgage;
2. Include a summary page (on Page 1 of the new GFE) that provides the key elements needed for shopping, such as the interest rate quote and the bottom line settlement charges; and,
3. Disclose settlement costs in major categories (including, for example, loan origination costs and title services). This will eliminate the proliferation of fees and allow consumers to focus on the major fees.

Second, the rule will improve consumer shopping by revising the GFE to:

1. Explain to the consumer the often complicated financial trade-off between settlement costs and interest rates, that is, the option of paying settlement costs through the use of higher interest rates (i.e., yield spread premiums) or reducing the interest rate by paying the lender additional amounts at settlement (discount points); and,
2. Require, in transactions originated by mortgage brokers, that yield spread premiums (the amount the wholesale lender pays for the loan in excess of its par value) be accurately reported and explicitly credited to the borrower. Similarly, discount point payments (the difference between the par value and the price paid by the wholesale lender) must be accurately reported and charged on the GFE and the HUD-1 Settlement Statement.

These two changes are intended to assist consumers in receiving the full benefit of any payments from or to wholesale lenders, either (a) by reducing their up-front settlement costs by the yield spread premium in exchange for accepting a loan with a higher interest rate, or (b) by requiring the broker to pass on the full discount points to the wholesale lender in order to reduce the interest rate and monthly payments. The trade-off table and the disclosure will make it more likely that interest rate variations available will be used by the consumer to his advantage rather than by the originator to enhance profit at the consumer's expense.

The GFE front page disclosure of mortgage terms also has explicit questions disclosing whether there are some important deviations from the simplest traditional mortgage terms

(versus non-traditional or exotic mortgage terms). It asks if the interest can rise (an ARM); if the loan balance can rise (negative amortization); if the monthly amount owed for principal, interest, or mortgage insurance can rise (not level payments) and how soon; the maximum possible monthly payment; if there is a balloon payment (not fully amortizing); or if there is a prepayment penalty (additional fee to terminate the loan). The “No” answers are in the first column and the “Yes” answers in a second column so that any “YES” answer sticks out. The “Yes” answers require the worst possible outcomes to be disclosed. All of this is designed to get the borrower’s attention in the event that any of these potentially detrimental loan features are present.

In addition, the front page of the GFE informs consumers about whether or not the loan on the GFE would include an escrow account for property taxes or other property-related charges in addition to the monthly amount for principal, interest, and mortgage insurance. It also notes that homeowners may be responsible for other obligations borrowers should keep in mind when deciding how high a monthly payment they can afford. The purpose of this disclosure is to warn consumers not to disregard these obligations if they are not covered by an escrow account.

Third, the final rule will implement new rules that will lead to lower originator and third-party costs:

1. Limit consumer fees for the GFE, if any, to the amounts necessary to the cost of a credit report;
2. Establish tolerances that require that loan originators adhere to the amounts reported in the GFE regarding their own compensation (absent unforeseeable circumstances);
3. Require that originators comply with upper limits or “tolerances” so that their total charges for other major settlement charge categories covered by the tolerances cannot exceed those stated on the GFE by more than 10 percent; and,
4. Clarify that loan originators can make arrangements with third-party settlement service providers to lower prices for their customers, provided these prices or any fees on the GFE are not “marked up” or “up charged”.
5. Clarify that settlement service providers may seek discounts for settlement services, providing the price charged on the HUD-1 is no more than the price paid to the third-party settlement service provider for the discounted service. This should lead to lower third-party settlement service prices.
6. Allow service providers to use average cost pricing for third-party services they purchase so long as the average is calculated using a documented method and the charge on the HUD-1 is no greater than the average price paid for that service. This will make internal operations for the loan originator simpler and less costly and competition among lenders will put pressure for these cost savings to be passed on to borrowers as well.

**Tolerances: A Brief Explanation.** The final rule contains a 10 percent tolerance on third-party fees where the borrower chooses a provider suggested by the loan originator.<sup>2</sup> The limited tolerances under the new GFE are intended to improve on today's current practices where consumers rely on referrals that may or may not be in their best interests. One purpose of the tolerances is to provide an incentive for the loan originator to come up with more accurate values for the Good Faith Estimate, or to put "good faith" into the estimate. Today, loan originators must have some idea of what these services cost in order to fill out the form currently, or they would be failing the "good faith" part of the requirement. If the total of these third-party fees (e.g., title, closing, appraisal, and survey fees) exceeded the total estimated, the loan originator would have to pay any amount in excess of the 10 percent tolerance. The new tolerances would apply only if the borrower used one of the providers identified by the loan originator. The tolerances will lead to well-informed market professionals either arranging for the purchase of the settlement services or at least establishing a benchmark that borrowers can use to start their own search. Under either set of circumstances, this should lead to lower prices for borrowers than if the borrowers shopped on their own since the typical borrower's knowledge of the settlement service market is limited, at best.

A significant benefit of this tolerance requirement is that third-party fees go into total estimated settlement charges, the bottom line on pages 1 and 2 of the new GFE. Higher third party fees raise this bottom-line figure in exactly the same way as higher loan originator charges. So, the loan originator has a powerful incentive to search for lower-priced services for the borrower. It makes his or her loan more appealing to the borrower.

As noted above, tolerances put an experienced loan professional (i.e., the loan originator) in the position of being a shopper for third-party settlement services for the borrower. The experienced professional in the business is far more likely to be a good shopper for such services than individual borrowers who might not even know that the price of settlement services can vary drastically among providers. The over-priced third-party providers will not be considered by the professional loan originators because using their high prices as a basis for the numbers on the GFE will make the loan originator's total estimated settlement charges less competitive.

This need not expose the loan originator to large risk. And the additional costs associated with setting up these arrangements to provide tolerance protection are unlikely to be large on a per-loan basis. If the loan originator lines up the third-party providers in advance and has reliable pricing agreements, he or she is protected. And if the borrower goes off and uses somebody else, the tolerance protection does not apply.

The 10 percent figure is one that consumers can easily remember and apply in order to calculate their tolerance amount; in addition, it seems reasonable as a basis for allowable adjustments by the loan originator to their initial third-party-fee estimates. It is also important to

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<sup>2</sup> The tolerance applies to lender-required-and-selected-third-party services as well as when the borrower uses a service provider identified by the lender; it does not apply if the borrower selects a service provider that is not identified by the lender. The 10 percent tolerance basis also includes government recording fees because these relatively small fees can be variable and not well known substantially before closing.

remember that there is zero tolerance on the loan originator's own fees, which account for the major portion of total settlement charges (net of transfer taxes and the various escrows). The loan originator is expected to know his or her own fees upfront and to stand by them exactly, with zero variation.

**HUD-1 Linked to GFE.** The HUD-1 has been adjusted so that it is consistent with the new GFE. The new lines and labeling on the HUD-1 are designed to make comparisons between the GFE and the HUD-1 simpler so that borrowers can verify whether the HUD-1 charges have met the tolerances implied by the GFE figures or not. Page two of the final HUD-1 changes the existing layout by inserting a new line for each item listed separately on the final GFE. Each of these new lines has the exact name as on the GFE and has the block number from where the figure is on the GFE right after the name on the final HUD-1. Each itemized number from the GFE subtotals on the HUD-1 is also required to have a reference back to its source on the GFE. So the Final HUD-1 should work for any settlement using the existing HUD-1.

Given that there has been no significant change in the basic structure and layout of the first two pages of the HUD-1, generating this new HUD-1 should not pose any problem for firms closing loans -- in fact, the closing process will be much simpler given borrowers and closing agents can precisely link the information on the initial GFE to the information on the final HUD-1.

**New Page 3 of HUD-1 Ties It All Together.** The new page 3 of the HUD-1 serves as the final assurance that the terms of the GFE have been fulfilled, and that the borrower fully understands the obligations imposed by agreeing to the mortgage. Even with the revised HUD-1, which is designed to make comparisons to the GFE easier, the complexity of the final transaction, especially sales transactions (e.g., splitting of fees between buyer and seller both at and outside of closing), may require the application of some expertise to determine that the GFE tolerances have been met. The new page 3 means that a knowledgeable and experienced person, the closing agent, will assemble the elements of the transaction to ensure the borrower understands whether tolerances have been met or exceeded.

The HUD-1 page 3 provisions of the rule require the lender to provide to the closing agent the necessary information from the GFE and the loan documents, including details on payment due dates, escrow estimates, and interest rate adjustment dates,, as well as the list of identified providers for purposes of calculating the tolerances. The closing agent would fill in the information that the lender could not provide from the remaining elements of the settlement, compute the difference between HUD-1 charges and the GFE estimates for the services included in the tolerances, and divide this difference (if positive) by the sum of the applicable estimates to calculate the tolerance ratio.

By providing a verifiable means of comparing loan offers and allowing average cost pricing to be passed to consumers, the rule will lead to increased competition among settlement service providers and to lower costs for consumers. The rule includes tolerances aimed at controlling third-party fees as well as origination fees. Broader categories of fees replace the long list of excessive, third-party fees that too often characterizes today's market.

## **I.B. Main Findings: Estimates and Sources of Consumer Savings**

The section presents the estimates of consumer savings from the rule and explains the reasons for these savings. The major industry groups that contribute these consumer savings are also identified. In addition, efficiencies and costs associated with the rule are summarized.

### **I.B.1. Estimates of Consumer Savings**

Section VII discusses the consumer benefits of the rule and provides dollar estimates of consumer savings principally deriving from improved shopping for both originator and third-party services. Consumer savings were estimated under a variety of scenarios about originator and settlement costs. In the base case, the estimated price reduction to borrowers comes to \$8.35 billion, or 12.5 percent of the \$66.7 billion in total charges (i.e., origination fees, appraisal, credit report, tax service and flood certificate and title insurance and settlement agent charges).<sup>3</sup> Thus, there is an estimated \$8.35 billion in transfers from firms to borrowers from the improved disclosures and tolerances of the rule. Sensitivity analysis was conducted with respect to the savings projection in order to provide a range of estimates. Because title fees account for over 70 percent of third-party fees and because there is widespread evidence of lack of competition and overcharging in the title and settlement closing industry, one approach projected third-party savings only in that industry. This approach (called the “title approach”) projected savings of \$200 per loan in title and settlement fees. In this case, the estimated price reduction to borrowers comes to \$8.38 billion, or 12.6 percent of the \$66.7 billion in total charges – savings figures that are practically identical to the base case mentioned above. If the savings in title and settlement closing fees due to RESPA reform were only \$150, then the estimated price reduction to borrowers comes to \$7.76 billion, or 11.6 percent of the \$66.7 billion in total charges. Other projections also showed substantial savings for consumers. As explained in Section VII, estimated consumer savings under a more conservative projection totaled \$6.48 billion, or 9.7 percent of total settlement charges. Thus, while consumer savings are expected to be \$8.35 billion (or 12.5 percent of total charges) in the base case or \$8.38 billion (12.7 percent of total charges) in the title approach, they were \$6.48 billion (or 9.7 percent of total charges) in a more conservative sensitivity analysis. This \$6.48-\$8.38 billion represents the substantial savings that can be achieved with the final rule.

The analysis in Section VIII of this chapter disaggregates the sources of consumer savings into the following major categories: originators with a breakdown for brokers (VIII.A) and lenders (VIII.B.), and third-party providers with a breakdown for the title and settlement industry (VIII.C.) and other third-party providers (VIII.D).<sup>4</sup> In the base case, originators (brokers and lenders) contribute \$5.88 billion, or 70 percent of the \$8.35 billion in consumer savings. This \$5.88 billion in savings represents 14.0 percent of the total revenue of originators, which is

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<sup>3</sup> Government fees and taxes and escrow items are not included in this analysis, as they are not subject to competitive market pressures.

<sup>4</sup> Readers are referred to Chapter 5 for a more detailed examination of the various component industries (e.g., title services, appraisal, etc.) as well as for the derivations of many of the estimates presented in this chapter.

projected to be \$42.0 billion.<sup>5</sup> The \$5.88 billion is divided between brokers, which contribute \$3.53 billion, and lenders (banks, thrifts, and mortgage banks), which contribute the remaining \$2.35 billion. The shares for brokers (60 percent) and lenders (40 percent) represent their respective shares of mortgage originations.

In the base case, third-party settlement service providers contribute \$2.47 billion, or 30 percent of the \$8.35 billion in consumer savings. This \$2.47 billion in savings represents 10.0 percent of the total revenue of third-party providers, which is projected to be \$24.738 billion.<sup>6</sup> The \$2.47 billion is divided between title and settlement agents, which contribute \$1.79 billion, and other third-party providers (appraisers, surveyors, pest inspectors, etc.), which contribute \$0.68 billion. Title and settlement agents contribute a large share because they account for 72.5 percent of the third-party services included in this analysis. In the title approach, title and settlement agents account for all third-party savings, which total \$2.5 billion if per loan savings are \$200 and \$1.88 billion if per loan savings are \$150.

Section VIII of this summary section will present the revenue impacts on small originators and small third-party providers.

## **I.B.2. Sources of Savings – Lower Origination Fees Due to Improved Consumer Shopping**

Lower origination fees are a major source of the consumer savings. The new GFE format in the final rule will improve consumer shopping for mortgages, which will result in better mortgage products, lower interest rates, and lower origination costs for borrowers. The revised HUD-1 will serve as a check to ensure that these savings are realized.

- The new GFE format simplifies the process of originating mortgages by consolidating costs into a few major cost categories. This is a substantial improvement over today's GFE, which contains a long list of individual charges that encourages fee proliferation and junk fees, and can often overwhelm and confuse consumers. The simpler presentation of the new GFE will improve the ability of the consumer to shop. The consolidation of fees is carried forward to the revised HUD-1.
- With fees firmer under the new GFE, shopping is more likely to result in borrowers saving money when they shop. A GFE with a summary page will make it simpler for borrowers to shop. The higher reward for shopping along

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<sup>5</sup> This assumes a 1.75 percent origination fee for brokers and lenders, which, when applied to projected originations of \$2.4 trillion, yields \$42.0 billion in total revenues from origination fees (both direct and indirect). See Steps (3)-(5) of Section VII.E.1 for the explanation of origination costs. Sensitivity analyses are conducted for smaller origination fees of 1.5 percent and larger fees of 2.0 percent; see Step (21) in Section VII.E.4.

<sup>6</sup> See Step (7) of Section VII.E.1 for the derivation of the \$24.738 billion.

with its increased ease with which borrowers can compare loans should lead to more effective shopping, more competition, and lower prices for borrowers.

- The new GFE contains a statement that urges consumers to shop and compare loan offers because only the consumer can find the best loan for her circumstances. This will put all borrowers on notice that they should protect their interests by shopping. The form includes a shopping chart to be filled out by the consumer where the terms and total settlement costs of 4 GFEs can be compared, a strong suggestion that consumers should shop for loans from more than one originator. Tests of the GFE form indicate that the statement and shopping chart increase the probability that a borrower will shop around before selecting an originator.
- The new GFE also makes cost estimates more reliable by applying tolerances to the figures reported. The sum of the originator's fees on the HUD-1 may not exceed the loan originator's fee on the GFE. Once the borrower locks the interest rate, the discount points or yield spread premium is also fixed. The sum of the third-party fees on the HUD-1 where the originator either selects the provider or refers the borrower to the provider may not exceed the sum of these estimates on the GFE by more than 10 percent. This will reduce the all too frequent problem of borrowers being surprised by additional costs at settlement.
- The new GFE will disclose yield spread premiums and discount points in brokered loans prominently, accurately, and in a way that should inform borrowers how they may be used to their advantage. Both values will have to be calculated as the difference between the price of the loan and its par value. Their placement in the calculations that lead to net settlement costs will make them very difficult to miss. That placement should also enhance borrower comprehension of how yield spread premiums can be used to reduce up-front settlement costs. Tests of the form indicate that consumers can determine the cheaper loan when comparing a broker loan with a lender loan.
- The new GFE will better inform consumers about their financing choices by including a table where originators can explain the different interest rate and closing cost options available to consumers. All originators with automated systems for issuing GFEs will have an incentive to fill in the table to avoid having to spend extra time with consumers that ask about the blank table. In addition, this table will be especially helpful to mortgage brokers in explaining the mechanics of the required YSP disclosure and ensuring consumers accurately assess the prices offered by mortgage brokers.
- Altogether, the simplicity and certainty offered by the new GFE should improve comparison-shopping for mortgage loans, reduce interest rates and settlement prices for borrowers, and eliminate surprises at settlement. There will be less of the sub-optimal consumer shopping that often characterizes today's mortgage

market. In addition, originators will be less able to take advantage of uninformed shoppers.

- As reported in Section IV of Chapter 2, studies indicate that consumers often pay excessive origination fees and that a substantial portion of the yield spread premiums paid indirectly by borrowers does not result in lower closing costs for borrowers – but rather results in extra compensation for brokers and lenders.

### **I.B.3. Sources of Savings: Lower Settlement Service Prices**

Chapter 2 reports evidence that consumers are overcharged for third-party services, particularly for the large category of title, closing and related settlement services. In today's market, it appears that high third-party costs are too often simply passed through to the consumers – there is not enough incentive for originators to monitor and control these costs for consumers. And, as noted earlier, consumers may not be the best shoppers for third-party service providers, often relying on real estate agents and lenders for recommendations. Thus, third-party fees are an important source of potential consumer savings from the final rule.

- The imposition of tolerances on fees will encourage originators to seek discounts, which should lower settlement service prices. The rule clarifies that loan originators can make arrangements with their third-party settlement service providers (appraisers, settlement service agents, etc.) to lower prices for their customers (i.e., borrowers), provided these prices or any fees on the GFE are not “marked up” or “up charged.”
- The final rule would allow service providers to use average cost pricing for third-party services, which should make internal operations for the loan originator simpler and less costly.
- The tolerances will lead to well-informed market professionals either arranging for the purchase of the settlement services or at least establishing a benchmark that borrowers can use to start their own search. Under either set of circumstances, this should lead to lower prices for borrowers than if the borrowers shopped on their own since the typical borrower's knowledge of the settlement service market is limited, at best. In addition to lower prices, the prices quoted are likely to be more reliable, without surprises at settlement.
- The shopping advantages of the new GFE and the volume discounting provisions will increase competition among third-party providers, which will lead to lower prices, particularly for title and closing services, which are probably the most excessive in today's market.
- In HUD's new GFE and revised HUD-1, single entries for various settlement service providers or groups of providers are substituted for the detailed itemizations currently

required. This will also lead to improved consumer shopping of third-party services and easier verification of compliance with tolerances.

- Section V of this chapter estimates that \$24.7 billion in third-party fees would be subject to increased price pressure as a result of the imposition of tolerances, expanded shopping by originators, and the competitive effects of discounting. This figure provides a base on which the expanded shopping and competitive effects of the final rule will be felt. The estimates reported above project that third-party fees would fall from \$1.9 billion to \$2.5 billion. Title and settlement agents contribute a large share (\$1.35 billion to \$1.79 billion) of the savings because they account for almost 73 percent of the third-party services included in this analysis. As note above, analysis was conducted with all the consumer savings in third-party costs coming from the title and settlement industry; evidence suggests there are more opportunities for price reductions in that industry, as compared with other third-party industries. In this case, consumer savings in title and settlement costs totaled \$2.5 billion (\$200 savings per loan) or \$1.9 billion (\$150 savings per loan).

The lower upfront costs and the user-friendly nature of the new GFE will lead to additional homeowners entering the market, as well as making it more likely that existing homeowners will refinance their loans when market rates fall below their contract rates. Therefore, there should be an increase in both home purchase and refinance business as the lending process becomes more palatable to the average borrower. There will be an increase in access to the capital market, and the relatively low mortgage rates at which mortgages are made.

#### **I.B.4. Savings and Transfers, Efficiencies, and Costs**

**Transfers.** It is estimated that borrowers would save \$8.35 billion in origination and settlement charges. This \$8.35 billion represents transfers to borrowers from high priced producers, and constitutes 12.5 percent of total charges.

- The assumption that consumers will benefit by a reduction of settlement costs of at least \$668 per loan has not been challenged.
- Indeed, results from a recent statistical analysis of FHA data imply that the savings to consumers may be as much as \$1,200 per loan.

**Efficiency Benefits.** There are efficiencies associated with the rule for consumers, industry, as well as far-reaching social benefits.

- Mortgage applicants and borrowers realize **\$1,169 million** of savings in time spent shopping for loans and third-party services. This amount is derived from a time savings worth \$55 per applicant (75 minutes at \$44 per hour) over 21.25 million applications.

- If half the borrowers' time saved comes from less time spent with originators and third-party settlement service providers, then originators and borrowers will spend 37.5 minutes less answering borrowers' follow-up questions.
- The value of the time savings from dealing with follow-up questions is \$956 million (37.5 minutes at \$72 an hour multiplied by 21.25 applications). Loan originators receive a saving of \$765 million (30 minutes per application) and third-party settlement \$191 million (7.5 minutes per application).
- There will be reductions in compliance costs from average cost pricing. It is estimated that the benefits of average cost pricing will lead to a reduction in originator costs of 0.5 percent, or \$210 million.
- Some or all of industry's total of **\$1,161 million** in efficiency gains have the potential to be passed through to borrowers through competition.
- The lower profitability of seeking out vulnerable borrowers for non-competitive and abusive loans should lead to a reduction in this non-productive activity. If, for example, the decline in this activity represented one percent of current originator effort, this would result in \$420 million in social surplus.
- One social benefit of the rule is its contribution to sustainable homeownership. Consumers who understand the details of their loans are more likely to avoid default and thus foreclosure. There are substantial negative economic externalities of a foreclosure to neighboring properties and local governments; as well as private costs to the borrower and lender. The size of this social benefit is not estimated, but would be in addition to the other benefits enumerated here.

**Costs.** The total one-time compliance costs to the lending and settlement industry of the GFE and HUD-1 are estimated to be **\$571 million**, \$407 million of which is borne by small business. Total recurring costs, in the high-cost scenario, are estimated to be **\$918 million annually** or **\$73.40 per loan**. The share of the recurring costs on small business is \$471 million.

### **I.C. Main Findings: Summary of Market and Competitive Impacts on Small Businesses**

The impacts on small brokers and small lenders of the rule are reported below and are discussed throughout this chapter. As also reported below, settlement service providers who are small businesses would also be impacted by any reduction in settlement service prices arising from the tighter tolerances on settlement fees and from the increased competition among third-party providers associated with RESPA reform.

It is estimated that \$4.13 billion, or 49.5 percent of the \$8.35 billion in consumer savings comes from small businesses, with small originators contributing \$3.01 billion and small third-

party firms, \$1.13 billion.<sup>7</sup> Within the small originator group, most of the transfers to consumers come from small brokers (\$2.47 billion, or 82 percent of the \$3.01 billion); this is because small firms account for most of broker revenues but a small percentage of lender revenues. Within the small third-party group, most of the transfers come from the title and closing industry (\$0.68 billion, or 60 percent of the \$1.13 billion), mainly because this industry accounts for most third-party fees. In the title approach, small title and settlement closing companies account for \$0.95 billion of the \$2.5 million in savings. Section VII.E.2 of this chapter explains the steps in deriving these revenue impacts on small businesses, and Section VII.E.4 reports several sensitivity analyses around the estimates. In addition, Chapter 5 provides more detailed revenue impacts for the various component industries.<sup>8</sup>

The summary bullets in Section I.B above highlight the mechanisms through which these transfers are expected to happen. The improved understanding of yield spread premiums, discount points, and the effect of the interest rate chosen on net upfront costs along with improved consumer shopping among originators, more aggressive competition by originators for settlement services, and the increased competition associated with RESPA reform will lead to reductions in both originator and third-party fees. There is substantial evidence of excessive fees and overcharging in the origination and settlement of mortgages. Originators (both small and large) and settlement service providers (both small and large) that have been charging these high prices will experience reductions in their revenues as a result of the final rule. There is no evidence that small businesses have been disproportionately charging high prices; for this reason, there is no expectation of any disproportionate impact on small businesses from the final rule. The revenue reductions will be distributed across firms based on their non-competitive price behavior. Section VIII examines the competitive and market impacts of the rule on small brokers, small lenders, and small third-party providers. The main findings from that analysis are discussed next.

**Small Brokers.** The main issue raised by the brokers concerned the treatment in the 2008 proposed rule of yield spread premiums on the proposed Good Faith Estimate. This was also the main small business issue with the proposed GFE since practically all brokers qualify as small businesses. Section I.B above explained that the final rule addresses the concern expressed by brokers that the reporting of yield spread premiums in the 2008 proposed rule would disadvantage them relative to lenders. The Department hired forms development specialists, the Kleimann Communication Group, to analyze, test, and improve the forms. They reworked the language and presentation of the yield spread premium to emphasize that it offsets other charges to reduce up-front charges, the cash needed to close the loan. The subjects tested liked the table on page 3 of the form that shows the trade-off between the interest rate and up-front charges. It illustrates how yield spread premiums can reduce upfront charges. There is the summary page

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<sup>7</sup> In the more conservative scenario of \$6.48 billion in consumer savings, small businesses would account for \$3.21 billion of the transfers to consumers, with small originators accounting for \$2.36 billion, and small third-party providers, \$0.84 billion.

<sup>8</sup> In Chapter 5, see Section II for brokers, Section III for the four lender groups (commercial banks, thrifts, mortgage banks, and credit unions), Section IV for the various title and settlement groups (large insurers, title and settlement agents, lawyers, and escrow firms), Section V.A for appraisers, Section V.B for surveyors, Section V.C for pest inspectors, and Section V.D for credit bureaus.

designed to simplify the digestion of the information on the form by including only total estimated settlement charges from page two. This is the first page any potential borrower would see. It contains only the essentials for comparison-shopping and is simple: a very simple summary of loan terms and the bottom line cost of the loan. Yield spread premiums are never mentioned here. Lender and broker loans get identical treatment on page 1. A mortgage shopping chart is on page 3 of the final GFE to help borrowers comparison shop. Arrows were added to focus the borrower on overall charges, rather than one component. All of these features work to keep the borrower from misinterpreting the different presentation of loan fees required of brokers vis-à-vis lenders.

HUD has redesigned the new GFE form to focus borrowers on the right numbers so that competition is maintained between brokers and lenders. The forms adopted in the rule were tested on hundreds of subjects. The tests indicate that borrowers who comparison shop will have little difficulty identifying the cheapest loan offered in the market whether from a broker or a lender. Brokers, as a group, will remain highly competitive actors in the mortgage market, as they have been in the past. There is substantial evidence that brokers are highly efficient producers of mortgages and that will not change with the final rule. The important customer contact function that brokers perform in the origination market also will not change with the rule.

While there is no evidence to suggest any anti-competitive impact, there will be an impact on those brokers who are charging non-competitive prices. And there is convincing evidence that some brokers (as well as some lenders) overcharge consumers (see studies reviewed in Chapter 2). As emphasized throughout this chapter, the rule will lead to improved and more effective consumer shopping, for many reasons -- the new GFE is simple and easy to understand, it includes reliable cost estimates, it effectively discloses yield spread premiums and discounts in brokered loans, it facilitates consumers being shown options, and it explains the trade-off between closing costs and yield spread premiums; the revised HUD-1 will ensure that consumers know when their GFEs are accurate. This increased shopping by consumers will reduce the revenues of those brokers who are charging non-competitive prices. Thus, the main impact on brokers (both small and large) of the final rule will be on those brokers (as well as other originators) who have been overcharging uninformed consumers, through the combination of high origination fees and yield spread premiums.<sup>9</sup> As noted above, small brokers are expected to experience \$2.47 billion in reduced fees.

Section VIII.A discusses other concerns raised by brokers about the GFE in the 2008 proposed rule. Brokers primarily objected to the YSP disclosure requirements saying that HUD should either require similar disclosures in non-brokered loans, or not require the YSP disclosure at all. As for other issues, brokers raised many of the same implementation issues voiced by lenders in their comments. Brokers supported a generic trade-off table but the Department concluded, based on consumer testing, that a customized trade-off chart was essential for increasing consumer understanding of the complex yield spread premium issue. The changes

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<sup>9</sup> As explained throughout this chapter, it is anticipated that market competition, under this new GFE approach, will have a similar impact on those lenders (non-brokers) who have been overcharging consumers through a combination of high origination costs and yield spread premiums.

that HUD made in the rule will make the GFE more workable for small brokers and small lenders.

**Small Lenders.** Lenders include mortgage banks, commercial banks, credit unions, and thrift institutions.<sup>10</sup> There are approximately 10,000 lenders that would be affected by the RESPA rule, as well as almost 4,000 credit unions that originate mortgages. While two-thirds of the lenders qualify as a small business (as do four-fifths of the credit unions), these small originators account for only 23 percent of industry revenues. Thus, small lenders (including credit unions) account for only \$540 million of the projected \$2.35 billion in transfers from lenders.<sup>11</sup> Section VIII.B of this chapter provides a detailed discussion of the anticipated impacts of the rule on lenders.

In general, there was less concern expressed by lenders (as compared with brokers) about potential anti-competitive impacts of the GFE on small businesses. Small lenders -- relative to both brokers and large lenders -- will remain highly competitive actors in the mortgage market, as they are today. Small mortgage banks, community banks and local savings institutions benefit from their knowledge of local settlement service providers and of the local mortgage market. Nothing in the rule changes that.

In commenting on the 2008 proposed rule, lenders wanted to delay the new GFE while packaging was given a chance to work. HUD recognizes that an adjustment period will be needed and establishes a 12-month implementation period during which the current GFE could be used, which should give lenders time to adjust their computer systems and train employees to the new GFE and other aspects of the rule (see Chapter 6).

Lenders had numerous comments on most aspects of the 2008 proposed GFE form -- some of them dealing with major issues such as the difficulty in predicting costs within a three day period and many dealing with practical and more technical issues such as the need for "opportunity to cure" provisions to handle harmless errors. HUD responded to many of the issues and concerns raised by lenders; Sections V, VI, and VIII of this chapter discuss lenders' comments and HUD's response.

Some lenders were concerned about their ability to produce firm cost estimates (even of their own fees) within a three-day period, given the complexity of the mortgage process. Lenders wanted clarification on their ability to make cost adjustments as a result of information they gain during the full underwriting process. The tolerances in the final rule require that lenders play a more active role in controlling third-party costs than they have in the past.

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<sup>10</sup> While it is recognized that the business operations and objectives of these lender groups can differ -- not only between the groups (a mortgage banker versus a portfolio lender) but even within a single group (a small community bank versus a large national bank) -- they raised so many of the same issues that it is more useful to address them in one place.

<sup>11</sup> Section III of Chapter 5 describes the characteristics of these component industries (number of employees, size of firms, etc.), their mortgage origination activity, and the allocation of revenue impacts between large and small lenders. That section also explains that the small business share of revenue could vary from 20 percent to 26 percent

However, some lenders emphasized that they have little control over fees of third-party settlement providers, while others seem to not anticipate problems in this regard. As explained in I.B above, the rule made several adjustments to the information collection and tolerance rules, which should make them workable for lenders. In addition, the rule allows average cost pricing, which should help lenders reduce their costs. Practically all lenders wanted clarification on the definition of application, and HUD did that, along the same lines that lenders suggested in their comments. Lenders wanted an opportunity to cure harmless errors. HUD has added such a provision to the final rule. In addition, preparation the new page 3 of the HUD-1 should allow for the correction of errors, or reduction of charges, that might otherwise cause a violation of tolerances on the GFE. These and other changes address a number of practical and implementation problems raised by lenders and others about the GFE and tolerances. They particularly address the day-to-day business problems that are likely to be face by small lenders, such as the difficulty of predicting third-party costs. These changes will make operating under the final rule easier for small lenders. Given their knowledge of local markets, small mortgage banks, community banks, credit unions, and local thrift institutions will continue operating in a competitive manner under the rule.

There will be an impact on those lenders (both large and small) who are charging non-competitive prices. Improved consumer shopping with the final rule will reduce the revenues of those lenders who are charging non-competitive prices. Thus, as with brokers, the main negative impact on lenders (both small and large) of the rule will be on those lenders who have been overcharging uninformed consumers.

**Title and Settlement Industry.** The title and settlement industry -- which consists of large title insurers, title agents, escrow firms, lawyers, and others involved in the settlement process -- is expected to account for \$1.79 billion of the \$2.47 billion in third-party transfers under the rule. Within the title and settlement group, small firms are expected to account for 38.1 percent (\$0.68 billion) of the transfers, although there is some uncertainty with this estimate.<sup>12</sup> Step (8) of Section VII.E conducts an analysis that projects all of the consumer savings in third-party costs coming from the title industry; evidence suggests there are more opportunities for price reductions in the title industry, as compared with other third-party industries. In this case, consumer savings in title costs (\$150-\$200 per loan) ranged from \$1.88 billion to \$2.50 billion. To a large extent, the title and closing industry is characterized by local firms providing services at constant returns to scale. The demand for the services of these local firms will continue under the rule.

Section VIII.C of this chapter summarizes the key competitive issues for this industry of the final rule. As noted there, the overall competitiveness of the title and closing industry should be enhanced by the RESPA rule. Chapter 2 and Section VIII.C of this chapter provide evidence that title and closing fees are too high and that there is much potential for price reductions in this industry. Increased shopping by consumers, as well as increased shopping by loan originators to stay within their tolerances, will reduce the revenues of those title and closing companies that

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<sup>12</sup> Section IV of Chapter 5 describes the component industries and estimates the share of overall industry revenue going to small businesses.

have been charging non-competitive prices.<sup>13</sup> Excess charges will be reduced and competition will ensure that reduced costs are passed through to consumers.

The title industry argued that greater itemization was needed in order for consumers to be able to adequately comparison shop among estimates. HUD's view is that the consolidated categories on the new GFE form provide consumers with the essential information needed for comparison-shopping. Itemization encourages long lists of fees that confuse borrowers.

It is important to emphasize that the services of the title and closing industry, as well as other third-party industries (appraisers, surveyors, and pest inspectors), are local in nature and are performed near or at the site. Local firms have advantages of knowledge and networks of clients, as well as transportation cost advantages. These advantages of small, locally based firms will not be negatively impacted by the new rule. In fact, RESPA reform should open up opportunities for efficient third-party firms to expand their operations.

## **II. The GFE Form**

Today's GFE is not an effective tool for facilitating borrower shopping. Today, no GFE is required until 3 days after the borrower submits a full application to an originator, a practice that frequently results in borrowers paying a significant fee before they receive a GFE, effectively preventing the possibility of shopping beyond the provider with whom the applicant applies. The current GFE is typically comprised of a long list of charges, as today's rules do not prescribe a standard form and consolidated categories. The lack of a standard format makes GFEs from different originators difficult to compare even if they use similar names for the vast arrays of fees. The result is a proliferation of all sorts of fees on today's GFE, making it virtually impossible to shop and compare the charges of various originators and settlement service providers. The current GFE does not provide information on important loan terms nor does it explain how the borrower can use the document to shop and compare loans. Also, the GFE fails to make clear the relationship between the closing costs and the projected interest rate on a loan, notwithstanding the fact that many mortgage loans originated today adjust up-front closing costs due at settlement, either up or down, depending on whether the interest rate on the loan is above or below "par." Finally, current rules do not assure that the "good faith estimate" is a reliable estimate of final settlement costs. There is little guidance and no meaningful standards for originators to adhere to in providing "good faith" estimates of settlement costs. As a result, under today's rules, the estimated costs on GFEs may be unreliable or incomplete, or both, and final charges at settlement may include significant increases in items that were estimated on the GFE, as well as additional surprise "junk fees," which can add substantially to the consumer's ultimate closing costs.

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<sup>13</sup> The reasons why the new GFE and its tolerances will lead to improved and more effective shopping for third-party services by consumers and loan originators has already been discussed, and need not be repeated here.

The new GFE of the final rule is designed to solve these problems with today's GFE. The remainder of this section describes the new GFE form, changes made to the GFE of the 2008 final rule, and the results of consumer tests of the new GFE form. The final GFE is an easy-to-understand form that includes a summary page (page 1 of the GFE) containing key information for shopping, including an array of indicators describing the type of loan priced. The forms have been changed to limit the potential for the treatment of yield spread premiums to confuse borrowers and thereby put brokers at a competitive disadvantage relative to lenders. First, the summary page contains the sum of all origination and settlement charges: it makes no mention of the yield spread premium. Those who use the summary page to comparison shop cannot be biased by the yield spread premium since it is not there. Second, the description of the yield-spread premium on page 2 of the GFE emphasizes that the YSP reduces settlement charges, lessening the likelihood that its disclosure will confuse borrowers. Third, the trade-off table, a component of the new GFE that consumers find most useful, should increase consumers' understanding of the financial trade-off between interest rates and settlement costs and of their available options. To reduce consumer confusion, the new GFE continues to consolidate settlement costs into a few manageable categories. Information on tolerances has also been improved. The end result is a form that consumers find to be clear and well written and, according to the tests conducted, one that they can use to determine the least expensive loan. In other words, it is a shopping tool that is a vast improvement over today's GFE with its variable formats, and long list of fees that can change (i.e., increase) at settlement.

## **II.A. The GFE Form in the Final rule**

In order to effectively develop the format and language used in the final rule forms, the Department hired forms development professionals (Kleimann Communication Group) to assist it in developing forms for the rule. Starting with the form in HUD's 2002 proposed RESPA rule, Kleimann simplified the 2002 proposed GFE form and tested revisions on members of the public; their results with respect to the GFE are summarized in Section II.D below. Having considered the results of these tests, and comments received on the proposed GFE, HUD determined that a standardized GFE, containing major cost categories along the lines of the 2002 proposed rule, will serve as an effective yield spread premium and cost disclosure that will facilitate borrower understanding of major categories and their costs; and will empower borrowers to shop, compare and achieve major cost savings where possible. The final GFE reflected changes in both basic content and style with a major emphasis on maintaining competitive balance between brokers and lenders so that borrowers can effectively compare the cost of loan from one source to the cost of a loan from the other. The final GFE form is little changed from the 2008 proposed GFE. The remainder of this section describes the final GFE.

### **II.A.1. Page 1 of the GFE**

The first page of the final GFE includes a few basic facts about the loan and three key numbers to make it easy for the borrower to comparison shop (thus it is essentially a "summary page" and will often be referred to as such).

**Overview.** The top of page one of the final form continues to include blank spaces for the loan originator’s name, address, phone number and email address as well as the borrower’s name, the property address and the date of the GFE. In addition, the top of the revised page one includes a statement about the purpose of the GFE and information about how to contact the loan originator and how to shop for a loan offer. While the revised page one also continues to include information about important dates such as how long the interest rate is available and how long the estimate for all other settlement charges is available, the rate lock period information that was included in the loan summary chart on the proposed GFE was moved from the summary chart to the “important dates” block on the revised form in order to consolidate all the information about dates in one section of the form and to minimize potential borrower confusion.

The revised page one also includes a summary chart of the loan on which the GFE is based but this section of the form is now referred to as “summary of your loan” instead of “summary of your loan terms” as proposed. The revised summary continues to include key terms and information about the loan for which the GFE was provided but certain changes were made to headings on the chart to address specific comments. In addition, in response to comments that the proposed form was too lengthy, HUD has shortened and merged with a question about the presence of an escrow account with the loan the information that was on page 4 of the proposed GFE regarding other financial responsibilities of the homeowner. This section now alerts the borrower to the fact that in addition to principal, interest and any mortgage insurance, there are other costs associated with homeownership that will have to be paid such as property taxes and homeowner’s insurance, and whether any of these expenses are included in an escrow account for the loan. This separate section also alerts the borrower that there may also be other costs that have to be paid such as homeowners’ association fees, condominium fees or other charges and these fees should be kept in mind when deciding how high a monthly payment the borrower can afford. (See section 4 below for a full discussion of changes made to the loan summary chart.)

The bottom of the first page of the GFE includes the settlement charges subtotals and directs the borrower’s attention to the overall settlement charge total. More specific explanations of the GFE page 1 sections follow.

**Purpose, Shopping for a loan offer, and Important dates.** The first page of the GFE form begins with the name, address, and phone number, and email of the originator, the borrower’s name, the property address, and date of the GFE. This is followed by a section “Purpose.” It includes a first statement of what a GFE is. A second statement, labeled “Shopping for a loan offer,” explains that it is up to the borrower to find the best loan in the market and tells the borrower to shop by comparing GFEs from multiple originators and referencing the shopping chart on page 3 for that purpose. Next, the “Important dates” section notes the date through which the interest rate, and interest-related payment estimates are valid, the business 10-day period for which the terms and condition of the GFE are valid, specifies the rate lock period as well as the number of days before settlement the rate must be locked. These dates were gathered from various places on the 2008 proposed GFE.

**Summary of your loan terms.** The next section on page 1 of the new form is the “Summary of Your Loan Terms.” The first table here (Your Loan Details) contains a description

of the loan product including the loan amount, the loan term, the initial interest rate, the monthly amount owed (including principal, interest, and any mortgage insurance), whether the monthly payment can rise and how soon, and the maximum possible monthly payment. The table continues with more information about the type of loan offered, specifically indications of whether: the interest rate can rise (an adjustable rate or hybrid loan), the loan balance can rise provided all payments are timely (a payment option loan), the monthly payment can rise provided all payments are timely, the loan has a prepayment penalty, or a balloon payment. The next part of the table starts with a question about the presence of an additional monthly payment for an escrow account to cover property taxes and other obligations. For an answer of “No”, the form includes a warning that the borrower will have to cover these expenses separately. For an answer of “Yes”, a checklist of the items included in the escrow account is provided.

**Escrow account information.** This section, referred to as “escrow account information” informs the borrower that some lenders require an escrow account to hold funds for paying property taxes or other property related charges in addition to the monthly payment. The section includes a disclosure as to whether an escrow account is required for the loan described in the GFE. If no escrow account is included for the loan, this section informs the borrower that the additional charges must be paid directly when due. If the loan includes an escrow account, the section informs the borrower that it may or may not cover all additional charges.

**Summary of your settlement charges.** The last lines on page 1 contains a consolidated presentation of the settlement costs. It includes the subtotals of adjusted origination charges” and “charges for all other settlement service,” as well as the Total Estimated Settlement Charges. This figures will be identical in otherwise identical loans from brokers or lenders. This page avoids differences in presentation that arise merely from the kind of originator involved, broker or lender, enhancing a “level playing field” between brokers and lenders. The summary page provides the key number for determining the least expensive loan (see below).

**Comments on Page 1 (the Summary Page).** The “Summary of your loan” table on page 1 has only minor changes from the 2008 proposed GFE made in response to public comments. These include expanding the questions about whether the monthly amount owed and the loan balance can rise if payments are made on time because, as commenters pointed out, loan delinquencies can result in increases in monthly payments and loan balance.

Some of this information describes the loan product. This is important for two reasons. First, it tells the borrower if there might be any changes or special circumstances that could arise in the future. With an adjustable rather than a fixed rate loan, the interest rate and monthly payment could change. With a payment option loan that allows “negative amortization” the principal balance can rise eventually leading to higher monthly payments. A prepayment penalty could result in a large charge, in addition to the unpaid principal balance, when payoff occurs prior to the full term of the loan. A balloon payment results when a loan is not fully amortizing so that a large principal payment is due at the “end” of the loan. This information is disclosed to eliminate surprises that could result from the terms of the loan chosen.

Second, all of these loan terms can have an impact on wholesale loan pricing at a particular interest rate affecting the YSP or discount points on otherwise identical loans, and thereby the total settlement cost. For example, the presence of a prepayment penalty increases the expected time period over which the higher payments on an above-par loan would be collected compared to the same loan for the same amount at the same interest rate without a prepayment penalty. In a brokered transaction, the loan with the pre-payment penalty would carry a higher YSP than the otherwise identical loan without the pre-payment penalty. For a direct lender, the pre-payment penalty loan would have a similarly higher present value. In either the broker or lender case, the loan with the pre-payment penalty should have lower settlement costs. If the two loans had the same settlement costs, the borrower would be clearly worse off choosing the loan with the prepayment penalty. Consumers need to know about such differences in loan products to make accurate comparisons of settlement costs.

The first page includes only total settlement costs for this loan. Page 2 of the new GFE contains a list of eleven figures that relate to loan charges. Thus, the consolidation on page 1 focuses the borrower on the total estimated cost of the loan and settlement. This simplifies the presentation for the borrower and makes comparison shopping easier, but still allows the borrower to go to Page 2 for any details he or she thinks are relevant. Note that loans from mortgage brokers are treated exactly the same as loans from lenders on page 1. The form is designed to focus the borrower on loan features and a summary of costs in order to help the comparison shopper evaluate alternative loan features and bottom line costs. Yield spread premiums are not mentioned on page 1. This is done to minimize the possibility that the borrower will make an error in comparing a loan from a broker with a loan from a lender.

The borrower who wants to comparison shop could line up the first (summary) page of several GFEs and easily compare some of the major loan features including the costs, to see what is different and make a choice. If the borrower simplified the process and shopped for the same loan product among originators, there are fewer things to compare. In the extreme, a borrower could get loan offers for loans with the same loan amount, interest rate, term, and other features except the upfront fees. Then comparison-shopping is simple regardless of whether some of the offers are from brokers and others are from lenders. The type of loan originator has no impact on the page 1 presentation. The borrower can just pick the loan with the lowest up-front fee, since that is the only difference. Page 1 is intended to provide the necessary summary information that a borrower needs to find the lowest cost loan. More cost details can then be found on Pages 2, and an explanation of tolerances on page 3.

With fees firmer under the new GFE, shopping is more likely to result in borrowers saving money when they shop. The creation of a summary page is designed to make it simpler for borrowers to shop. The higher reward for shopping along with its increased ease with which borrowers can compare loans should lead to more effective shopping, more competition, and lower prices for borrowers.

## **II.A.2. Page 2 of the GFE**

Page 2 of the GFE provides more details on the charges and information on tolerances.

**Understanding Your Estimated Settlement Charges.** The second page begins with “Understanding Your Estimated Settlement Charges” which presents the main components of the settlement charges. This section consolidates settlement charges into 11 categories – a significant improvement over the long lists of fees that consumers face on today’s GFEs. Subsection II.C below provides a further discussion of the consolidation of settlement charges.

The top of the second page continues to require that the origination charge be listed, and the credit or charge for the specific interest rate is required to be subtracted or added to the origination charge to arrive at the adjusted origination charge. However, this portion of the second page includes some minor changes from the proposed form. First, block 1 is now titled “Our origination charge”, and the text description is shorter. Block 2 now references “points” after the “charge” in the heading rather than at the end of the sentence to better inform the borrower. The heading now reads “Your credit or charge (points) for the interest rate chosen. In addition, to draw the borrower’s attention to the “credit” in box 2 and the effect of the credit, the terms “credit” and “reduces” are now bolded in box 2. To draw the borrower’s attention to the “charge” in block 3, the terms “charge” and “increases” are now bolded in box 3 of the second block. Finally, the second sentence in box 2 and box 3 in block 2 refers to “settlement” charges rather than “upfront” charges in order to be consistent with other language on the form.

Page two of the final GFE, like the second page of the proposed GFE, also contains an estimate for all other settlement services. While the categories from the proposed form have generally been retained on the final form, certain changes have been made to the categories to streamline the form in response to comments. Block 10 of the proposed form “optional owner’s title insurance” is now block 5 of the final form and provides the following information: “You may purchase an owner’s title insurance policy to protect your interest in the property.” In Block 4, “Title services and lender’s title insurance,” the loan originator states the estimated total charge for third party settlement service providers for all title related services, including closing services, and, when such services are required by the loan originator, for lender’s title insurance premiums, regardless of whether the providers are selected or paid for by the borrower, seller, or loan originator.

Block 6 of the final form, “Required services that you can shop for” is the same as block 5 of the proposed form. While block 6 of the proposed form included both government recording charges and transfer taxes, in response to comments, government recording charges are now listed in Block 7 of the final form with the explanation that “these charges are state and local fees to update records of ownership and mortgages.” Block 8 now lists transfer taxes with the explanation that “these charges are state and local fees on mortgages and home sales.” This change was made in response to comments so that these two different types of government fees could be treated differently with respect to tolerances.

Block 7 of the proposed form, “Reserves or escrow” is now block 9 of the final form. The sentence below the title has been revised to include check boxes to indicate whether the reserves or escrow includes all property taxes, all insurance or other payments. The “other” category may include non-tax and non-insurance escrowed items, and/or specify which taxes or insurance payments are included in the escrow if the escrow does not include all such payments.

Block 8 of the proposed form, “Daily interest charges” is now block 10 of the final form. Block 9 of the proposed form, “Homeowner’s insurance” is now block 11 of the final form.

The final GFE requires the charges in blocks 3-11 to be subtotaled at the bottom of page two. The sum of the adjusted origination charges and the charges for all other settlement services are required to be listed on the bottom of page two. This figure will also be listed on the bottom of page one, in the block “Total Estimated Settlement Charges.”

### **II.A.3. Page 3 of the GFE**

**Understanding Which Charges Can Change at Settlement.** Located at the top of Page 3, is a section with a table titled “Understanding Which Charges Can Change at Settlement” covers the tolerances. There is a brief introduction and the charges are broken down into four categories. “cannot increase” includes three items: our service charge (which is subject to zero tolerance), the charge for the interest rate chosen (which cannot change if the borrower locks in the interest rate), and transfer taxes. The second heading is “cannot decrease” and includes the credit for the interest rate chosen (which cannot change if the borrower locks in the interest rate). The next heading is “cannot increase more than 10% if you use companies we identify” and the last is “can increase”. The table identifies the appropriate fees for each heading. This is a more compact presentation than on the proposed GFE to consolidate space.

Page 3 also contains the trade-off table.

**Using the tradeoff table.** This section on Page 3 compares the loan for which this GFE is filled out with two alternatives that the borrower could have obtained from this loan originator. The form has a sentence that explains that if a borrower wants one of the alternatives, the borrower must ask for a new GFE for that loan. Because HUD determined that it could not legally require the alternatives to be presented, there is a statement informing the borrower that filling out the form is optional on the part of the originator. It also advises the borrower to ask for more information if the form is incomplete. If the originator chooses to fill out the tradeoff table, it is required to include alternative loans that differ only by the interest rate and up-front costs from the loan offered as part of the GFE. All other terms must be similar.<sup>14</sup>

Finally, page 3 contains: a section on getting more information on loans and settlement services; the shopping chart and instructions for its use, which allows a borrower to compare loan terms and total estimated settlement costs among different GFEs; and a disclosure about the potential for lenders to receive additional compensation if the loan is sold in the future.

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<sup>14</sup> It may not be possible for originators to offer loans with different interest rates and otherwise identical terms. For example, the maximum interest rate on an adjustable rate loan may depend upon the initial interest rate, although the difference between the original and maximum rates on the two loans may be the same.

## II.B. Consolidating Categories on Page 2 of the GFE

**Your Estimated Settlement Charges.** There are eleven categories of charges in the “Your Estimated Settlement Charges” section on Page 2 of the 2008 proposed GFE. Single entries for various settlement service providers or groups of providers are substituted for the detailed itemizations currently required. The goal of the new GFE is to simplify and summarize the information to make it easier to comparison shop. It will lead to the elimination of the fee itemization that is often pointless and overwhelming and that goes beyond that required by law, sometimes referred to as “junk fees,” that can lead to higher loan costs. Exhibit 1 provides an example of the fees and charges from an actual Good Faith Estimate of Settlement Services. We include only the items payable in connection with the loan (800 series) and the title charges (1100 series). Exhibits 2 and 3 list fees collected from a sample of approximately three thousand HUD-1 forms. Exhibit 2 provides lists examples of fees in connection with the loan and Exhibit 3 lists title charges. The eleven categories are as follows.

(1) Our Origination Charge. Originators will no longer produce a list of fees itemizing lender charges. All originator fees except the charge or credit for the specific interest rate chosen will be included in one charge called “Our Service Charge.”

(2) Your charge or credit (points) for the specific interest rate chosen. This is where the yield spread premium (credit) or discount points (charge) are disclosed. Brokers must put down the exact figure that results at closing. Lenders have no such requirement.

(3) Required services that we select. The next category is non-title, lender-required third-party services where the providers are selected by the originator. These would often include appraisal, credit report, flood certificate, and tax service, which are usually selected by the originator. They might include a pest inspection or a survey. Non-title services that the borrower has no choice about are lumped together in this section on the GFE.

(4) Title services and required title insurance. The settlement agent and title insurance are next as one figure rather than a potentially long itemized list of fees that relate to them. These are grouped together because these charges are usually the result of making one choice of who is to provide these services. The detailed breakdown into a long list of fees is unnecessary and confusing.

(5) Owner’s title insurance. Borrower’s title insurance coverage is optional in any transaction since the originator only requires that it be protected from title defects. If the borrower does purchase borrower’s coverage when the house is first purchased, no borrower’s coverage would be purchased in any refinance transaction since the initial coverage does not expire: new coverage would be largely redundant and pointless. It is listed here despite the fact that it is optional since borrowers often get coverage at purchase and the price of borrower’s title is often lower if it is tied to the purchase of lender’s coverage. In some transactions, sellers purchase owners’ title coverage for buyers. In certain transactions, particularly foreclosures, the lender requires the purchase of an owner’s title policy. In such a case, the estimate for owners title is included in item 4 of the GFE. Checkboxes indicate which of these three situations

applies to the GFE. (6) Required services that you can shop for. Lender-required third-party services where the borrower selects the providers are separate since the borrower must choose the providers of these services or the loan cannot close. Examples could be a pest inspection or a survey. Such services can either be selected by the lender and appear in category (2), or be selected by the borrower and appear in category (5).

(7) Government recording charges. Government charges for the recording of loan and title documents are estimated here. In response to public comments, these are separated from transfer taxes because, while generally small charges, they are frequently variable and unpredictable at the GFE stage, so they are included in the charges to which the 10 percent tolerance applies.

(8) Transfer taxes. State and local taxes on mortgages and home sales are included here. Because these can be large, and are highly predictable, they are subject to zero tolerance. Taxes and other fees on the transaction are separate from other costs since they are not discretionary, are equal for identical loans, and are, for the most part, not for any service rendered.

(9) Reserves or escrow. Escrow is separate for several reasons. One is that the borrower has to pay these charges eventually anyway. Another is that differences could result from one originator using a low cushion relative to another originator, but that low cushion could disappear as soon as the loan is sold to another servicer who could charge to make up the full cushion after settlement. Borrowers who are comparing loans would want to make any necessary adjustments so that the escrow account charges are comparable.

(10) Daily interest charges. Per Diem interest is itemized because it depends on the date of settlement. In some cases, the borrower might want to compare loans as if the settlement date were the same. Another point is that this charge is for the use of money to own the home for the remainder of a payment period (part of a month, for example) until the regular amortization begins. In return for a higher fee, the homebuyer also gets to move in earlier in the month.

(11) Homeowner's insurance. Homeowner's insurance is a separate item since the price is dependent on the coverage selected on the homeowner's policy. It could vary according to the tastes of the borrower. Coverage could vary according to whether it is an umbrella policy, whether it includes jewelry coverage, boat coverage, contents coverage, and a host of other considerations. Other than basic coverage required by the lender, these are all up to the borrower and might be the same regardless of the originator chosen.

## **II.C. Trade-off of Interest Rate and Loan Charges**

An important objective of the final GFE is to highlight the trade-off that borrowers can make between interest rates and loan charges. Chapter 2 and Section III of this chapter explain that it is important that consumers fully understand the various options that are available to them when considering trade-offs between interest rates and loan charges. Because these financial

concepts are complicated, some consumers may not fully understand them, placing them in a vulnerable position when negotiating terms with originators. Brokers and lenders may not always inform consumers that there are alternative products with different combinations of interest rates, points, and settlement charges.

For the most part, originators usually offer a variety of interest rate and point combinations on any loan product. Higher points compensate for a lower interest rate and vice versa. If the rate goes high enough, the borrower can get the originator to pay some or all of the closing costs. Many originators explain this to their borrowers, giving them an array of choices to meet their needs. However, as noted above, this is not always the case. Some borrowers are shown only one of the combinations, so the borrower is unaware of the potential for reductions in closing costs at higher interest rates. This inhibits their ability to shop. As explained in Section IV of this chapter, the yield spread premium controversy has highlighted the importance of borrowers understanding the trade-off and its potential for covering closing costs. The new GFE is intended to ensure that the trade-off is explained to each borrower.

The section of the GFE on Page 3 – entitled “Understanding the tradeoff table” -- shows the inverse relationship between interest rates and monthly payments on the one hand and total estimated settlement charges on the other. The originator has the option give two alternative rates for the loan presented on the GFE and show the impact on monthly payments and the net upfront fee. The idea is that the originator would, as is the practice of some originators today, do more than simply fill out these two examples and explain how the higher (lower) income stream resulting from the higher (lower) rate is worth more (less) in the market and how that generates yield spread premiums (discount points). The originator would go over all the options available and help the borrower compare the alternatives so that the borrower has a rational basis for making a decision about what is best for him or her.

In addition, so long as the borrower has had even one originator explain the relationship between the interest rate and net fees, the borrower will be aware of this and expect that any other loan offer would reflect the tradeoff. The borrower would expect that other originators would have an array of rates available and that each had associated with it a different net upfront fee that varied inversely with the rate. The basis for the existence of yield spread premiums and discount points would be better understood by the borrower, making it more likely that interest rate variations available would be used by the consumer to his advantage rather than by the originator to enhance profit at the consumer’s expense. With this trade-off table on the form, there would be a substantial increase in information about the nature of the trade-off between interest rates and upfront cash payments. The studies reviewed in Chapter 2 suggest that consumers are most confused about loans involving upfront cash payments and above-market interest rates – fees are particularly excessive on these loans meaning that originators are taking advantage of borrowers by not only charging them excessive direct origination fees but also placing them in high-interest-rate loans. The information gained from the trade-off table (as well as the anticipated publicity surrounding the table) should highlight these financial trade-offs to consumers and encourage them to consider all their options.

To conclude, the trade-off section on Page 3 of the new GFE provides an option for the originator to show the borrower two of the options that were available to the borrower, but not chosen as the basis for the loan terms disclosed in this GFE. While originators can choose to show one option and nothing else to a borrower, the borrower is encouraged to ask for more information when none is initially provided. The form itself seeks only to alert the borrower that options are available, especially if none have been presented before that point. HUD expects that originators will usually fill out the tradeoff table to present options as well as continue to use more sophisticated worksheets to help borrowers decide which interest rate/fee option is best for them.

**Comments on the Trade-off Table.** In their comments, many lenders noted the usefulness of the trade-off table but felt it should be placed in the Settlement booklet, rather than in the GFE. Among other things, they said it would be difficult to program in the characteristics of the current loan transaction, and compare that transaction with two alternatives that had been available to the borrower, but not chosen, when the interest rate and points on which the GFE is based were chosen. These comments were carefully reviewed. As explained above, consumers must be fully informed of their options and must understand the trade-off issue in order to effectively shop in today's market. The trade-off table on Page 3 is intended to assist in doing this. As reported in Subsection II.D.1 below, 90 percent of the consumers in the tests conducted by the Kleimann Communication Group understood how the trade-off table worked, that is, they knew that if they wanted a lower interest rate, they had to pay more at settlement, or vice versa. In the second round of testing, consumers stated that the trade-off table was the most useful aspect of the GFE. According to Kleimann, the trade-off table appears to be very important to many consumers.

## **II.D. Consumer Testing of the GFE Form**

At the simplest level, the goals for the final GFE were to facilitate shopping for mortgages; distinguish items homebuyers can shop for; make basic costs clear; show yield spread premiums and discount points to borrowers; make tolerances clear; and clearly convey loan terms including prepayment penalties and balloon payments. In a more sophisticated sense, these goals are not about the content of the GFE, but rather about how consumers use the GFE to inform their decisions about how to finance one of the largest purchases made by most consumers—buying a house. Consumer testing provides a means of collecting data from the public for two purposes: (1) to fine-tune and develop a form that ensures that consumers can use the GFE in the way intended (often known as qualitative testing); and (2) to validate with objective measures the performance of consumers as they use the GFE (often known as quantitative testing).

Because of the feedback following the 2002 proposed rule, input from HUD's RESPA Roundtables, and because of the complex nuances of the information that the Department wanted to include in the GFE form, the Department contracted with Kleimann Communication

Group, Inc.<sup>15</sup> to help revise the proposed GFE and to conduct consumer tests of the usability of the final form. The testing of the GFE form was conducted in two phases. In Phase 1, the Department used three rounds of one-on-one testing interviews to collect data about what worked in the forms under development and what misled or misled the consumers about the information in the form. In the second stage, FTC conducted one round of objective testing on an extracted portion of the 2002 proposed GFE form, and HUD conducted two rounds of objective testing on final and improved versions of the complete GFE form to validate the ability of participants to use the form to select the least expensive loan offer.

### **II.D.1. Phase 1. Qualitative Consumer Testing**

In this phase, the goal of the testing is to fine-tune and develop the GFE form and ensure that consumers can use the GFE in the way intended. As a result, testing in this phase solicits consumer feedback through individual interviews with consumers as they actually use the GFEs in the simulated task of buying a home and needing to select between several loan offers. Data are qualitative and not intended to be statistically significant, but rather provide guidance about problems consumers have and the reasons for those problems. This phase consisted of three rounds of testing.

**First Two Rounds of Testing.** Each of the first two rounds of testing involved interviews with a total of 45 consumers in three cities. New homebuyers and experienced homebuyers were part of the groups tested. The groups included members from diverse racial and ethnic groups, the elderly, and low-education and low-income groups.

Kleimann made several format and language changes to improve the readability and clarity of the form. Kleimann then developed a comprehensive testing protocol that addressed the key objectives of the GFE form for consumers, such as the following: facilitate shopping for mortgages; distinguish items homebuyers can shop for; make basic costs clear; show yield spread premium and discount points to borrowers; make tolerances clear; and clearly convey prepayment penalties and balloon payments.

The interviews with each participant lasted for an hour and a half with a 10-minute break. The interviews had two parts, one unstructured and one structured. In the *unstructured* portion of the interview, participants were asked to think aloud as they looked at each form for the first time. This unstructured and unprompted portion of the interview allowed Kleimann to capture users' initial reactions—including areas that they responded well to, areas they did not understand, and areas they questioned. In addition, the unstructured portion ensured that the testers did not influence the comments of the participants by leading them to discuss information they would not have noticed on their own. In the *structured* portion of the interview, Kleimann gave each consumer completed GFEs<sup>16</sup> and asked targeted questions to determine how well

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<sup>15</sup> Kleimann Communication Group, Inc. is a woman-owned, small business that specializes in developing, designing, testing, and researching consumer-based forms.

<sup>16</sup> Updated versions of the forms developed for Guaranteed Mortgage Package Agreements, or as they were renamed, Mortgage Package Offers (MPOs), were also tested as these regulatory alternatives were still under consideration at the time.

participants understood certain areas of the forms, whether the consumers could determine the least expensive loan, and how Kleimann might improve the forms.<sup>17</sup> The study design focused on how the forms performed as stand-alone documents. The interviewer neither helped the participant understand any of the information on the forms nor answered any questions the participant asked to clarify information.

Because the GFE form was revised between the first and second rounds in response to weaknesses identified in the first round, the results reported below are often from the second round of testing:

- In rounds 1 and 2, approximately 90 percent of the participants said they would shop and would get different GFEs from other lenders.
- Ninety-three percent of the participants chose the least expensive loan (out of three possibilities), indicating that the GFE was helpful in facilitating consumer choice. The three possibilities included a GFE from a broker, a GFE from a lender, and an MPO.<sup>18</sup>
- About two-thirds of the participants could distinguish between items they (as consumers) could shop for and items for which they would use the broker's or lender's providers.
- Essentially all participants could identify the basic loan costs (interest rate, monthly payment and interest, settlement charges) and basic loan features (loan amount, balloon, prepayment penalty, etc.). Practically all (91 percent in round 1 and 97 percent in round 2) could identify the total estimated settlement charges.
- Ninety percent of the participants understood the trade-off table, that is, they knew that if they wanted a lower interest rate, they had to pay more at settlement, or vice versa.
- In round 2, almost two-thirds of the participants could explain the adjusted origination charge.
- Seventy percent of participants were able to identify the tolerances correctly (after the form had been improved in round 2).

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<sup>17</sup> For the first round of testing (45 consumers in Baltimore, Birmingham, and Chicago), Kleimann developed two versions of the GFE. One of the major issues they wanted to collect data about was whether participants found it easier to use the GFE that had a summary page or one that did not. Half of the participants received one version of the GFE with the summary page and half of the participants received a version without the summary page. As a result of this testing a summary page was added to the form. For the second round of testing (45 consumers in Austin, San Diego, and Portland, Oregon), Kleimann was concerned with different issues. They developed a crosswalk from the GFE to the HUD-1 and wanted to test it with participants (see Chapter 6). Kleimann had only one version of the GFE and the Mortgage Package Offer (MPO) to test; however, Kleimann still wanted to vary the order of presentation of the GFE and the MPO, so Kleimann decided to have two-thirds of the participants work with copies of the GFE and MPO. Of these 30 participants, half received the GFE first and then the MPO and half had the reverse order. The other third of the participants received copies of the GFE, but worked primarily with the crosswalk to the HUD-1.

<sup>18</sup> Consumers were initially asked to select the best deal between the lender GFE and the broker GFE – the percentage of consumers picking the best deal increased from 73 percent in round 1 to 90 percent in round 2.

During the testing, Kleimann asked participants a number of questions about how they felt about the forms—how comfortable or uncomfortable they felt with the forms, what they liked and disliked, and how they perceived the information and the level of writing. An overview of participants’ perceptions is as follows (in some cases including round 1 as well as round 2):

- In both rounds, participants found the most useful types of information to be those that gave them facts about the money they would have to pay or options about the amount that they would have to pay. They were able to use the form to identify key information that would help them in making decisions—the costs they can expect and ways to manipulate those costs to their own benefit.
- In round 1, participants found the summary page on page 1 most useful and in round 2, the trade-off table most useful. Asked to identify the most important or useful pieces of information, many consumers chose the trade-off table to be very important. Participants also found the breakdown of charges on page 2 useful.
- When commenting on what they liked most about the GFE, participants in both rounds reacted strongly to the GFE’s simple language and clear layout as well as the clear delineation of charges.
- When asked what they liked least about the GFE, many did not mention any aspect of the form. In round 2, the form was generally clear to participants so they were able to focus on specific aspects of the GFE (e.g., references to other sections). Kleimann reports that most participants in round 2 said “nothing” when asked what they disliked about the form.
- In round 2, 86 percent said the GFE had the right information for them, almost 90 percent said the GFE was written at the right level for them, and about two-thirds of participants said they were comfortable with the forms.

According to Kleimann, the changes made to the form between rounds 1 and 2 worked quite well, and almost all indicators improved. After round 2, Kleimann made some additional minor changes to improve the clarity of the GFE (see pages 36–37 of Kleimann’s Report).

This testing was designed to see how the GFE form would perform as a stand-alone document. The interviewer neither coached nor led the participant by asking questions before the participant could work alone with the document. While this technique identifies how well participants use the GFE form as a stand-alone in a testing situation, consumers using these forms in actual situations, that is, within a context, may perform even better. First, this testing involved no interaction at all between the potential borrower and a loan originator. In an actual situation, a loan originator would be able to answer borrower questions about the information on the forms and improve the borrower’s understanding of it. Of course, some originators might try to confuse the borrower in order to collect higher fees, but a competitor might be more than willing to clear up that confusion since doing so might get him the borrower’s business. In addition to the help coming from the originator, borrowers could always ask someone else for help: a spouse, friend, their real estate agent, etc. Moreover, local consumer groups that focus on lending issues will also assist borrowers in understanding the new, streamlined GFE form. Since

none of these sources were available during the testing, the Kleimann results should be viewed as underestimates of how much the new forms will help consumers once the forms are placed in an actual context of obtaining financing to purchase a home or refinance an existing loan.

**Third Round of Testing.** The third round of testing consisted of 60 participants with 15 each in four cities.<sup>19</sup> As in the first two rounds, the participants covered a diverse range of demographic characteristics. The tests followed the same procedures as in the first and second rounds (one and a half hours, “think-aloud” protocol, and closed questions) and addressed the same issues.

The GFE form, however, was changed for the third round of testing in order to consider whether an alternative presentation of the discount points and yield spread premium would increase consumer understanding. (1) The yield spread premium (YSP) and discount point disclosure was removed from the top of page two, where it had been integrated into the calculations of total upfront charges to the borrower, and moved to page three. As a consequence, page two included only the adjusted origination charge at the top.<sup>20</sup> Thus, otherwise identical loans from a broker and a lender would have identical figures on page two as well as on page one, the summary. Page three contained the YSP and discount points. The form did not include a full calculation of total broker compensation as was presented in the 2002 proposed rule and rounds one and two. (2) The section, “Understanding which charges can change at settlement,” was moved to the bottom of page 2, was presented as a paragraph rather than a column, and was relabeled “Charges that can change.”

With the exceptions noted below, the GFE forms worked well, consistent with the performance in round two. Some of the more interesting findings include:

- The shopping language at the beginning of the form (stating that originator cannot guarantee best rates and encouraging consumer to compare other offers) seems to have an impact. About half of the respondents said they would shop around before they saw the forms. However, after reading the shopping language, 80 percent said they would shop around. This result supports that looking at the GFE influences the attitude of consumers toward shopping for and comparing other offers.
- Participants were given two GFEs and asked to compare the two loans and identify the one that was cheaper. In this test, the lender loan had zero for the points, while the broker loan had a credit that resulted in the adjusted origination charge being lower for the broker loan. The charges for the rest of the categories were the same for both loans. Thus, someone who could use the form correctly would identify the broker loan as the cheaper loan. Those who were confused by the differential disclosure requirements and misled by the higher broker service charge would pick the lender loan as the cheaper alternative. Of

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<sup>19</sup> The cities were Wilmington (Delaware), Tulsa, Minneapolis, and Los Angeles.

<sup>20</sup> This charge was labeled “Our Service Charge” in round three, but it is the equivalent of the adjusted origination charge in the other rounds.

course, anyone could make mistakes for any number of other reasons. The results showed that 93 percent of the participants selected the broker loan as the cheaper loan as opposed to 90 percent in round two. In round three, 89 percent of participants would have chosen the cheaper broker loan as opposed to 86 percent in round two. None of the differences between these percentages in round two and round three is statistically significant.

- As in the first two rounds, participants generally liked the form and would use it to comparison shop. They could identify the basic terms of the mortgage and the estimate of total settlement costs, and 86 percent understood the trade-off table (if they want a lower interest rate, they will pay more at settlement and vice versa). The material seemed to be presented at the right level and to be clearly laid out. Participants again identified the trade-off table, the breakdown of charges (on page 2), and the summary page as useful.
- On the other hand, participants had problems with some aspects of the GFE. While the participants seemed to understand the trade-off table (see above), they had trouble understanding the concepts of yield spread premium and discount points.<sup>21</sup> Only 3 percent and 30 percent, respectively, of the participants could paraphrase what yield spread premiums and discount points represented leaving over two-thirds of the participants unable to paraphrase. Participants did not understand how these two concepts (located on page 3) related to other settlement charges (on page 2). Essentially, placing these terms outside the calculation (that is, on page 3 instead of page 2 as in the first two rounds) seems to decrease participants' understanding of how the yield spread premium and discount points fit into total loan costs. Since there was no sizeable improvement in participants' ability to determine the cheapest loan, and most participants did not understand the concept of YSP, the Department decided to keep the YSP on page two in the calculation as in the 2002 proposed rule.
- Another concern was the decline in the ability of the participants to identify the charges on the GFE that could not increase on the HUD-1. Only 7 percent knew that the service charge was fixed once the rate was locked. The presentation of the tolerances in the three-part column (as in round 2) seems to work better than the presentation of this information in a paragraph form. The GFE in the proposed rule presents this information in the column approach.

## **II.D.2. Phase 2: Quantitative Consumer Testing**

In this phase, the goal of the testing is to validate the performance of consumers using the GFE. As a result, testing in this phase limits the testers' interactions with the participants to asking a few objective questions and the answers can be summed to indicate a level of performance. Some open-ended questions can be combined with the objective questions in order to document the rationale behind answers. This phase consisted of three rounds of testing.

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<sup>21</sup> These results are consistent with the work of Jackson and Berry (2001) and Woodward (2003a).

**FTC Testing.** During the same period that the Department was developing the GFE, FTC tested the effect of yield spread premium disclosure to see if it had an adverse effect on the consumer's ability to comparison shop. FTC extracted and tested only a portion of the 2002 proposed GFE form. The first page of extract consisted of an abbreviated form of the Summary Table from page 1 of the GFE. The second page of the extract contained the "Your Charges for Loan Origination" Box and an abbreviated form of the "Your Charges for All Other Settlement Services" box from page 2 of the GFE. As a control, they took these same two extracts and eliminated the YSP and service charge producing a second set of extracts. Thus the FTC isolated elements of the proposed GFE and created two variations of their extracts: with the YSP and without the YSP.

FTC testers gave each participant a pair of loan extracts to evaluate: one was a lender loan and the other a broker loan. The broker loan was \$300 less than the lender loan. They asked participants which loan was cheaper and also which loan the participant would choose. Each participant also received a second set of extracts in which each loan offer was the same cost. The participants were asked the same two questions: which loan was cheaper and which loan would the participant choose.

FTC tested five groups with 103 or 104 participants per group. The first group received the extract of the proposed GFE without the YSP disclosed (control) and the second group received the extract with the YSP disclosed. Group three received an extract based on round two forms without the YSP disclosed (another control) and group four received the same extract with the YSP disclosed. Finally, a fifth group received the extract based on round two forms with the YSP disclosed, but with modified language that the FTC thought might work better.

The results of the round two control and the round two form that discloses the YSP are reported below, since the other results support the same conclusions.<sup>22</sup>

- When the YSP was disclosed and the broker loan offer was cheaper, 72 percent of participants could correctly identify the broker loan as the cheaper loan; 17 percent incorrectly identified the lender loan as cheaper. Asked to identify which loan offer they would choose, 70 percent of participants would have chosen the cheaper broker loan; and 16 percent would have chosen the lender loan.
- In contrast, when the form extract did not disclose the YSP, 90 percent correctly identified the broker loan as cheaper, and 85 percent would have chosen it. Disclosing the YSP caused an 18 percent drop in participants correctly identifying the cheaper loan and a 14 percent drop in the number who would choose it in the market.

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<sup>22</sup> FTC test results and the Department test results varied considerably because conditions of the FTC test and the Department's testing in the first three rounds were substantially different. First, in the Department's testing, participants were given the complete GFE, while the FTC gave participants only an extract from the form. Second, participants in the Department's testing worked extensively with the GFE, reading it and commenting on it for about 20 minutes before making their choices while the FTC testing took about 10 minutes.

- When costs of the broker and lender loans were the same on GFE forms that contained the YSP, participant performance decreased. Fifty-three percent reported that the loan costs were a tie; 30 percent believed the lender was cheaper; 11 percent believed the broker was cheaper. When asked to identify which loan offer they would choose, 25 percent of the participants chose either the lender or the broker loan offers; 46 percent selected the lender loan offer; and 17 percent selected the broker offer.
- In contrast, when the form omitted the YSP, 96 percent correctly identified the tie, and 78 percent chose one or the other as their preference.

The FTC concluded that the disclosure of the YSP on GFE forms had two drawbacks. First, the disclosure of the YSP impaired the ability of borrowers to comparison shop leading many to choose the more costly alternative. Second, the disclosure of the YSP introduced bias in the selection process that favored lenders over brokers. Neither of these is a policy goal of the Department.

**Fourth Round of Testing.** The radically different results FTC reported served as a catalyst for the Department to undertake additional testing. For round 4, the Department asked Kleimann Communication Group to parallel aspects of the FTC study, including the questions asked, the difference between the amounts of each offer, and the length of the test situation.<sup>23</sup> However, because the Department thought that the context of the entire form might provide a more accurate measure of participants' understanding of the GFE, the study design used a full length GFE rather than the extract from the FTC study. For each site, 120 participants were selected for demographic diversity.<sup>24</sup>

For round four, 600 participants were given full length GFEs. The control group (285 participants) received GFEs which omitted the YSP disclosure, while the experimental group (315 participants) received GFEs with the YSP disclosed. Each participant was given two pairs of loans: one in which the broker loan was \$300 less than the lender and one in which the broker and lender loan offers were the same cost. Each participant was asked three questions for each set of GFEs: (1) which offer was cheaper or if they cost the same, (2) which offer would they choose, and (3) why they made that choice.

The results of this testing showed both consistency and divergence with the FTC results.

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<sup>23</sup> Kleimann's report, entitled *Testing HUD's New Mortgage Disclosure Forms With American Homebuyers Rounds 4 & 5* (dated March 19, 2004, [http://www.huduser.org/Publications/PDF/GoodFaith\\_4and5voll1.pdf](http://www.huduser.org/Publications/PDF/GoodFaith_4and5voll1.pdf)), provides information on the specific characteristics of the consumers tested, revisions that Kleimann made to the form and the reasons for those revisions, the specific cities where the tests were conducted, the testing protocols, testing conditions, and the main results from each round of testing.

<sup>24</sup> The five cities for round 4 included Atlanta, Boston, Denver, Seattle, and Tulsa.

- When the YSP was disclosed, 83 percent of the participants correctly identified the broker loan as cheaper, and 8 percent incorrectly identified the lender as cheaper. These results are an improvement over the FTC results of 72 percent and 17 percent. In this GFE scenario, 72 percent of the participants said they would choose the broker offer and 11 percent said they would choose the lender. Similarly in the FTC study, 70 percent of the participants chose the broker offer and 16 percent chose the lender offer.
- When the YSP disclosure was removed, 92 percent correctly identified the broker loan as cheaper, and 1 percent incorrectly identified the lender as cheaper. These results are quite similar to FTC's results of 90 percent and 4 percent. When asked to choose a loan, 88 percent of participants chose the broker offer, while 1 percent chose to the lender loan. These results compare to 85 percent and 3 percent respectively in the FTC testing.
- When given same cost loan offers with a YSP, 81 percent correctly identified both loans as costing the same; 15 percent incorrectly identified the lender as cheaper; and 3 percent incorrectly identified the broker as cheaper. In contrast, in the FTC study, only 53 percent correctly identified the offers as costing the same; 30 percent incorrectly identified the lender as cheaper; and 11 percent incorrectly identified the broker as cheaper. In this GFE scenario, 50 percent of participants would have chosen either offer; 39 percent chose the lender offer; and only 5 percent chose the broker's. In contrast in the FTC study, only 25 percent chose either offer; 46 percent chose the lender offer; and 17 percent chose the broker's offer.

Of particular concern was the difference between participants who could identify the cheapest loan offer, but did not choose it. Analysis of the participant responses to the open-ended question of "why did you choose that offer" led to further modifications of the GFE to address this concern and to a fifth round of testing. First, in many comments, participants stated that they chose a particular offer because they did not want the "higher interest rate" indicated on page 2 of the GFE. They concluded from the language on the YSP disclosure that the interest rate was higher than the rate cited on page 1 "Loan Details." Second, many comments reflected that participants felt that the broker YSP disclosure was not straightforward and perhaps manipulative. Third, several participants chose a loan based on the loan origination fee as opposed to the overall adjusted charges. Finally, many of those who had no preference for the cheaper broker loan indicated that \$300 was not a big enough difference to be a deciding factor.

**Fifth Round of Testing.** As a result of the testing and analysis, revisions to the GFE included the following: (1) The language in box 2 on page 2 of the GFE referring to the "higher interest rate" and "lower interest rate" was modified to reduce the possibility of borrowers' misinterpreting that the interest rate had changed from what was reported on the first page. (2) A third option was added to the YSP/discount points section on page 2 so a lender could indicate that their credits or charges were already included in "Our Service Charge." This addition was designed to mitigate the sense of some participants that credits and charges were not straightforward. (3) Arrows were added on pages one and two to focus the borrower's attention on the subtotals and the total estimated charges rather than individual components. In addition,

the font size in the Total Estimated Settlement Charges on the bottom of page 1 was increased to further draw attention to the bottom-line.

For purposes of testing, three other changes were made to the GFEs. First, the difference in the total cost was changed to \$500 to increase the likelihood that the difference would be a deciding factor. Second, another pair of loan options was added in which the lender offer was \$500 less than the broker offer. This addition was intended to identify any bias for or against the broker and lender options. Finally, we added a set of four loans to verify whether the comparison across more than two offers increased or decreased participant performance. No version was tested without the YSP and discount points language.

For round five, 600 participants were divided into two groups, both of which received the GFE.<sup>25</sup> The first group (315 participants) received the GFE with changed language and with the addition of a third option so lenders could indicate that YSP and discount points had been included in “Our Service Charge.” The second group (285 participants) received the identical GFE, but the third option box was removed. All participants received three pairs of loans, one with the broker offer being lower by \$500, one with the lender offer being lower by \$500, and one in which both offers were the same. In addition, each participant received a set of four offers to compare.

The three-option GFE and the two-option GFE performed quite similarly with the three-option form consistently getting slightly better results. As a result, the following discussion is for the three-option form only and reflects a general trend of improved performance.

- In the GFE in which the broker was cheaper, 92 percent of the participants correctly identified the broker as the cheaper loan offer. This result represents an improvement over the 72 percent reported by the FTC study and the 83 percent reported in round four results. Only three percent of the participants incorrectly identified the lender as the cheaper loan offer, but again an improvement over the 17 percent reported by the FTC and eight percent in round four. When asked to choose a loan, 87 percent of the participants chose the cheaper broker loan as compared to 70 percent of the participants in the FTC study and 72 percent of the participants in round four. The success rates for the two option form are almost as good, just a percentage point or two below the three option form. These results of round five of testing are dramatically better than the FTC’s results and are based on a much larger sample.
- In the GFE in which the lender was cheaper, 92 percent of the participants correctly identified the lender as the cheaper loan offer. A mere one percent incorrectly identified the broker as cheaper. When asked to choose a loan, 89 percent of the participants chose the lender loan and less than one percent (0.3) chose the broker. Again, the two-option form results are very close to the three-option results.

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<sup>25</sup> Participants were chosen for demographic diversity in the same five cities: Atlanta, Boston, Denver, Seattle, and Tulsa. No participant from round 4 was permitted to participate in round 5.

- The purpose of testing the case in which the lender was cheaper than the broker was to test for bias by seeing if the GFE forms performed equally well when either the lender or broker was the cheaper loan. A comparison of the results (92 percent vs. 92 percent, 3 percent vs. 1 percent, 87 percent vs. 89 percent, and 3 percent vs. 0.3 percent) provides no support for the charge of anti-broker bias when the loans have different borrower costs. And these results reflect a large sample of loans.
- In the GFE in which the broker and lender loan offers were of equal cost, 90 percent of the participants were able to correctly identify that fact. This result compares very favorably with the 53 percent reported by FTC and the 81 percent from round four. Participants in round five with equal-cost loans misidentified the lender as cheaper seven percent of the time, a large improvement over 30 percent in the FTC results and 15 percent in round four. Participants misidentified the broker as cheaper one percent of the time as compared to 11 percent in the FTC study and three percent in round four. Participants said they would choose either loan 70 percent of the time, a dramatic increase over the 25 percent in the FTC study and the 50 percent in round four. Twenty-one percent would choose the lender as compared to 46 percent in the FTC study and 40 percent in round four. Four percent of participants chose the broker compared to 17 percent in the FTC study and five percent in round four. The two-option form results in round five show the same basic sizeable trend in success rates and reduction in bias.

To further test whether increased context improved or decreased consumer performance with the GFE, the Department asked Kleimann to give the participants a four-loan comparison as well. For this four-way comparison, the Department included a blank worksheet to aid participants in comparing the loans. The worksheet contained spaces for the originator's name, loan amount, interest rate, term, monthly payment, adjusted origination charge, charges for all other settlement services, and total estimated settlement charges. On page one of the GFE, a sentence telling participants to use the table to compare offers was inserted. Additionally, half of the participants were given explicit verbal directions to use the worksheet.

The 300 participants who had received the three-option GFE were included in this four-way comparison. Half of them were given a set in which a broker loan offer of \$6,100 was the cheapest. The other three GFEs reflected a lender loan offer of \$6,400 and a lender and a broker loan offers in which both cost \$6,500. The other half were given a set in which a lender and a broker loan offers cost the same and were the cheapest at \$6,500. In this same set, participants received a broker loan offer of \$6,900 and a lender loan offer of \$6,600. In addition, only 150 participants received explicit verbal instructions to use the worksheet in their comparison, while half received no instructions.

Participant performance on the four way comparison is impressive.

- In the comparison in which the broker loan offer of \$6,100 is the cheapest, 92 percent of participants who were not verbally reminded to use the comparison worksheet correctly reported the \$6,100 broker loan as the cheapest. Three percent incorrectly identified the \$6,400 lender loan as the cheaper loan. These results are the same as for the paired

comparison discussed earlier where the broker was \$500 less. Interestingly, very few of the participants who were not verbally reminded to use the comparison worksheet used it.<sup>26</sup> When instructed to use the comparison sheet, many participants did, and 97 percent correctly identified the \$6,100 broker loan as the cheapest, and none wrongly picked the \$6,400 lender loan. The overall success rate for correctly identifying the correct loan as the cheapest for both those getting and those not getting the verbal instructions to use the comparison worksheet was 95 percent, with only one percent misidentifying the lender as cheaper.<sup>27</sup>

- In the case where one broker loan and one lender loan cost the same and no verbal instructions were given to use the comparison sheet, 41 percent picked the broker loan as cheaper and 49 percent picked the lender loan. With verbal instructions to use the worksheet, 57 percent picked the broker at \$6,500 and 35 percent picked the lender at \$6,500. The combined average was 49 percent for the broker and 41 percent for the lender.

**Sixth Round of Testing** The sixth round of consumer testing consisted primarily of qualitative tests of the GFE and an initial qualitative test of the closing script (referred to in testing as “the summary”). Compared to previous rounds of testing, the testers found that participants were more aware, due to recent intensive media coverage of mortgage market difficulties, of the issues facing a consumer choosing a loan. The modifications to the GFE for round 6 included changes in the language on timeframes, new language on additional compensation lenders may receive after closing for selling the loan, changes in the title and description of government recording and transfer charges, and an expansion of disclosed loan terms to alert the borrower to potentially unfavorable changes in their obligations.

- The modifications in the loan terms disclosure worked well with consumers.
- Ninety percent of participants were able to correctly identify the highest and lowest cost loans.
- Participants stated that they liked the form length, the language of the GFE, and the layout of pages 1 and 2.
- Participants appreciated the trade-off table and used it to compare loans.

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<sup>26</sup> This lack of use may be attributed in part to the constraints of being in a testing situation and thus concerned about doing only the tasks requested.

<sup>27</sup> A success rate of 95 percent may be as high as one could expect in this kind of testing. This is the same success rate the FTC got when they gave borrowers two equally costly loans, one from a broker and one from a lender, without the YSP disclosed. In other words, where borrowers got two identical forms with identical loan data on them, only 95 percent could figure out they were the same.

The language on the timeframes did not work well so the final GFE uses a language closer to what resulted after round 5 of testing. The new language on additional compensation lenders may receive after closing for selling the loan created concerns that there could be more borrower charges. To mitigate this perception, this language in the proposed GFE was moved out of the YSP disclosure area on page 2 to the end of page 4, and the explanation was rewritten to avoid the impression that borrower charges could rise after closing. Finally, the terms “government recording and transfer charges” confused some borrowers and the terms were eliminated from the explanation part of #6 on page 2, “Government recording and transfer charges.” After round six, the GFE information was rearranged. In addition, information on the existence of an escrow account was added in the loan terms section on page 1 and in a more expanded section on page 4. Finally, the tolerance presentation was changed from a list of headings and bullets to three columns according to the tolerance that applied and bullets within each column to provide details. .

Testers conducted settlement/closing simulations to test the idea of the closing script. Half of those participants worked with a summary (script). They used the summary in conjunction with other documents to answer questions and sometimes even used it as a primary information source. Participants thought the loan details were clear and understandable and reacted positively to having the summary read aloud.

- Participants to whom the script was read were more attentive to loan details than participants who reviewed the documents independently.
- Participants to whom the script was read were more aware of the tolerance categories and how they related to charges. Four out of 10 summary participants mentioned tolerances, compared to none of the non-summary participants.
- Participants to whom the script was read were able to identify tolerance violations. When asked to identify the actual percent increase, 8 out of 10 summary participants correctly identified the 25% violation.

**Seventh Round of Testing.** This round of testing tested the GFE and HUD-1 that resulted from HUD’s response to the public comments. To summarize, the changes to the GFE, which was tested in round 7, from responses to public comments are as follows

- Page 1 summarized key loan information (including escrow), but the Total Estimated Settlement Costs line at the bottom of page 1 was reduced to one line to make room for the “other financial responsibilities” disclosure from the top of page 4 of the proposed rule GFE that was incorporated into an expanded escrow account disclosure on page 1.
- Page 2 retained the YSP disclosure as in the proposed rule in Item 2, and increased the categories of All Other Settlement Charges to nine by separating “Government recording and transfer charges” into two separate items in response to public comments.

- Page 3 was condensed to include a very abbreviated tolerance chart, the trade-off table, the shopping chart, and the post-settlement sale of loan disclosure.
- Page 4 of the proposed GFE was deleted.

**Implementation of Round 7 Testing.** The primary purpose of the Round 7 testing was to validate these changes to the GFE based primarily on public comment and reduction of the length of the GFE from four pages to three. HUD conducted Round 7 of testing consisting of 28 individual qualitative interviews, and 120 participants in focus groups to quantify performances. The quantitative testing also tested the performance of page 3 of the HUD-1 added to replace the closing script. Round 7 was divided into a pre-test of 7 qualitative interviews and 30 quantitative focus group participants in Denver, with the remaining 21 qualitative interviews and 90 quantitative focus group participants in 3 separate cities, Minneapolis, Washington, and Atlanta.. Further details of the testing are provided below.

- HUD’s decision to allow loan originators the option of filling out columns two and three of the trade-off table with similar loans with different interest rates and settlement charges was tested in the qualitative interviews.
- One set of GFEs in which one GFE was for an adjustable rate loan, was included in the qualitative tests because of earlier criticism that HUD’s previous testing varied only settlement costs.
- Participants in the quantitative study reviewed four sets of GFEs: two GFEs with lender (no YSP) settlement costs lower than the broker (YSP disclosed): two with the broker loan lower; two with the same settlement costs but different loan interest rates; and a four-loan test with one lender and one broker tied with the lowest settlement cost. Participants were asked the standard questions used in prior rounds of testing: (1) Which loan costs less? (2) Why? (3) Which loan would you prefer? (4) Why? The “why” questions allowed for additional qualitative insights into the numbers generated in the quantitative tests.
- In the Denver pretest, two elements did not perform well: the escrow information on page 1 and the tolerance table on page 3. For the escrow information, participants needed more details and were unclear how the information on page 1 related to the escrow item on page 2.
- Since escrow language had been added to the GFE in response to public comment and had not been previously tested, HUD anticipated needing to modify the language for the remaining tests.
- More importantly, the tolerance table, which had worked well in Round 5 of testing, did not work well in the abbreviated version introduced to reduce the length of the GFE from

4 pages to 3. Participants had difficulty looking at the item number in the chart on page 3 and matching it to the description on page 2.

- For the remaining three test sites, HUD modified the escrow language and drastically reworked the design of the tolerance table. We embedded zero-tolerance information in the description of the items on page in Block 2 on page 2, added graphic elements on page 2 to “flag” other tolerances, and shifted the tolerance language on page 3 to focus on the items with a 10% tolerance.
- However, in the final three test sites, neither set of changes was successful. See Form Improvement Section on page 3.

**Results of Round 7 Testing.** The qualitative results were positive. Participants comprehended the information in the GFE, compared information across GFEs, and identified and chose a loan based on lowest cost whether a broker-originated or lender-originated loan. Participants were easily able to identify the adjustable rate loan offer, and no one selected it. The qualitative results concerning the trade-off table were that participants far preferred to have the trade-off table filled out than to have it blank. Participants tended to choose the loan offer that had a completed trade-off table, expressing some suspicion when it was not completed. The qualitative results suggested form improvements. Participants did not fully understand the items around the escrow disclosure on page 1 of the GFE tested. Participants were also not able to accurately identify zero-tolerance and no-tolerance items as a result of the changes to the tolerance table at the top of page 3 made to reduce the length of the GFE from four pages.

**Quantitative Results – Two-Loan Comparison.** The table below compares Round 5 and Round 7 results when consumers were given two loan offers:

When participants compared two different loans with only interest rates different, 84.4% identified the lower interest rate and 86.7% chose the loan offer with the lower interest rate. The percentages are somewhat lower than the results from Round 5, and are attributable to two major differences in presentation on the GFE: (1) efforts to add zero-tolerance language to Items 1 and 2 that complicated the presentation of these elements of the form and was misinterpreted by many consumers, and (2) the replacement of the three-line settlement cost summary on page 1 with a 1-line summary. In Denver, where the GFE did not include the tolerance language on page 2, the results closely approximated the Round 5 testing.

**Results of Identification and Choice Questions for Task 1, Two-Loan Comparison in Rounds 5 and 7**

Different Cost Loan Comparison (broker lower)	Round 5 3-option YSP (Percent)	Round 7 Denver (Percent)	Round 7 3 sites (Percent)
<b>Which loan costs less?</b>			
Broker (correct)	91.6	86.7	82.2
Lender (incorrect)	4.3	10.0	4.4
Same (incorrect)	2.7	3.3	8.9
<b>Which loan would you prefer?</b>			
Broker (correct)	87.3	96.7	82.2
Lender (incorrect)	6.7	3.3	3.3
Either (incorrect)	3.7	—	11.1
Different Cost Loan Comparison (lender lower)	Round 5 3-option YSP (Percent)	Round 7 Denver (Percent)	Round 7 3 sites (Percent)
<b>Which loan costs less?</b>			
Lender (correct)	92.3	90.0	82.2
Broker (incorrect)	1.0	6.7	4.4
Same (incorrect)	6.0	3.3	8.9
<b>Which loan would you prefer?</b>			
Lender (correct)	88.6	90.0	80.0
Broker (incorrect)	0.3	10.0	1.1
Either (incorrect)	8.1	—	14.4

**Quantitative Results, Four-Loan Comparison.** In the four-loan comparison, GFEs with one lender and one broker tied with the lowest settlement cost were presented. In total, 95.0% correctly identified loans with lower settlement charges.

**Form Improvement as a Result of Integrated Qualitative and Quantitative Analysis.** While nearly all of the participants chose a lower cost loan, the answers to the question “Why did you make that choice” of a lender or broker originated loan suggested three elements of the GFE form that could be improved.

- In the tested Round 7 form, language about tolerances was inserted into Items 1 and 2 that complicated the overall presentation of the difficult concepts communicated in this section, and led some participants to believe that their origination charges would not change with a lender loan when these charges may in fact change until the interest rate is locked. While this suggests that tested consumers should behave differently with lender and broker loans, this did not happen. Rather the introduction of tolerance information on page 2, the most significant design difference between Round 5, Denver Round 7, and the remainder of Round 7, caused a general decline in performance by adding information to page 2 extraneous to determining which was the lowest cost loan.
- Another change from Round 5 was the removal of the summing lines for Total Estimated Settlement Charges at the bottom of page 1. Without a reminder that cost is determined by the sum of all settlement charges, some participants went to the “Our Origination

Charge” in Item 1, page 2 to assess lowest cost and made their choice based on that cost without considering the Other Settlement Charges on page 2.

- In addition, based on the information in Item 2, at the top of page 2, some participants thought that lenders did not have similar charges or credits for a selected interest rate because the language in Box 1 of Item 2 was not parallel to the other two boxes.

**The HUD-1 and Closing Script after Public Comment.** The closing script was withdrawn, but a new page 3 to the HUD-1 was designed to help consumers compare loan details between the GFE and the HUD-1. In addition, page 3 of the HUD-1 included a table devised to identify the percentages of change between estimated and actual charges and to identify if the total is within the tolerance limits.

**Round 7 Testing of the HUD-1.** Participants in the Round 7 quantitative testing were asked to compare a GFE and HUD-1 which contained the page 3 in the draft final rule submitted to OMB. The HUD-1 mirrored the details of the GFE exactly except for one these four details:

- The prepayment penalty increased from \$2,000 to \$4,000.
- The interest rate and monthly payment increased from 6.5% (\$632.07 per month) to 6.75% (\$648.60 per month).
- Charges for items 3 through 7 increased 11%.
- Charges for items 3 through 7 increased by 8%

Participants were asked to identify (1) if there was a change between the two documents, (2) what the change was, (3) if that change was allowed, and (4) if they would move forward with the HUD-1 at settlement and why.

**Quantitative Results for the HUD-1.** The comparison between the GFE and HUD-1 clearly showed that participants were concerned if they noticed a change in any of the loan details or settlement charges.

- Of the participants, 89% noticed a change between the GFE and HUD-1, indicating that most participants could move easily from one document to the other.
- A total of 70 participants received a HUD-1 with a change from the GFE that increased interest rate, added a prepayment penalty, or settlement charges rose above the tolerance level of 10%. Sixty three noticed the change and only 7 said they would still move forward with the settlement.
- The difference between raising the charges \$150 (up 8%) or \$205 (up 11%) of items 3 through 7 at settlement did not cause a difference in the decision making. Sixty-five percent in each group said they would not move forward with the HUD-1, and several mentioned being upset to find that charges had increased between the two documents.

**Recommendations for HUD-1.** Based upon the Round 7 consumer testing, page 3 of the HUD-1 is retained in the form sent to OMB. However, because participants were not sure what to do once they had identified discrepancy, based upon a testing recommendation, HUD added a note to page 3 to suggest that consumers ask their lender if discrepancies occur.

**Conclusions from Round 7 Testing.** The extensive consumer testing across seven rounds with both qualitative and quantitative methodologies and analytic techniques has resulted in a consumer-focused Good Faith Estimate that consumers can understand and use. This research documents that the policy changes to HUD’s RESPA regulations and the accompanying changes to the GFE will not bias consumers in their choice of loan offers. The changes to the HUD-1 further ensure that consumers will be better protected against accidental and unwarranted changes between the estimates of the GFE and the actual charges on the HUD-1. In short, the key elements of the revised GFE and the HUD-1, page 3 are useful for consumers and the mortgage lending industry who serve the public:

- The standardization of the design and language of the Good Faith Estimate facilitates loan comparisons.
- Consumers can identify and select the lowest cost loan when asked to compare more than one GFE.
- The summaries on page 1 of the GFE work. The “Summary of your loan” section allows consumers to identify variations in the loan details. The three-line summary of “Total Estimated Settlement Charges” enhances identification of lowest cost loan offers.
- The details of the estimated settlement charges on page 2 of the GFE are clear to most consumers. Consumers understand the relationship of charges and credits to the interest rate. The inclusion of a box to identify the interest rate for lenders in the first box of “Item 2” further enhances their understanding.
- The “Understanding which charges can change” (tolerance) table on page 3 of the GFE allows consumers to identify those items for which they can shop themselves or opt to take the assurance of no more than a 10% increase in the total. The table also helps identify those charges that cannot change, thus providing a level of confidence in the stability of the estimates.
- The “trade-off table” on page 3 allows consumers to understand that alternative loan options are available. Most consumers far preferred to have the table filled out, expressing some suspicion when it was not completed. Importantly, the table enhanced understanding of the reciprocal relationship between interest rates and settlement costs.
- The “shopping chart” on page 3 of the GFE helped consumers identify the key elements to consider when they compare offers. Further, the shopping chart suggests the importance of shopping for a loan offer that best meets a consumer’s needs.
- The addition of page 3 to the HUD-1 allows consumers to compare and identify more easily the changes that may have occurred between the Good Faith Estimate and the actual charges at settlement. The addition of a brief note to remind consumers to ask their lenders if discrepancies occur provides the consumers with options and would increase communication.

**Comment.** The National Association of Mortgage Brokers characterizes Kleimann Communications’ testing of our form as “flawed” for several reasons (p. 49). (((reference))) The first is that Kleimann “failed to test the disclosures in actual transactions involving competing disclosures.” The second criticism of Kleimann’s methodology is that the communications firm “failed to test consumer understanding of loan terms and comparative shopping when YSP was not disclosed. Instead, the contractor assumed the answer to the most fundamental question, that is, whether YSP disclosure aided consumers in comparative shopping. Accordingly, the tests focused only on how, not whether, to disclose YSP.”

**Response.** HUD disagrees that Kleimann Communications Group’s consumer testing of the GFE form was flawed. Independent reviews by experts in consumer testing and forms development found no flaws in the design of the tests. NAMB’s suggestion of testing forms in actual transactions is unworkable and an invalid basis for criticism. The hardest part of such a test would be finding loan originators (both brokers and lenders) willing to volunteer to test a form that is designed to improve consumer understanding and thereby reduce the originators’ information advantage and market power in the transaction. Perhaps as difficult would be keeping tested consumers from shopping outside of the experimental group of originators to keep the test valid, especially since the forms so strongly urge consumers to shop among different originators.

The NAMB’s second criticism is also invalid because the third round of testing was exactly on the point of whether to disclose the YSP. The purpose of the YSP disclosure is to inform consumers about the full cost of originating loans through a broker and help them to understand the tradeoff between interest rates/monthly payments and origination costs so that consumers can use the relationship to their benefit. The third round of testing did not include the YSP disclosure, and the important finding was that, without the YSP disclosure, consumers did not understand the existence of the tradeoff between interest rates and origination charges as well as when the YSP was disclosed. Helping consumers to understand this tradeoff is a fundamental goal of HUD’s RESPA reform effort and of the design of the GFE form. The third round of testing confirmed that inclusion of the YSP disclosure helped consumers understand the tradeoff, and that if they take a loan with a relatively high interest rate, they should pay lower settlement charges. Since the need for the YSP disclosure to improve consumer understanding of the tradeoff was established in round 3, whether a YSP disclosure should be included was not the subject of later rounds of testing. Rather, later rounds of form development and testing were aimed at making the YSP disclosure free of anti-broker bias. This effort was successful.

**Comment.** The Board’s letter makes the following statement:

In July 2008 the Board withdrew its proposed rule regarding yield spread premiums, after limited consumer testing showed deep confusion about broker compensation and the incentives it creates.

The Board of Governors of the Federal Reserve had proposed amendments to Regulation Z, which implements the Truth in Lending Act (TILA), to provide mortgage broker disclosures that would be clear and understandable to consumers. The Board contracted with Macro

International (2008) to test their model language through a series of cognitive in-depth interviews with consumers. Macro conducted four rounds of consumer testing in March through May 2008: two in Washington, DC, and one each in Los Angeles, CA and Kansas City, KS. A total of 35 separate interviews were completed: 31 with individuals and 4 with couples who had jointly made mortgage decisions. Interviews lasted between 60 and 90 minutes.

Participants for the interviews were recruited by telephone, and were selected because they had all obtained or refinanced a mortgage in the past two years. Potential participants were also screened to include a range of ethnicities, ages, and education levels. For each round of testing, Macro and Board staff developed an agreement for a fictional broker that included the information about broker compensation as required in the Board's proposal.

The language used in all rounds successfully communicated the amount of the broker's commission to participants, as well as the fact that they would have to pay that commission. However, Macro's testing showed that several other comprehension issues remained, despite repeated attempts to address them through revisions of the agreement. The Board describes these misunderstandings as:

- Most participants who read the agreements did not understand how lender payments to brokers created a financial incentive for brokers to provide loans with higher interest rates.
- In some cases, the broker agreement seemed to bias participants against working with a broker—particularly those who learned for the first time that brokers' compensation depends on the interest rates of the loans they offer.
- In some cases, the agreements being tested also led to an additional bias against brokers that was unrelated to any conflict of interest. Some participants were uncomfortable that a broker would discuss his or her commission in such detail before providing any services, and felt that this showed the broker was overly concerned with his or her own compensation.

Several participants in different rounds commented that they found the broker agreement internally inconsistent in that it seemed to fix the commission at a certain amount but then stated that the broker received greater compensation for providing loans with higher interest rates. When asked how they would resolve this perceived contradiction, participants either ignored the text about increases in broker compensation and assumed that the amount was fixed, or assumed that the broker would receive a separate payment from lenders in addition to the amount shown. This latter belief—that the broker would receive two separate payments—often led to bias against the broker.

**Response.** Based on the discussion of the withdrawal of the mortgage broker disclosure provision from the preamble of the Board's final HOEPA rule, HUD maintains that the Board's tested form may have been more successful than the Board was willing to give it credit for being.

According to the preamble of the Board's final HOEPA rule, the Board tested a mortgage broker compensation agreement form which was designed to accomplish two goals: (1) impart to the consumer an understanding that mortgage brokers have an incentive to steer borrowers into higher interest rate loans because of the possibility of indirect compensation through the yield spread premium (YSP); and (2) establish that the form was an agreement to fix the total compensation of the mortgage broker involved in the transaction regardless of the source of compensation (either borrower direct payment or lender indirect payment through YSP).

The Board maintains that tested consumers were confused because they either (a) understood that mortgage brokers had an incentive to steer them into higher interest rate loans and did not believe that the broker compensation agreement was binding, or (b) they believed the agreement was binding, and that the mortgage broker did not have an incentive to steer the borrower into a higher interest rate loan. It is HUD's view that this second group of consumers (group "b") understood the form perfectly well. When a binding agreement on mortgage broker total compensation (no matter the source) is in place, *something group "b" consumers accepted as fact*, the broker who is party to the agreement no longer has an incentive to steer the consumer into a higher interest rate loan. Stated more simply, a mortgage broker who agrees to accept no more than a specified amount to originate your loan no longer has an incentive to steer you into a higher interest rate loan. He is indifferent to the source of compensation between direct fees paid by you and YSP. Group "b" consumers appeared to understand this clearly.

While it is not clear from the statements in the preamble, perhaps the Board was troubled because group "b" consumers generalized from the context of the individual agreement a lack of incentive for brokers to steer consumers into higher interest rate loans at any point in the process. Such generalizations are understandable if group "b" consumers were considering a world where the mortgage broker compensation agreement was in place in every broker transaction. Then the incentive to steer only exists before the compensation agreement is issued. Perhaps if the Board had asked tested consumers why they thought a mortgage broker compensation agreement was important, they would have gotten a more satisfactory answer.

The results for group "a" are more troubling in that these consumers failed to believe the validity of a binding agreement. Perhaps this is the primary reason the Board withdrew its mortgage broker compensation agreement provision from the final HOEPA rule. Be that as it may, it is no basis for the following statement in the Board's comment on the RESPA rule:

Based on our experience, we believe it is highly unlikely that consumers will recognize the GFE disclosure of a "credit for the interest rate chosen" as broker compensation, or that they will be able to use the information appropriately.

HUD's testing of its GFE forms at <http://www.huduser.org/publications/hsgfin/goodfaith.html> which shows that HUD was able to develop, through a process sequential testing and improvement, a GFE form that consumers were indeed capable of using appropriately. The Board did not evaluate HUD's GFE form, or language derived from it, in their own consumer testing. HUD's primary goal in designing the GFE is not to disclose mortgage broker compensation, but to provide consumers with a disclosure that helps them understand the costs they will have to pay to get a mortgage loan, makes this estimate more reliable, helps consumers

understand the tradeoff between interest rates and settlement charges, and allows easy comparison among offers to encourage shopping for mortgage loans. The GFE discloses total fees received by originators involved in the transaction without the unneeded distraction of how this fee might be divided up between broker and lender. HUD's GFE also discloses the compensation the broker derives when the lender pays more for the loan than its face value (the YSP) in the context of total compensation for origination services. That is why the YSP is presented as a credit against the amount due for origination services from the borrower at settlement.

## **II.E. Shopping Benefits from the New Good Faith Estimate – A Summary**

Our consumer testing yielded several important results.

1. Participants are highly successful in identifying the cheapest loan with success rates as high as the 90+ percent range whether the broker loan is cheaper, the lender loan is cheaper, or the loans cost the same.
2. Broker bias is not evident. The success rate for participants identifying the cheapest loan offer is the same whether the broker loan or lender loan offer is cheaper and the drop-off rate from identifying the cheaper loan to deciding which one to choose is about the same for brokers as it is for lenders.
3. This success rate is maintained when the number of loan offers increases, thus showing that, to some extent, additional context eases the task of differentiating among the offers for consumers. Rather than being overwhelming, the additional loan offers help them to focus on the key information.
4. The bias that does show up in comparisons in which broker and lender loans are otherwise completely identical. In which case, borrowers that do not think of the two loans as identical tend to favor the lender loan. The likelihood of borrowers getting two otherwise identical loans is extremely low however.

The new GFE will improve the ability of the consumer to shop. The presentation is simpler, with a combined figure for each functional category, so that borrowers are less likely to be overwhelmed by detail. The additional graphic elements help to guide consumers to the bottom line rather than elements of the offer. Tolerances make the estimates on the GFEs more reliable, which will make it more likely that decisions based on this information will make the borrower better off. The trade-off table and language encouraging consumers to shop help consumers understand more clearly their options. These factors make it likely that consumers will obtain loans at lower cost. When borrowers do a better job shopping, are able to compare across offers knowledgeably and with confidence, and can select loans with more favorable terms, borrowers assume more control over their lives and their options. The final GFE helps to de-mystify the often confusing and overwhelming process of financing the purchase of a house. It empowers the consumer.

The final GFE front page disclosure of mortgage terms has explicit questions disclosing whether there are some important deviations from the simplest traditional mortgage terms (versus non-traditional mortgage terms). It asks if the interest can rise (an ARM); if the loan balance can rise (negative amortization); if the monthly amount owed for principal, interest, or mortgage insurance can rise (not level payments) and at which date; the maximum possible monthly payment; if there is a balloon payment (not fully amortizing); or if there is a prepayment penalty (additional fee to terminate the loan). The “No” answers are in the first column and the “Yes” answers in a second column so that any “Yes” answer sticks out. The “Yes” answers require the worst possible outcomes to be disclosed. All of this is designed to get the borrower’s attention in the event that any of these potentially detrimental loan features are present.

Section VII.B of this chapter below will provide a more extensive discussion of the consumer and market benefits of the new GFE, covering how the new GFE can be used in both the prime and sub prime markets. Section II.E provides estimates of cost savings to consumers from the new GFE.

## **II.F. Comparing new GFE with the new HUD-1**

One of the purposes of RESPA is to reduce unnecessarily high settlement costs. The final GFE promotes that goal in several ways. Through consolidation of loan and title fees, the presentation of GFE settlement cost figures is greatly simplified by eliminating fee proliferation that often serves little purpose and that can easily overwhelm the borrower. Comparison shopping by borrowers that promotes competition is made easier through standardization and clear presentation of fees on the GFE. The need to adhere to the tolerances means that there GFE cost estimates can be more reliable compared to today, providing the borrower with more incentive to comparison shop. Since the GFE figures will be more reliable, it is more likely that the borrower who shops will wind up getting the lower price they found by comparison shopping.

In order for the borrower to become an enforcer of the figures presented on the GFE from the loan source selected, the borrower has to be able to compare the figures on the HUD-1 to the figures on the GFE and determine that the HUD-1 figures are within the tolerances placed on the figures from the GFE. The rule includes two methods for helping the borrower compare the HUD-1 to the GFE. First, the rule changes the HUD-1 so there is a line on the HUD-1 for each figure appearing on page two of the GFE and that line is labeled exactly as it is on the GFE. The borrower can then compare the figures on the like-named lines of the HUD-1 to the corresponding lines on the GFE. Second, a new page is added to the HUD-1 where some figures from the GFE and some figures from the modified HUD-1 are transcribed so as to appear next to each other in order to make it easier for the borrower to compare the fees on the GFE to the fees charged on the HUD-1.

**(1) The Consolidated HUD-1.** In order to enhance comparability of the GFE to the HUD-1 HUD is modifying the HUD-1 so that, for each settlement cost item on the GFE, there is a line on the HUD-1 with exactly the same label as on the final GFE. These matching categories

on the HUD-1 also identify the location on the GFE where the corresponding entry is located. The borrower could simply hold the HUD-1 next to the GFE and compare the lines with the same labels.

Lines 801, 802, and 803 on the modified HUD-1 would be labeled “Our origination charge (from GFE #1),” “Your charge or credit for the specific interest chosen (from GFE #2),” and “Your Adjusted Origination Charges (from GFE A),” respectively. Only the “your adjusted origination charges” would be included in the borrower column, the seller column, or POC, in order to avoid double counting that would result if “our service charge” and “your charge or credit for the specific interest rate chosen” appeared there as well. The sum of the figures in the borrower’s and seller’s column and any POC amount for “your adjusted origination charges” would add up to the figure on the GFE. This summing of figures from these three locations will be necessary for every comparison back to the GFE.

Lines 804, 805, 806, and 807 would now read “Appraisal fee to (from GFE #3),” “Credit report to (from GFE #3),” “Tax service (from GFE #3),” and “Flood certification (from GFE #3),” respectively. Lines 901, 902, and 903 now read “Daily interest charges (from GFE #8),” “Mortgage insurance premium (from GFE #3 or #5),” and “Homeowner’s insurance (from GFE #9),” respectively. The borrower would simply compare these figures from the HUD-1 back to the GFE.

Line 1001 would read “Reserves or escrow (from GFE #9).” Only this line of the 1000 series will have figures in the borrower’s column, the seller’s column, or POC. The breakout into components, including the aggregate adjustment, can be listed on subsequent lines but not put into the borrower’s column, the seller’s column, or labeled as POC since that would lead to a double counting error.

Line 1101 would now read “Title services and required lenders title insurance (from GFE #4)” and “Owner’s title insurance (from GFE #5),” respectively. Just as with reserves or escrow, the title insurance and lender’s title insurance breakout into components can be listed on subsequent lines but not put into the borrower’s column, the seller’s column, or labeled as POC since, again, that would lead to a double counting error.

Line 1201 now reads “Government recording charges (from GFE #7)” and line 1203 now reads “Transfer Taxes (from GFE #8).” The breakout would follow the pattern above for the escrow and title sections. Lines 1301 now reads “Required services that you can shop for (from GFE #6)” with breakouts of the specific services following.

Any item mentioned above could be omitted from the HUD-1 if not charged and any other legitimate HUD-1 entry could be placed where it is currently placed. Clearly, sometimes there will be the need to enter items on the HUD-1 that were not included on the GFE such as repairs, payoffs, etc., and these still have a place on the HUD-1 where they can be located.

**(2) Comparing GFE and HUD-1 Charges on Page 3.** The new page 3 of the HUD-1 includes reprises the information on the loan from the GFE, with some additional details on adjustable interest rate loans and escrow payments, if any. Page 3 also includes a comparison of

charges estimated on the GFE to charges as they appear on the HUD-1 and a computation of the differential between the GFE and HUD-1 for charges subject to tolerances and the ratio of this differential to the tolerance baseline. This part of the HUD-1 will be referred to as the crosswalk table. The table contains 3 columns. The first column of the crosswalk table contains spaces for the names of the items from page 2 of the final GFE. The second column contains the quoted prices for those items from the GFE. Third column has corresponding spaces for figures from the HUD-1

The first group are the zero-tolerance items including “our origination charge”, “your credit or charge for the specific interest rate chosen”, “your adjusted origination charges”, and “Transfer taxes”. “Our origination charge” plus the charge or minus the credit for the specific interest rate chosen equals the adjusted origination charge. If the HUD-1 amount for any of these items exceeds the corresponding GFE amount, the zero tolerance requirements of the GFE have been violated.

As with any charge showing up on the HUD-1, the correct number to show on the crosswalk table is the sum of any dollar values appearing as “paid outside of closing” (POC), in the borrower’s column, and in the seller’s column since any charge could be paid any of these three ways or in any combination of the three. So, all three potential sources of these dollar values must be checked: POC, buyer, and seller: in order to catch the full size of the charge. This is true for all items coming from the HUD-1. When we refer to the “HUD-1 figure,” we will always be referring to the sum of these three numbers.

There is zero tolerance on this first set of items which means that the HUD-1 figure for our origination charge may not exceed the GFE figure for that same charge and that the HUD-1 figure for your adjusted origination charge may not exceed the GFE figure for that charge either. So long as these HUD-1 figures are less than or equal to their respective GFE figures, the tolerance has not been violated.

The second set of lines on the crosswalk table comes from sections three, four, five, six and seven on the GFE. These charges are subject to the overall 10 percent tolerance if either the provider is selected by the originator (three, and possibly four and five), or is selected by the borrower from a list of providers identified by the originator (six, and possibly four and five) Section seven of the GFE, government recording charges, is included in the 10 percent tolerance as well at the suggestion of public comments. If the service providers are selected by the buyer and *do not* come from the originator’s list of providers, the prices are not subject to the 10 percent tolerance, and are not added to the denominator in calculating the overall 10 percent tolerance. Services for which the 10 percent tolerance does not apply are listed in the next section of the crosswalk table, “Charges that can change,” which also includes sections nine, “Reserves or escrow”, ten, “Daily interest charges”, and eleven, “Homeowners insurance.”

There is no tolerance constraint on any of these figures.

The fees mentioned above from the HUD-1 should exhaust all of the required settlement service provider fees. If there are any other HUD-1 fees for loan origination, title work, or any

other settlement service required to get the loan, they should be closely examined to see if they should have been included in the first section of the crosswalk table and subject to the zero tolerance, or if they should have been included in the second section charges and subject to the 10 percent tolerance. Real estate commissions, charges for roof repairs or termite extermination, charges for homeowner's warranties, or escrowed amounts to satisfy some contingency are examples of figures that probably do not belong on the crosswalk table since these are not likely to be fees that should be included in the GFE and to which tolerances apply.

The changes that were made to the HUD-1 to enhance the ease of use and comprehension of the crosswalk table portion of page 3 are the re-labeling of some of the HUD-1 lines mentioned above so that there are lines that exactly match the individual entries from the final GFE that are entered on the crosswalk table.

**Comment.** Many comments were opposed to the proposed HUD-1 Addendum or "script." The purpose of requiring settlement agents to complete and read this form document was to have them describe, at settlement, the terms of the loan and to compare the settlement charges on the GFE to those on the HUD-1.

The primary objection to the script was the time costs. HUD estimated the worst case scenario of the added time required of a non-conscientious agent dealing with a very complicated loan product to be an additional 45 minutes. We assumed that the script would lead to an additional thirty minutes preparing the script, and an additional fifteen minutes to the actual closing procedure consisting of five minutes reading the script, and ten minutes answering questions. To be cautious, we applied this estimate to establish the outer bound of the opportunity cost of the closing script to the settlement firm at \$54 per settlement. The total cost of the script in a normal year (12.5 million originations) could be \$676 million. Settlement industry groups were concerned about the potential additional costs of preparing and reading the script.

A second objection is that the script could place a settlement agent in the position of committing the unauthorized practice of law. This would occur if they were required to answer questions concerning issues such as the loan terms for which they had no responsibility.

**Response.** At recent roundtables, representatives of the settlement industry have assured HUD that their primary goal is transparency and customer service. HUD assumed that without the script settlement agents would neither take any time to explain the HUD-1 to borrowers nor take any time to answer questions. Thus, HUD's cost estimate of the script may be exaggerated. In the world of the conscientious settlement agent, the additional burden of the script at closing would be closer to zero. However, because of the concern expressed concerning the implications of the potential cost and legal implications of the script, HUD will not require a script in its final rule.

To replace the script, HUD has added a page to the HUD-1 form. This will contain much of the same information but will be much easier to fill out and will not have to be read by the settlement agent. As described in detail above, the top half will contain a table that compares

settlement charges with those on the GFE and shows the amount and percentage by which the charges have changed (in order to check whether the change is within the tolerance). The bottom half of the page consists of a summary of the loan terms, very similar to the first page of the GFE.

### **III. Treatment of Premiums and Discounts**

As noted earlier, the Department considered changing the instructions for the reporting of loan premiums and discounts in brokered loans, but decided that the explicit credit or charge for yield spread premiums and discount points, respectively, better served borrowers' interests. The issue of yield spread premiums and discount points is a complex issue, particularly since there can be different treatment in broker and lender transactions. This issue is discussed in some detail in this section. Subsection A provides background information on yield spread premiums, noting that consumers do not always receive the benefits of yield spread premiums. Subsection C first summarizes these issues and then explains the treatment of yield spread premiums and discount points in the final GFE, emphasizing (a) the importance of both the explicit credit for yield spread premiums and charge for discount points, (b) the addition of the summary page that does not include yield spread premiums, and (c) the trade-off table to assist consumers in understanding these somewhat complex financial concepts.

#### **III.A. Background Discussion of Premiums and Discounts**

Both brokers and lenders may make loans at interest rates above or below par. If the rate is above par, the stream of monthly payments will be greater than otherwise. If the loan is sold, the market price for that loan will be higher than for a loan with a par rate. Buyers will offer a premium for the stream of higher monthly payments. Lenders have the option of keeping the loan in portfolio and earning the premium over time or selling the loan and getting the premium as a lump sum from the investor who will earn the higher payments for the life of the loan.<sup>28</sup> The yield-spread premium (YSP) is the premium value, or value above par, of the loan and is realized upon sale of the loan.<sup>29</sup> It is created, implicitly, upon creation of the above-par interest rate loan. Those originators who keep the loan in portfolio have an implicit YSP equal to the present value of the increase in monthly payments associated with the loan. It becomes recognizable in an accounting sense when the loan is sold.

Conversely, loans made at lower than par rates have lower monthly payments generating lower market prices for such loans. Buyers will buy these loans only at a discount. This discount (sometimes called discount points) is implicitly created at origination but realized in an

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<sup>28</sup> Some will hold the loan for a while and then sell it, getting a combination of the two.

<sup>29</sup> Discount points are the mirror image of yield-spread premiums. Loans originated at lower interest rates sell for less in the market. The value of the discount points is the amount by which the price of the loan is below par, as opposed to the yield spread premium, which is the amount by which the price of the loan is above par.

accounting sense upon sale of the loan (although it would be included in any market valuation of the loan).

Originators usually offer mortgages at various rates above and below par. Higher rate loans may lead to lower loan origination fees paid by the borrower, or even money back in some cases, as a result of yield spread premiums that are implicitly created upon origination and received either at the time of sale or over time so long as they are held in portfolio. Lower rate loans often generate charges to borrowers for discount points to offset the discounted market value of the loan.

Currently, HUD-defined brokers are required to report the dollar value of yield spread premiums on the GFE and HUD-1 as going from the wholesale lender<sup>30</sup> to the broker and paid outside of closing (POC). Other originators, HUD-defined lenders, do not report yield spread premiums since they are either realized in the secondary market and are exempt from reporting requirements or are realized over time after closing since the loan was not sold at closing. If the loan has not been sold by the time of the closing, there is no readily available indisputable value for the yield spread premium. The value is readily available at closing in a brokered transaction. In a transaction where the broker uses table funding, the premium price of the loan is available at closing. In the case of a broker who originates in the name of another, the wholesale lender's payment based on the premium value of the loan would be available as well. As noted above, the value is not available at closing for many transactions involving lenders.

There are no specific requirements for the reporting of discounts under current rules. For lenders, the sale, if any, is considered a secondary market transaction. Unlike the case of yield spread premiums, there is no explicit requirement in brokered transactions for the discount points charged to the borrower to equal the discount in the transaction between the broker and the wholesale lender. For example, the broker could charge the borrower two discount points while the price paid to the broker by the wholesale lender is in excess of 98 percent of the initial balance of the loan. The broker's direct charge to the borrower (i.e., the discount points) may exceed the charge from the wholesale lender to the broker as reflected in the price of the loan (i.e., par value of the loan minus the discounted price that the wholesale lender pays the broker for below-par interest-rate loan).

Thus all originators have the potential to increase their compensation by generating yield spread premiums that exceed the reduction in other fees charged to the borrower or by charging the borrower more in discount points than is warranted by the wholesale value of the loan. That is, the originator can profit by failing to reduce other charges by the full amount of a yield-spread premium or by overcharging for discount points. This is the problem that much of the public discussion on broker compensation has focused on, particularly the discussion of the yield-spread premium. Issues related to discount points, on the other hand, have not received much attention.

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<sup>30</sup> The term "wholesale lender" will be used to describe the lender in a brokered loan.

Chapter 2 reviews studies that present evidence of the substantial variability in origination fees and broker compensation. These studies present a picture of a market characterized by excessive fees and price dispersion with some borrowers getting market-rate deals but others getting bad deals. Readers are referred to Section IV.D of Chapter 2 for a review of these studies. The discussion in Chapter 2 highlights the importance of encouraging consumers to shop among more than one originator, of having shopping forms (i.e., GFEs) that are simple to understand and that focus on the important bottom-line numbers, and of developing improved methods for explaining the trade-off between interest rates and upfront cash payments.

### **III.B. The 2002 Proposed Rule**

The 2002 proposed rule would have fundamentally changed the way in which mortgage broker compensation was reported by requiring in all loans originated by mortgage brokers, any payments from a wholesale lender based on an above par interest rate on the loan (payments generally called “yield spread premiums” in today’s market) be reported on the Good Faith Estimate (and the HUD-1 Settlement Statement) as a lender payment to the borrower. Additionally, that any borrower payments to reduce interest rate (“discount points”) must equal the discount in the price of the loan paid by the wholesale lender, and be so reported on the GFE (and HUD-1). These changes would have required mortgage brokers to disclose, at the outset, the maximum amount of compensation they could receive from a transaction, in the “origination services” block of the proposed GFE. They would have then disclosed the amount of the lender payment to the borrower that would be received at the interest rate quoted, if any. Under the 2002 proposed rule, any premium in the price of a brokered loan would have gone back to the borrower in the form of an explicit credit to cover closing costs. Under HUD’s proposed GFE and HUD-1 process, the broker was seen as not being a party to this payment from the wholesale lender to the borrower. The intention of HUD’s rule was to bring more focus on the yield spread premium, which was a far cry from the current system that reports yield spread premiums outside the buyer’s and seller’s columns in cryptic terms like “Yield Spread Premium POC”<sup>31</sup> that are likely to be meaningless to the average borrower and do not require a dollar for dollar offset to closing costs.

**The 2002 proposed rule’s Treatment of YSPs.** As noted above, the 2002 proposed rule changed the way yield spread premiums were treated, requiring brokers to report YSPs as lender payments to the borrower and report them in the "200" series on the HUD-1. This resulted in brokers having to report as fees for origination services the sum of the net originator charges to the borrower and the yield spread premium. Lenders were free to omit the yield-spread premium or its equivalent with the result that for an otherwise identical loan, brokers would report a higher figure for origination services than would lenders. Brokers commented that this would put them at an unfair disadvantage as compared to lenders.

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<sup>31</sup> “POC” is Paid Outside Closing.

Lenders earn the equivalent of yield spread premiums when they originate loans with the same interest rates as brokers. Lenders either sell the loans and receive premium prices or they keep the loans in portfolio and collect a stream of higher monthly payments which has a higher present value represented by the yield spread premium. So both kinds of originators face the same reward structure derived from interest rates. Brokers argued that the differential disclosure requiring them to report higher origination fees than lenders report is unfair (in other words, results in an “un-level playing field”).

**Examples.** An example can illustrate how the requirement in the 2002 proposed rule for the wholesale lender in a brokered loan to pass through premium prices and discount points directly to the borrower might adversely affect the competitive position of brokers as compared to lenders. While lenders could continue to simply reduce explicit fees in the presence of premium rate loans, brokers could not.<sup>32</sup> Suppose a broker and a lender are offering the same terms on a loan, and both have the same origination services fee, \$3,000 and the same other settlement costs, \$4,000. Assume that the interest rate on each loan is the same, is higher than par, and that the premium value of the loan is the same for both originators, \$2,000. On today’s GFE, both originators could simply quote \$1,000 for originator fees and keep the yield spread premium of \$2,000. Today, the broker would have to report the yield spread premium as \$2,000 and paid outside of closing while the lender would report nothing. Both would report the other settlement costs of \$4,000 and the total due from the borrower would be \$5,000.

In the 2002 proposed rule (as well as with the 2008 proposed GFE), lenders could report origination fees of \$1,000 and show it on line 1 (see Table 3-1). The lender does not have to show any credit, so \$0 can be put on line 2. The subtotal on line A would also be \$1,000. Other settlement costs (line B) would be \$4,000 and the settlement cost total (A + B) would be \$5,000. On a brokered loan, the 2002 proposed rule required that the interest rate dependent payment (\$2,000) be shown as a \$2,000 lender payment to the borrower and then shown as minus (-) \$2,000, since it goes to the borrower instead of being a payment by the borrower (see line 2 of Table 3-2). In order for the broker to get \$3,000, the origination fee would have to show \$3,000. The net loan origination charge would be \$1,000, the other settlement cost would be \$4,000, and the settlement cost total would be \$5,000.

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<sup>32</sup> Sales of loans by lenders are considered “secondary market transactions” which are exempt from RESPA scrutiny by HUD regulation. Even if they were not exempt, the premiums are often not available at closing. For example, the loan may never be sold, the loan may be sold after closing with the price unknown at closing, or only part of the loan gets sold.

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**Table 3-1**

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**SETTLEMENT COSTS**

1. ORIGINATION FEES	<u>\$1,000</u>	
2. INTEREST RATE DEPENDENT PAYMENT	<u>0</u>	
A. NET LOAN ORIGINATION CHARGE		<u>\$1,000</u>
B. (OTHER SETTLEMENT COSTS)	<u>\$4,000</u>	
A + B. TOTAL SETTLEMENT COSTS		<u>\$5,000</u>

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**Table 3-2**

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**SETTLEMENT COSTS**

1. ORIGINATION FEES	<u>\$3,000</u>	
2. INTEREST RATE DEPENDENT PAYMENT	<u>-2,000</u>	
A. NET LOAN ORIGINATION CHARGE		<u>\$1,000</u>
B. (OTHER SETTLEMENT COSTS)	<u>\$4,000</u>	
A + B. TOTAL SETTLEMENT COSTS		<u>\$5,000</u>

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To see the originator segment of the cost of this loan, a knowledgeable shopper would ignore 1 and 2 and go to the "NET LOAN ORIGINATION CHARGE" in Tables 3-1 and 3-2 (or simply go to the "TOTAL SETTLEMENT COSTS" to determine the overall cost of the loan). The "NET LOAN ORIGINATION CHARGE" would be the same for the lender and the broker, \$1,000. In this case, the "TOTAL SETTLEMENT COSTS" are the same, \$5,000. The knowledgeable shopper would conclude that these two loans cost the same and the borrower would be indifferent between the two loan offers. In these cases, there would be no adverse impact on the broker relative to the lender.

However, a potential problem arises if a shopper is not knowledgeable. A lender trying to convince a borrower to take his loan instead of the broker's might try to focus the borrower's attention on the reported origination fee the two charge: \$3,000 for the broker (Table 3-2) and \$1,000 for the lender (Table 3-1). The lender would try to keep the borrower's focus away from the numbers that show the same total cost (i.e., the "NET LOAN ORIGINATION CHARGE") and constantly emphasize the \$2,000 additional fee charged by the broker. In the case of borrowers who cannot see through this erroneous argument, the lender will appear cheaper than the broker and is more likely to get the borrower's business. In fact, borrowers whose attention is focused on the origination fee might be persuaded that a loan from a lender (see Table 3-3) with higher total cost than from a broker (Table 3-2) is better for them based on their comparison of the origination fees alone. While HUD had attempted to design the proposed GFE in the 2002 proposed rule to reduce any anti-competitive effects between brokers and lenders, the proposed form did treat them differently, and the potential existed for anti-competitive effects against brokers.

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Table 3-3

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**SETTLEMENT COSTS**

1. ORIGINATION FEES	<u>\$1,500</u>	
2. INTEREST RATE DEPENDENT PAYMENT	<u>0</u>	
A. NET LOAN ORIGINATION CHARGE	<u>\$1,500</u>	
B. (OTHER SETTLEMENT COSTS)	<u>\$4,000</u>	
A + B. TOTAL SETTLEMENT COSTS		<u>\$5,500</u>

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The potential source of bias with the proposed form was that the first number a borrower would see would differ for the same loan with a YSP offered by a broker and a lender. The first fee on the broker's form would be higher and, if the borrower failed to focus on the net loan origination charge, this could work to the competitive disadvantage of the broker.

**III.C. Summary of YSP Issue and Treatment in the Final rule**

As explained above, the problem and potential source of the anti-competitive effect is that some borrowers may not know how to comparison-shop. The numbers presented to them when applying for a loan may confuse them. They might not know that the first two numbers presented to them on the 2002 proposed form, origination fees and the interest rate dependent payment, are irrelevant to comparison shopping. They might see the higher figure for origination fees from a brokered loan and falsely conclude that such a loan is more costly than an equivalent loan from a lender. In addition to any confusion the borrower might fall into all on his or her own, a lender trying to convince a borrower to take his loan over a broker's might well draw the borrower's attention to the "high" origination fee of the broker as compared to the "low" origination fee of the lender and try to use this to convince the borrower that the broker's loan costs more.

Less sophisticated borrowers are susceptible to making these mistakes all on their own or being drawn into them by lenders seeking a competitive advantage. Borrowers would be harmed by these mistakes if they selected a more costly loan as a result. So brokers and borrowers could be harmed by such outcomes. It is also true, however, that every broker will know about the potential for the borrower to misinterpret the fees disclosed under the different requirements. As a result, every broker will have a powerful incentive to effectively explain the correct interpretation so that loans are not misevaluated. This ought to serve as a powerful counterbalance to potential bias.

In commenting on the 2002 proposed rule, brokers argued to eliminate the bias created by the proposed presentation of yield spread premiums in the 2002 GFE. They favored eliminating the fee for origination services and the interest rate dependent payment at the top of the disclosure listing the fees. Thus, all loans would be presented in the same terms regardless of whether originated by a broker or a lender. Comparison-shopping errors would be eliminated by the elimination of the numbers that led to these errors. Brokers and lenders would then compete

on accurate and relevant measures of cost to the borrower, the potential for borrowers to get tangled up in irrelevant numbers would be reduced, and comparison shopping should work better leading to a more competitive market for mortgages.

**Treatment of Premiums and Points in the Final GFE.** The treatment of yield spread premiums and discount points remain the same in the final rule as they were in the 2002 proposed rule (although additional changes were made to the form to reduce any anti-competitive impacts on brokers, including placing the disclosure to the second page of the GFE). The Department believes that the disclosure of yield spread premiums as offsetting other closing costs within the disclosure of the array of fees rather than as a separate disclosure elsewhere on the form is the best method for making the borrower aware of the existence of yield spread premiums and the tradeoff between interest rate and upfront cost of a mortgage loan. In addition, using it as an offset makes it more likely that yield spread premiums will be used to reduce settlement costs rather than increase broker compensation – in other words, using it as an offset seeks to change the behavior in today’s market where statistical studies indicate that yield spread premiums are too often used to increase broker compensation rather than to reduce consumer settlement costs.

In response to the concern that this treatment may lead to consumer errors that impede comparison shopping and that disadvantage brokers, the Department has taken several steps to reduce the likelihood that borrowers will make systematic errors in evaluating loan offers from brokers. The Kleimann Communication Group, experts in form development, was hired to improve the form. They worked on the wording and layout with the goal of improving borrower comprehension of the cost of the loan. Several improvements relate to the chance of misinterpretation of the yield spread premium and total loan cost.

First, the second entry on page 2 of the GFE is now called “Your credit or charge (points) for the specific interest rate chosen.” The yield spread premium is now identified with the following statement: “You receive a credit of \$\_\_\_\_\_ for this interest rate of \_\_\_\_%. This credit reduces your settlement charges.” An interest rate-related charge is identified with: “You pay a charge of \$\_\_\_\_\_ for this interest rate of \_\_\_\_%. This payment (discount points) increases your settlement charges.” These replace “(-) Lender Payment to the Borrower for Higher Interest Rate” and “(+) Borrower Payment to Lender for Lower Interest Rate” that were on the 2002 proposed form. The new description explicitly states what happens to the bottom line cost as the borrower chooses a higher or lower interest rate. In consumer testing, comprehension showed measurable improvement as a result.

Second, an additional option has been added to “Your credit or charge (points) for the specific interest rate chosen.” The new option reads: “The credit or charge for the interest rate you have chosen is included in ‘Our origination charge.’ (See item 1 above).” This was added so that borrowers would not have questions about what was going on when some originators’ GFEs would have an entry and others would not. Lenders who choose not to report a figure as a credit or charge must check this option in “Your credit or charge (points) for the specific interest rate chosen.”

Third, a summary page has been added, moving the detailed list of costs to the second page. The summary page contains loan features as well as total settlement . Borrowers wanting to comparison shop could do so with this first page only in front of them. Loan terms, interest rate, monthly payment, and up-front charges are all there. The comparison shopper has all he or she needs to compare loans on this front page. No one could possibly be confused by the yield spread premium on the summary page because it is not there. Lenders and brokers are treated identically.

Fourth, the table showing the trade-off between interest rate chosen and up-front cost has been improved. This is important because evidence suggests that consumers do not always understand the financial trade-off between higher (lower) interest rates and lower (higher) settlement charges. The explanations in this table are more closely tied in to the effect of the charge or credit for the specific interest rate chosen, the yield spread premium or discount points, on the whole transaction. The table now contains language indicating how the interest rate affects the bottom line: “Your lower interest rate will raise your settlement costs by \$\_\_” and “Your higher interest rate will lower your settlement costs by \$\_\_.” It is now easier for the borrower to realize that this table is tied into the concept underlying the figure in “your charge or credit for the specific interest rate chosen.”

The table explaining the trade-off between the interest rate (and monthly payment) and settlement charges is on page 3 after the section describing tolerances. This table shows the loan amount, interest rate, monthly payment, and total settlement charges for the loan selected by the borrower for which this GFE is filled out. Then it shows the loan amount, interest rate, monthly payment, and total settlement charges for two actual alternative loans that were available to the borrower but not chosen, one at a higher rate and one at a lower rate. It also shows the change in the monthly payments and change in the total estimated settlement charges relative to the loan chosen.

This shows the borrower several things. First, there are multiple mortgage interest rates available in the market, not just one. Second, there is a trade-off between the interest rate chosen and upfront charge to get a loan. Third, the borrower can see an example of what trade-offs are available in the market so that the borrower can decide whether it is in his or her best interest to finance some of the closing costs with a higher interest rate or, instead, to pay more upfront for a lower monthly payment. Of course, since this table will be on the form anyway, the originator is likely to show the borrower information like this before writing up the GFE so that the borrower gets the loan he wants written up the first time. While it is likely that a more conscientious originator would have explained these options anyway, this table makes it more likely that the other originators will do so now since the failure to do so might result in a bunch of questions on the topic, and a change in the loan requested, and the need to write-up a new GFE. Finally, the new language used in this section referring to the effect of the interest rate chosen on settlement costs complements the language used to describe the yield spread premium and discount points, which should improve the borrower’s comprehension of the trade-off between interest rate and

up-front fees and its relationship to yield spread premiums.<sup>33</sup> Improving the borrower's comprehension of this relationship is one of his primary objectives of the final rule.

Fifth, a “Mortgage Shopping Chart” has been added on the bottom of page 3 of the GFE. It has spaces for the loan originator’s name, the loan amount, interest rate, term of the loan, monthly payment, other characteristics of the loan, and total estimated settlement charges. Borrowers can fill in the information for various loan offers and use the chart to help in evaluating and comparing them. It is designed to help borrowers comparison shop.

Sixth, arrows have been added to the subtotals on page two, “Your Adjusted Origination Charges” and “Your Charges for All Other Settlement Services,” as well as to the “Total Estimated Settlement Charges” at the bottom of page two, and the bottom of the “Mortgage Shopping Chart.” This done to focus the borrower’s attention on the net or overall charges rather than any one component that might be meaningless considered by itself.

The above-mentioned six changes along with the professional layout of the form will lead to good borrower comprehension of the information and minimize any potential adverse impact of disclosing yield spread premiums on borrowers who are comparing loans from brokers and lenders. Tests of the new GFE form indicate that consumers make the right decisions when comparing the costs of a broker’s loan with the costs of a lender’s loan. As explained in Section II.D.1, consumers in these tests correctly chose the cheapest loan over 90% of the time.

#### **IV. Permissibility of Average Cost Pricing and Negotiated Discounts**

**Average Cost Pricing.** The final rule clarifies that pricing based on average charges is not a violation of RESPA. The Department is seeking to make unambiguously clear that some pricing arrangements that will benefit consumers will now be allowed, but not those that might lead to uncontrolled kickback and referral payments. The Department will permit loan originators and third-party settlement service providers to adopt average cost pricing for services they buy, or make arrangements for, provided they use a documented averaging technique, charge the borrower no more than this average, and that the aggregate amount charged for the service does not exceed the aggregate amount actually paid to third parties for the service over the time the average charge was used.

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<sup>33</sup> The borrower’s awareness of the trade-off is likely to be enhanced under the new rule if the borrower applies for a loan with even one broker. The new GFE’s treatment of YSPs is much more likely to get the attention of the borrower than a “YSP POC” item placed off to the side outside the number columns in the “800” series. This increased awareness of YSPs should lead the curious to find out where it comes from, if they do not already know, by bringing up the issue with the broker (or lender) and to find out how it is being used in their case (e.g., to offset closing costs). Once this understanding is acquired, the borrower should be able to interpret the figures disclosed and effectively comparison shop among brokers and lenders that offer a variety of trade-offs between settlement costs and yield spread premiums.

The final rule includes these provisions because HUD's current regulations implementing RESPA have sometimes been cited as obstacles to consumer-friendly business practices. Discussions at the RESPA Reform Roundtables during 2005 and additional comments from both industry representatives and consumer advocates have suggested the need for a more level playing field in the settlement process. In light of these suggestions, HUD has determined that, in its implementation of RESPA, there should be greater flexibility for pricing mechanisms that bring more innovation and increased price competition to the settlement process without violating the statutory requirements of RESPA.

Currently, with transaction specific price requirements, all individual prices must be precisely tracked and assigned properly to each borrower. If there are any changes, these must be noted and changed for all the records that will be the source of the HUD-1 entries. Inadvertent tolerance violations might occur if the increase in prices is large enough.

Average cost pricing also has the advantage of eliminating the need to precisely follow each exact price for every service. GFEs can be filled out with the average as permitted by the Department. HUD-1s can be filled out in the same way. Borrowers get charged no more than what they were told at the GFE stage. Providers collect what they expected to get. On average, this would be acceptable to the party charging the average. Sometimes the individual price is higher, sometimes lower, but it averages out in the end. If that were unacceptable to the loan originator, for example, they would not utilize average cost pricing.

Another consequence of average cost pricing is a reduction in internal administrative costs that results from the elimination of the need to follow who does what and for what price for every third-party service associated with the loan. The end result is that the cost of filling out a GFE is reduced, internal costs are reduced, and the cost of generating HUD-1 figures is reduced. So there are savings in compliance costs and internal costs. Competition will create pressure for these savings to be passed on to borrowers.

Lender comments to the proposed rule of 2002 and discussions during the RESPA Reform roundtables in 2005 continued to cite a need for a complete exemption from Section 8 before lenders could seek discounts, including volume-based discounts, and to utilize average cost pricing. In advance of that proposal, HUD had determined that in order to fully develop the potential to reduce closing costs, loan originators would need to be able to seek discounts and to utilize average cost pricing. The final rule relies on adapting the GFE requirements to broaden the mortgage lending and settlement services marketplace, without a need for specific packaging proscriptions and requirements or a section 8 exemption.

HUD believes that no such exemption is necessary in order to permit discounting and average cost pricing. Rather, HUD has determined that RESPA provides enough flexibility to permit a variety of approaches to fee calculations average cost pricing, so long as they do not unnecessarily increase fees charged to the consumer. During the 2005 RESPA Roundtables, some loan originators and third-party settlement service providers also took the position that neither a full Section 8 exemption nor formal authority for packaging is needed. These providers believed that the development of average-cost pricing could promote lower prices. This final

rule would obtain the benefits of average cost pricing in the GFE context without the need for a Section 8 exemption.

**Discounts.** The 2008 proposed rule encouraged volume discount arrangements, which would lead to more competitive third-party prices, by clarifying that volume discounts are legal as long as the cost reduction is passed along to consumers. In the final rule, HUD has decided not to implement the proposed changes at this time.

## V. Tolerances on Settlement Costs

A fourth feature of the changes to the GFE is to more strictly interpret the term “good faith.” Currently, there is no objective accuracy standard to which originators are held when filling out the numbers on the GFE. The final rule contains zero tolerance for error in some categories, a 10 percent tolerance standard for some others, and no required tolerance standard (no change from today’s rules) for the rest. This would reduce or eliminate surprise fees at the settlement table. Subsection V.A describes the tolerances and subsection V.B and V.C discusses the rationale and impacts of tolerances. Subsections C and D discuss several issues raised in the comments concerning the market implementation of tolerances – and HUD’s response to those issues.

### V.A. Zero and 10 Percent Tolerances<sup>34</sup>

**Zero tolerance** would apply to the charges that the originator should know: his own origination charge, as indicated by “Our origination charge” in item #1 on page 2 of the new GFE and transfer taxes.<sup>35</sup> After the borrower locks the interest rate, the credit or charge (points) for the specific interest rate chosen is also subject to zero tolerance as is, by arithmetic, the adjusted origination charge. The rationale for zero tolerance is that any originator should know its own fee, as well as applicable transfer taxes. As will be discussed below, there were some issues raised (a) about the lender's ability to determine its charge within the three-day period allowed before GFE issuance and (b) about the need for adjustments in costs when there were legitimate but unforeseeable events that lead to extra work and costs. These issues are discussed in subsections C and D below.

An overall **10 percent tolerance**, with protection coming from the originator, would apply to the charges for all of the required third-party services except those where the borrower

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<sup>34</sup>The zero and 10 percent tolerances discussed in this section would be in effect “absent changed circumstances” beyond the originator’s control such as acts of God, war, disaster, or any other emergency, marking it impossible or impractical to perform, or new or different information about the borrower or transaction from that used to generate the GFE. A list of examples is provided in the proposed rule (e.g., flood insurance, a second appraisal, and extra title work to clear up a problem).

<sup>35</sup> There is also zero tolerance on points in item #2, once the borrower locks in his or her interest rate.

selected a provider that was not identified by the originator.<sup>36</sup> In other words, the 10 percent protection for the borrower would apply for the services where the provider was selected by the originator and for the services where the borrower asked for and utilized originator-identified providers for the title services and title insurance and the borrower-selected third-party services.<sup>37</sup> The 10 percent tolerance is an overall tolerance rather than a set of individual tolerances. All of the items on the GFE with the 10 percent tolerance protection would be summed and compared to the sum of those entries on the HUD-1. If the sum of the HUD-1 entries is greater than the sum of the GFE entries, the borrower would have to cover the first 10 percent of the excess. The rest of the excess would have to be covered by the loan originator. The originator could have arrangements set up for settlement services to be provided for its customers at a predetermined price, protecting the originator from prices beyond the tolerance. The originator could also have lined up a settlement service subpackage (which are increasingly appearing on the market) provided by a third-party settlement provider. Or the originator could survey the market and make referrals without any arrangements with settlement service providers, but the originator would have to hope that no settlement service provider to whom it makes referrals suddenly raises prices to take advantage of the tolerances. HUD's reasoning behind changing the tolerance for lender-selected services from zero percent in the 2002 proposed rule to being included in the overall 10 percent tolerance is discussed in subsections C and D below.

There would be **no tolerance** protection on homeowner's insurance, per diem interest, escrow reserves, or optional borrower's title insurance. Homeowners often choose greater hazard insurance coverage that costs more than the minimum required by lenders, so tolerances would be inappropriate. Per Diem interest depends on the closing date, which is not always easily predictable. Any excess in the escrow account will be returned when the first annual escrow analysis is performed. Borrower's title charges are simply a matter of consumer choice. Originators do not receive any of these charges except the per diem interest and that charge is the result of the interest rate on the note and the day of the billing cycle on which the loan settles.

## **V.B. Tolerances: More Detailed Analysis**

The final rule maintains the zero tolerance on the originator's charge (called "Our origination charge" on item #1 of page 2 of the GFE). As explained in Section V.B below, the Department believes that three days is long enough for the originator to determine his own price for the product he chooses to offer to the borrower. Arguments to the effect that three days is insufficient for the originator to determine his prices for the products he sells were not persuasive. Once the borrower locks in the interest rate, there is also zero tolerance on discount points or the yield spread premium (item #2). Since any premium or discount cannot be known

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<sup>36</sup> Upfront private mortgage insurance premium is included in the overall 10 percent tolerance as are government recording fees.

<sup>37</sup> The 10 percent tolerance also applies for any required services where the originator does not select the vendor and identifies no providers for the borrower,

until the borrower locks the interest rate, the composite figure called “Your Adjusted Origination Charges” (item A, which combines items #1 and #2) cannot also be known until the lock takes place. Thus, the zero tolerance for this figure must await the lock.

Zero tolerance also applies to transaction taxes. These are dependent on the location of the mortgaged property and are easily determined from the details of the transaction. If something causes the amount to change, like a difference in house price that significantly changes a transfer tax amount, a new GFE is to be issued. Government recording charges are in the 10 percent tolerance category in the final rule based on public comments that these amounts are usually a very small part of the transaction, and may not be known until an actual page count of recorded documents is established just before closing.

Allowing transfer taxes to be included in the 10 percent tolerance, or allowing them to be outside the tolerances, provides an incentive for originators to provide inaccurate GFEs. For example, if transfer taxes were not subject to tolerances, originators would have an incentive to underestimate them to make their loans look cheaper to shoppers. Similarly, if transfer taxes were subject to the 10 percent tolerance, they would inflate the denominator over which the 10 percent is computed meaning there is more room available for prices of settlement service to increase at settlement. In this case, there may be an incentive to overestimate transfer taxes. The zero tolerance on the daily per diem interest has been eliminated and no tolerance applies. Total per diem interest is the product of the number of days from the closing until the first day of the regular mortgage cycle times the daily per diem rate. The total cannot be guaranteed since the closing date is never certain. Thus, the total fee cannot be guaranteed. This diminishes the value of guaranteeing a component, especially since the guarantee does not come into existence until the borrower locks the interest rate and establishes a firm closing date.

Some third-party services that are required by the lender are chosen by the borrower rather than by the lender. In the final rule, there is still no tolerance protection that applies where the borrower chooses vendors not identified by the originator. In the case where the borrower asks for a referral and uses a provider to whom he or she was referred, the overall 10 percent tolerance (lender selected and lender referred) applies in the final rule. If the originator does not identify providers of any required service that the borrower must shop for, the 10 percent tolerance still applies to the originator’s estimates for those services on the GFE. As explained in Section V.A, this tolerance was not set at zero for several reasons. First, it might not be known at the time of application exactly what services are needed to close the loan. With title services, for example, it could range from the preparation of powers of attorney to clearing up a complicated title issue. The overall 10 percent tolerance is only a partial solution. If lender-selected and lender-referred third-party services come to \$1600, the tolerance would cover problems costing up to \$160. Problems that require more than the overall 10 percent to remedy need some kind of an exception, which is explained in Section V.E below.

The escrow account deposit is not subject to tolerances. This is because originators have little incentive to put too much in the escrow account. They cannot pocket the excess as profit as they would in the case of an origination fee. And any higher balance in the escrow account would be returned to the borrower when the first annual escrow analysis is performed at the end

of the first year of the loan. There seems to be little danger to the borrower from eliminating this tolerance.

Homeowner's insurance remains the same with no tolerance applying, since the homeowner decides on the level of coverage and, therefore, the price.

## **V.C. Impact of Tolerances**

The tolerances will lead to well-informed market professionals either arranging for the purchase of the settlement services or at least establishing a benchmark that borrowers can use to start their own search. Under either set of circumstances, this should lead to lower prices for borrowers than if the borrowers shopped on their own (or if the borrower simply relied on a referral) since the typical borrower's knowledge of the settlement service market is limited, at best. In addition to lower prices, the prices quoted are likely to be more reliable, without surprises at settlement, since the originator could retaliate by cutting off the settlement service provider who comes to the closing table with too many surprises. The result will be lower prices for the other settlement services. This is a transfer from other settlement service providers. The recipient is either the borrower or the lender. To the extent that the market for loans is more competitive, competition for borrowers will tend to force these savings to be passed on to borrowers. To the extent that these markets are less competitive, there will be less pressure for these benefits to be passed on. So the recipients of these transfers will be either borrowers or originators depending on the degree of competition in the mortgage market. Evidence reviewed in Chapter 2 indicates that the mortgage market can be quite competitive when consumers are well informed, which suggests that borrowers will be the main recipients of these transfers.

Tolerances should also lead to a reduction in unexpected fees at closing. Where tolerances apply, the originator may be liable under State breach of contract law for whatever charge is in excess of the tolerance. The originator's service charge, with zero tolerance, should have no surprises. Lender required and selected third parties should have few surprises. Lender-required but borrower-selected third parties should have few surprises if the borrower asks the originator where to go so that the tolerance protection applies. Originators can retaliate against any third parties who do not charge the expected prices. At the least, the offenders can be cut off from future business. The tolerances will not protect the borrower from unexpected fees in the event that the borrower buys his or her own third-party services without the referral.

As the above discussion emphasizes, tolerances are aimed at controlling third-party fees as well as origination fees. It is anticipated that originators will seek to protect themselves from tolerance violations. When asked for a referral, the originator could simply refer the borrower to a third-party firm with whom the originator has a prearranged price for the borrower. This reduces the originator's tolerance risk for the included services. Subsections D and E will pull together various issues related to tolerances, origination costs, and third-party costs. Section IV above has already discussed the permissibility of discounts, a feature of the final rule that relates to the tolerances.

## **V.D. Tolerances: Comments and Further Discussion**

**Comments on the 2008 Proposed Rule.** Many commenters expressed various degrees of support for the concept of tolerances. A trade group, representing mortgage brokers as well as some large lenders expressed support for the concept of tolerances, albeit with certain clarifications or modifications. However, the strongest support for tolerances came from federal banking regulators and from groups representing consumer interests. These commenters agreed that unexpected increases in costs between those provided in the GFE and those actually charged at settlement are a significant problem for prospective borrowers, and that the tolerances proposed by HUD would be an effective way of preventing such surprises. These commenters made various suggestions for strengthening the tolerance provisions to provide additional protections for borrowers. Suggestions included calculating the tolerances item-by-item rather than by grouping certain items together and strengthening enforcement.

Most lenders, trade groups representing lenders, and trade groups representing other settlement service providers were generally opposed to the proposed tolerance provisions. These commenters stated that tolerances and particularly the zero tolerance for loan originator charges are equivalent to a settlement cost guarantee, and therefore conflict with the explicit statutory requirement for an estimate of settlement charges. Several comments reviewed the legislative history of section 5 of RESPA, emphasizing that the statute was designed “to provide the prospective homebuyer with general information as to what their costs will be at the time of settlement.” H.R. Rep. No. 667, 94th Cong., 1st Sess., at 2, 1975 U.S.C.C.A.N. 2448, 2449 (Nov. 14, 1975) (emphasis added). These commenters also stated that tolerances may be inconsistent with the statutory provision permitting disclosure of a range of charges for settlement services.

Trade groups representing other settlement service providers, especially realtors and title companies, focused on the potential anticompetitive effects of the tolerance provisions. These groups suggested that large lenders would seek to manage the risks associated with tolerances by contracting with large third party settlement service providers, and thereby placing small settlement service providers at a competitive disadvantage.

In addition to their general objections to the tolerance provisions, lenders and trade groups representing lenders and other settlement service providers strongly supported removing government recording and transfer charges from the tolerances. They stated that these charges are outside of the control of the loan originator and cannot be known with any certainty at the time the GFE is provided.

Several lenders and trade groups representing lenders suggested alternatives to the proposed tolerance provisions. For example, certain trade groups representing lenders recommended that tolerances not apply to the initial GFE, which would be used as a shopping tool, but tolerances would apply only to a “final” GFE that would be provided after a full mortgage application had been completed. These trade groups also supported more flexibility in the tolerance for the loan originator’s own charges, suggesting a five percent tolerance rather than a “zero tolerance.” Another alternative suggested by at least one lender was to evaluate

overall compliance with tolerances rather than compliance on a loan-by-loan basis. This suggestion, according to the commenter, would alleviate many of the difficulties in anticipating unusual aspects of individual loans but still hold lenders accountable for providing GFEs that, as a rule, accurately reflect charges at settlement. Another suggestion offered was to make providing a list of third party settlement service providers to prospective borrowers optional, with tolerances only applying where the loan originator selected the service provider or where the loan originator provided a list of service providers.

Based on the comments received in response to the proposed rule, HUD has revised a number of provisions dealing with the tolerances, and in particular has clarified the situations where the loan originator would no longer be bound by the tolerances. However, HUD has determined that only limited changes are necessary in the tolerance provisions themselves. Through all of these provisions, the final rule seeks to balance the borrower's interest in receiving an accurate GFE early in the application process to enable the borrower to shop effectively, with the lender's interest in maintaining flexibility to address the many issues that can arise in a complex process such as loan origination.

Many commenters recommended changes to the size of the tolerances for different categories of settlement costs, especially the zero tolerance for loan originator charges. With one exception described below, the final rule does not change the amounts of the tolerances permitted for the different categories of settlement costs. As noted in the proposed rule, HUD considered the best available data on the variation in the costs of settlement services, in particular title services, in determining that a 10 percent tolerance is reasonable. No commenters submitted or identified any alternative data sources that would support expanding the tolerances beyond 10 percent.

With respect to the zero tolerance for a loan originator's own charges, HUD recognizes the comments characterizing the tolerance as a settlement cost guarantee. However, the final rule provides substantial flexibility to loan originators in providing a revised GFE when circumstances, unforeseeable or otherwise, necessitate changes. By providing such flexibility, HUD intends to prevent only those increases in the loan originator's charges that are made in "bad faith." Section 19(a) provides explicit authority for the Secretary to make such interpretations as may be necessary to achieve the purposes of RESPA. Providing a clear, objective standard for what constitutes "good faith" under section 5 of RESPA is necessary to provide more effective advance disclosure to home buyers and sellers of settlement costs, and as such, falls directly within the Secretary's interpretive authority under section 19(a). In the context of residential mortgage negotiations, HUD finds that the term "good faith" requires that, once a loan provider has quoted in writing a certain price as the cost of its own services in a specific transaction and absent the relevant exceptions mentioned elsewhere in the rule, the provider must adhere to the quoted price.

The one exception to the amounts of the tolerances remaining the same as in the proposed rule is the tolerance for the government recording and transfer charges. HUD has adjusted how these charges are treated under the tolerances, based on the numerous comments received on this

issue. The final rule splits the government recording and transfer charges into two categories: government recording charges, and transfer taxes.

Transfer taxes should generally be known at the time the GFE is provided, so those taxes continue to be subject to a zero tolerance. If there are changes in the tax rates or in the price of the property after a GFE is provided, those changes would either constitute unforeseeable circumstances or new information that would be the basis for providing a revised GFE. It is HUD's view that these provisions will provide sufficient flexibility to protect loan originators from changes outside their control, while still preventing loan originators from providing "low-ball" estimates of transfer taxes on the GFE that could mislead prospective borrowers. Government recording charges, in contrast, often may not be known with any certainty at the time the GFE is provided, and in many cases not until close to or at closing. Therefore, HUD has determined that these charges should be included with the third party charges that are subject to an overall 10 percent tolerance. Because the government recording charges typically are small in relation to other settlement costs, this should provide ample flexibility to loan originators on these charges without unduly impacting the permitted tolerances for other third party settlement charges.

**Response to Comments.** HUD has made a number of changes to the tolerances provisions to clarify and provide additional flexibility in managing the tolerances. The final rule adds a new paragraph providing loan originators with an opportunity to cure any violation of the tolerance by reimbursing the borrower any amount by which the tolerances were exceeded. This reimbursement may be made at settlement or within 30 calendar days after settlement. HUD will deem a payment to have been provided in a timely fashion if it is placed in the mail by the loan originator within 30 calendar days after settlement. HUD has determined, based on the comments received, that 30 calendar days provides sufficient time for loan originators to identify and cure any tolerance violations through their post-closing review process. In most cases, HUD expects that violations will be identified at or before settlement when completing the revised HUD-1 form, which provides a clear format for comparing the charges estimated on the GFE with those actually imposed at settlement.

The opportunity to cure violations of the tolerances is an important tool for loan originators to manage compliance with the tolerance requirements. Many lenders and groups representing lenders and other settlement service providers objected to the imposition of tolerances because of the difficulty of providing accurate estimates to prospective borrowers early in the application process. The opportunity to cure will permit loan originators to give an estimate of expected settlement charges in good faith, without subjecting them to harsh penalties if the estimate turns out to be lower than the actual charges at settlement.

HUD has also made clarifying changes to the proposed provision describing the circumstances in which the GFE can be revised. As described in more detail below, unforeseeable circumstances that result in higher costs can be a basis for providing a revised GFE. In addition, information that was either not known at the time the original GFE was provided may also be the basis for providing a modified GFE.

## V.E. Changed Circumstances

The March 2008 proposed rule provided that loan originators would not be held to tolerances where actions by the borrower or circumstances concerning the borrower's particular transaction result in higher costs that could not have reasonably been foreseen at the time of the GFE application, or where other legitimate circumstances beyond the originator's control result in such higher costs. The proposed rule also provided that if unforeseeable circumstances would result in a change in the borrower's eligibility for the specific loan terms identified in the GFE, the borrower must be notified of the rejection for the loan and be provided a new GFE if another loan is made available.

**Comments on the 2008 Proposed Rule.** Most of the commenters who commented on unforeseeable circumstances generally supported the proposed rule's provision on this matter, but many recommended changes or additions to the proposed definition of unforeseeable circumstances. Several lenders and trade groups representing lenders indicated that, while "unforeseeable circumstances" encompasses many things that would fall under the statutory requirement that estimates of settlement costs be in "good faith," the two concepts are not always equivalent. Some commenters suggested that the definition be expanded or clarified to include any situation that is outside the lender's control, even if such situation involves a change that occurs often enough to be "foreseeable" in some sense. An example of such situation that was offered is that in which the changes in the price of the property or in the estimated value of the collateral may necessitate new information about the credit quality of the borrower that is developed during the underwriting process, or any other situation for which there is a reasonable explanation and still consistent with "good faith."

Several commenters, including FTC staff and a trade group representing mortgage brokers, found the proposed definition of "unforeseeable circumstances" to be vague. They suggested adding specific examples of common situations to clarify the scope of "unforeseeable circumstances."

These commenters also offered suggestions regarding the definition. A group representing consumer interests recommended that HUD carefully monitor how often unforeseeable circumstances override the tolerance requirements to ensure that the exception does not swallow the rule. A joint comment letter from groups representing state regulators suggested that a provision be included requiring loan originators to provide written notice to borrowers describing the "unforeseeable circumstance" that resulted in the higher costs.

**HUD Response to Comments.** Based on the comments received in response to the proposed rule, HUD has made a number of changes to the proposed provisions describing the circumstances in which the GFE can be revised. HUD has determined that several changes are needed to the proposed grounds for providing a revised GFE.

The final rule clarifies the different types of circumstances that can be a basis for providing a revised GFE. The final rule continues to emphasize that market price fluctuations by themselves are not unforeseeable circumstances. For example, if an appraiser that a loan

originator intends to use for a particular transaction raises its prices by \$50 after the loan originator has already provided a GFE, that increase would not constitute an unforeseeable circumstance.

HUD recognizes that numerous commenters recommended elaborations of, or technical changes to the definition of unforeseeable circumstances. Because many of the changes described in the proposed definition of “unforeseeable circumstances” happen frequently enough that they could be reasonably foreseen, the final rule replaces the definition of “unforeseeable circumstances” with a new definition for “changed circumstances.” However, the types of circumstances included in the new definition are similar to the types of circumstances that were included in the proposed rule. The first clause in the definition of unforeseeable circumstances still includes acts of God, war, disaster, or other emergencies. The final rule clarifies that the other circumstances in the second clause are separate from and in addition to the circumstances listed in the first clause. The final rule also clarifies that the other circumstances include situations where information particular to the borrower or the transaction either change or are later found to be different from what was known at the time the GFE was provided. For example, new information affecting the borrower’s credit quality or a change in the loan amount might occur often enough to be reasonably foreseeable, but they would still fall within the types of circumstances included in the second clause of the definition of “changed circumstances.”

Under the final rule, changed circumstances that result in an increase in settlement costs such that the tolerances would be exceeded or that result in a change in a borrower’s eligibility for the loan offered may be the basis for providing a revised GFE. For example, if the actual loan amount turns out to be higher than the loan amount indicated by the borrower at the time the GFE was provided, and certain settlement charges that are based on the loan amount increase as a result, the loan originator may provide a revised GFE reflecting those higher amounts. Compliance with the tolerance provisions would be evaluated by comparing the revised GFE with the actual amounts charged at settlement.

Similarly, if underwriting and verification show that a borrower’s monthly income is different from the income relied on in providing the original GFE, and the difference results in a change in the borrower’s eligibility for that loan with those particular terms, the loan originator would no longer be bound by the original GFE. If a loan with different terms is available for that borrower, then the loan originator would have the option of providing a modified GFE. Conversely, as an example, if the borrower’s total assets were relied on in providing the original GFE, and those assets are not materially different from what was stated at application, then the borrower’s total assets may not be used a basis for providing a revised or modified GFE.

While these changes are intended to provide loan originators with more flexibility in providing revised GFEs, HUD is also mindful of the potential for abuse. Unscrupulous loan originators might seek to avoid providing a reliable GFE by claiming not to have relied on information provided by the prospective borrower. In order to discourage loan originators from providing “generic” GFEs that are not based on a preliminary evaluation of a particular borrower, the final rule limits the ability of loan originators to provide a revised GFE based on information that was collected prior to providing the GFE. However, if a loan originator

documents that it relies on a limited range of information in providing GFEs to borrowers, the loan originator may provide a revised GFE based on any other information that results in increased settlement costs or a change in the borrower's eligibility, even if the information was received by the loan originator prior to providing the GFE.. Loan originators are presumed to have relied on the same minimum information that must be collected by the lender before providing a GFE: the borrower's name, the borrower's monthly income, the property address, the borrower's best estimate of the value of the property, the amount of the mortgage loan sought, and any credit report that is obtained by the loan originator before providing the GFE. These limitations on providing a revised GFE only apply if subsequent underwriting and verification confirm that the information remains substantially the same as the information provided by the borrower at the time of the GFE. For example, if the borrower's monthly income turns out to be substantially less than the monthly income stated by the borrower in the initial application, the final rule would not prevent the loan originator from either providing a revised GFE or from denying the loan altogether. If the loan originator decides to provide a revised GFE, HUD encourages the loan originator to explain to the borrower the reasons for providing a revised GFE based on the changed circumstances.

Several other provisions in the final rule that permit revisions to the GFE have not changed significantly from those proposed. The final rule provides that a revised GFE may be provided if a borrower requests changes in the loan product, such as changing from a 30-year term to a 15-year term, or from a fixed rate mortgage to an adjustable rate mortgage. A revised GFE would be permitted whether such change is first suggested by the loan originator, or by any other party. The final rule also provides that if a prospective borrower does not express an intent to continue with an application within 10 business days of receiving the original GFE, or such longer time specified by the loan originator on the GFE, the loan originator is no longer bound by the GFE. While HUD does not intend the GFE form to in any way affect state laws regarding contract formation, this provision is intended to make clear that the estimated charges on a GFE are not open-ended.

The final rule also clarifies that, where a borrower has not locked a particular interest rate, or where an interest rate lock has expired, all interest rate-dependent charges on the GFE are subject to change. The charges that may change include the charge or credit for the interest rate chosen, the adjusted origination charges, and per diem interest. The loan originator's service charge, shown in block 1 on page 2 of the GFE, is not subject to change even if the interest rate floats. Of course, the various specific places where the interest rate is identified on the GFE would also be subject to change if the interest rate is not locked. If the borrower later locks the interest rate, a revised GFE should be provided at that time to show the revised information.

Finally, the final rule includes the proposed provision on revision of the GFE for transactions involving new home purchases. HUD recognizes that in cases of new construction, the original GFE may be provided long before settlement is anticipated to occur. In those cases, the loan originator may provide a clear and conspicuous disclosure to the borrower that a revised GFE may be provided at any time up until 60 calendar days prior to closing. If no such disclosure is provided, or if no revised GFE is actually given, then compliance with the tolerances will be evaluated by comparing the charges on the original GFE with the actual

charges at settlement. During the 60 calendar days prior to closing, a revised GFE may only be provided in accordance with the other paragraphs in this section.

In any case where a revised or modified GFE is provided to a prospective borrower, the loan originator is required to document the reasons for changes that are made and to maintain that documentation for 3 years after settlement.

## **VI. Additional Topics**

The 2008 proposed rule includes a number of changes that HUD made concerning the implementation of the GFE, in addition to those already discussed. This section briefly describes some of the more significant of these changes and their rationale. The section begins with one of the more important changes – the definition of an application.

### **VI.A. Definition of an Application**

The March 2008 proposed rule provided separate definitions for a “GFE application” and a “mortgage application” in an effort to promote shopping. Under the proposed rule, a loan originator would have provided a borrower a GFE once the borrower provided the originator six pieces of information that included: borrower’s name, Social Security number, property address, gross monthly income, borrower’s information on the house price or best estimate of the value of the property, and the amount of the mortgage loan sought. The rule provided that the GFE application would have to be in written form, and if provided orally, would have to be reduced to a written or electronic record. Under the March 2008 proposed rule, a separate GFE would have to be provided for each loan where a transaction involved more than one mortgage loan.

The proposed rule would have required that once a borrower chose to proceed with a particular loan originator, the loan originator could require the borrower to provide additional information through a “mortgage application” in order to complete final underwriting. This additional information could be used to verify the GFE, and could include income and employment verification, property valuation, an updated credit analysis, and the borrower’s assets and liabilities.

The March 2008 proposed rule provided that a borrower could be rejected at the GFE application stage if the loan originator determined that the borrower was not credit worthy. The borrower could not be rejected at the mortgage application stage unless the originator determined there was a change in the borrower’s eligibility based on final underwriting, as compared to information developed for such application prior to the time the borrower chose the particular originator. Under the proposed rule, the originator would have been required to document the basis for such a determination and maintain the records for no less than three years after settlement.

The March 2008 proposed rule also provided that where a borrower was rejected for a loan for which a GFE had been issued, but the borrower qualified for a different loan program, the originator would have to provide a revised GFE. If a borrower was rejected for a loan and no other loan product could be offered, the borrower would have to be notified within one business day and the applicable notice requirements satisfied.

Under the March 2008 proposed rule, for loans covered by RESPA, the TILA disclosures would be provided within 3 days of a written GFE application, unless the creditor, i.e. loan originator, determined that the application could not be approved on the terms requested. The proposed rule indicated that based on consultations with the Federal Reserve Board, when a GFE application is submitted, an initial TILA disclosure would also have to be provided so long as the application is in writing, or, in the case of an oral application, committed to written or electronic form. HUD noted that whether a GFE application under a particular set of facts triggers the Home Mortgage Disclosure Act (HMDA) or the Equal Credit Opportunity Act (ECOA) requirements would be determined under Regulation B and Regulation C, as interpreted in the Federal Reserve Board's official staff commentary.

**Comments on the 2008 Proposed Rule.** Consumer representatives supported early delivery of the GFE, which, under the proposed rule, would be issued when a lender receives the proposed "GFE Application." However, they emphasized that enforcement and private rights of action are necessary to ensure that a meaningful GFE will be provided to consumers early in the mortgage application process.

Consumer representatives also raised the issue of whether HUD's definition of "GFE Application" triggers other regulatory requirements. They recognized the Federal Reserve Board's rulemaking authority under ECOA and the Fair Credit Reporting Act (FCRA) and indicated that requirements under these statutes and their implementing regulations would be triggered by the newly defined GFE application. They noted that current definitions in both statutes and their implementing regulations cover the GFE application.

According to their comments, the application of ECOA and FCRA to the GFE application is important because such application ensures binding and accurate disclosures. These commenters recommended that HUD coordinate with the FTC to ensure that the GFE application remains covered by ECOA and FCRA.

Industry representatives expressed significant concerns about the "GFE Application" and "Mortgage Application" approach under the March 2008 RESPA proposal. Specifically, they expressed concerns about the limited information originators would be permitted to collect in order to conduct preliminary underwriting before issuing a GFE. One commenter stated that this limitation precludes an originator from considering, at the GFE application stage, important information that a lender currently collects early in the transaction in order to develop a GFE. Some of those additional items include loan product type sought, purpose of loan, and information to compute the loan-to-value ratio. The commenters claimed that limiting consideration of this type of information would make it difficult for originators to provide a meaningful GFE because they would be unable to provide any reliable estimate of cost or

determine a borrower's ability to repay the loan. They also stated that the inability to consider important underwriting information until the mortgage application stage would result in the issuance of more than one GFE. The net result, they concluded, would lead to borrower confusion and increased costs to the borrower.

Industry commenters also expressed further operational concerns related to the limitations on underwriting information at the GFE stage. They stated that the limitation on information that loan originators can take into consideration in developing a GFE, would force lenders to develop systems that could underwrite based on very limited information. They further stated that the originator would not have sufficient information to determine the type of property the consumer is considering – such as whether the property is commercial, industrial, vacation, or residential – or the type of loan the consumer is considering such as a purchase money loan, refinance, or home equity loan. They stated it is important for the lender to have this information because the lender may not engage in the kind of lending a consumer seeks.

In addition, industry commenters expressed confusion over whether a credit report was one of the six pieces of information they could collect as part of the GFE application, and requested that HUD provide such clarification. Industry representatives also requested that HUD permit borrowers to expedite the application process and proceed to the mortgage application stage where the borrower so desires due to timing or other concerns.

Industry representatives stated that the new application definitions in the March 2008 proposed rule would present uncertainty in complying with other mortgage related statutes and regulations. They commented that compliance with other statutes and regulations is triggered by a mortgage “application.” Because HUD’s proposal includes both a “GFE Application” and a “Mortgage Application”, they commented that it is not clear which one is the “application” for purposes of compliance with other regulations. In particular, lenders expressed concern with the possibility that the “GFE Application” would trigger compliance obligations under FCRA, ECOA, HMDA and the TILA requirements. They requested that ambiguities surrounding compliance with these statutes and other laws be addressed to provide clarity and mitigate litigation exposure. For example, one lender noted that to calculate the spread for high cost loans under Regulation Z and many state predatory lending laws, the index used is based on the month in which the “application” for credit is received by the creditor. This lender stated that it was not clear from the proposed rule whether the GFE application is an application for purposes of Regulation Z.

Industry commenters expressed confusion about preamble statements regarding whether HMDA or ECOA is triggered by the GFE Application. They indicated that the preamble stated that whether HMDA or ECOA is triggered by the GFE Application should be determined under Regulations C and B as interpreted by the Board. They noted, however, that the preamble stated that based on consultations with the Federal Reserve Board, TILA disclosures would be provided within three days of a written GFE application unless the creditor determines that the application cannot be approved on the terms requested. The commenters further noted that the Regulatory Impact Analysis states “[t]he proposed rule clarifies that only the “mortgage application” would

be subject to Regulations B (ECOA) and C (HMDA), which is the current situation today.” These commenters requested clarification of this matter.

Industry representatives questioned HUD’s legal authority to: limit information originators can request to underwrite a loan; require that originators accept an abbreviated application from which to complete a GFE; require a new GFE when a counteroffer is made; and require a consumer to be notified within one business day of a lenders decision to reject an application, among other concerns.

Additionally, one lender commented that under HUD’s March 2008 proposed rule, lenders would be required to retain the GFE application for three years which is different from the 25 month retention requirement by TILA or ECOA. The lender commented that this difference presents additional expense without a substantive benefit to the consumer.

The FTC staff recommended that HUD reevaluate the proposed “GFE application” as this terminology is new and could generate consumer confusion in the already complex mortgage process. FTC staff suggested that HUD characterize it as the “GFE application” concept so consumers do not confuse it with the mortgage application. They also recommended that HUD educate consumers about these two components of the mortgage lending process. Further, FTC indicated that the industry would also benefit from guidance on how the GFE application relates to other mortgage lending laws that include an “application” concept.

The Conference of State Bank Supervisors, the American Association of Residential Mortgage Regulators, and the National Association of Consumer Credit Administrators) also expressed concern over the creation of a “GFE application” and a “mortgage application” because, they asserted, these application concepts will cause consumer confusion. They recommended that HUD coordinate with other federal regulatory agencies to ensure consistency and clarity to regulatory requirements from loan application to loan closing.

**Response to Comments.** To address the concerns raised by the commenters about the bifurcated application approach set forth in the proposed rule, HUD has adopted a single application process for the final rule. Under this approach, at the time of application, the originator will decide which information that it collects from a borrower to issue a GFE will be used to deliver a meaningful GFE. The originator, however, must collect at least the following six items before providing the GFE: the borrower’s name, social security number, and gross monthly income; the property address; the house price; and the amount of the mortgage loan sought. The borrower’s social security number would be collected for purposes of obtaining a credit report.

The originator will continue to be required to deliver or mail a GFE to the applicant within 3 business days after the application, including all necessary information, is provided by the borrower. HUD is revising the definition of “business day” to maintain consistency with the timing of the TILA disclosure under the Federal Reserve Board’s recently finalized rule limiting the fees that consumers can be charged for the delivery of TILA disclosure (see revisions of § 226.119(a), (73 FR 44522, July 30, 2008). HUD is also limiting the fee that may be charged for

providing the GFE, consistent with the Federal Reserve Board's recently finalized rule. A loan originator also may not require the applicant to provide supplemental documentation to verify the information that will be used to provide the GFE.

After the GFE has been provided, the loan originator may collect additional fees needed to proceed to final underwriting for borrowers that decide to proceed with a loan from that originator. At that time, verification information or any other information could be required from the applicant, such as bank statements and W-2 forms, to confirm representations made by the applicant in the application.

None of the information collected by the originator prior to issuing the GFE may later become the basis for a "changed circumstance" from which a loan originator may offer a revised GFE, unless there is a material change in that information, or unless the loan originator has an established policy of relying on a more limited set of information in providing GFEs. If a loan originator can document such a policy, then the limitation on providing a revised GFE would only apply to the information that the lender relied on pursuant to its policy. Other information collected by the loan originator may be the basis for a "changed circumstance" that could give rise to a new GFE. However, a loan originator may not claim that it has policy of not relying on one or more of the six pieces of information that are required prior to providing a GFE. The loan originator is presumed to have relied on the borrower's name, the borrower's monthly income, the property address, the borrower's best estimate of the value of the property, the mortgage loan amount sought, and any information contained in any credit report obtained by the loan originator before providing the GFE, unless that information changes or is later found to be inaccurate. HUD determined that this approach balances the flexibility originators need to properly underwrite, while limiting bait-and-switch methods whereby the originator uses the GFE to draw in a borrower and, after a significant application fee is paid or burdensome documentation demands are made, claims that a material change has resulted in a more expensive loan offering. If a loan originator determines that changed circumstances necessitates the issuance of a new GFE, such new GFE must be provided to the borrower within three days. The three-day requirement is in response to comments on the proposed rule which stated that providing a new GFE within one day is not workable.

The approach set forth in this rule furthers HUD's goal to promote consumer shopping among mortgage originators because it does not overly burden a consumer at an early stage. Rather, a consumer provides information that is easily communicated and pays a nominal fee in order to get a GFE.

As noted, this public policy is further supported by the Federal Reserve Board through its recently issued final rule limiting fees that can be charged for the delivery of the TILA disclosure. Under this rule, borrowers must receive the TILA disclosure before paying or incurring any fee imposed by a creditor or other person in connection with the consumer's application for a closed-end mortgage, except that creditors may charge a bona fide and reasonable fee for obtaining the consumer's credit history.

## **VI.B. Trade Off Chart for Interest Rates and Costs**

Most comments supported the idea of a chart showing settlement cost and interest rate trade-offs; however, some lenders wanted a generic chart rather than a customized chart that compares alternatives to the shopper's own loan. Some lenders stated that the trade-off chart was more appropriate for the Settlement Cost Booklet that HUD publishes for consumers. HUD has made clear that consumers should be advised of how their interest rate affects their settlement costs. HUD believes that consumers should be apprised of the interrelationship between their interest rate and their up-front settlement obligations as early as possible when shopping for a loan, and that their options in this regard should be presented on the GFE form. During the tests of the GFE, consumers indicated that the trade-off chart provided useful information. Thus, the final rule continues to include the customized chart that compares the borrower's selected option with higher- and lower-interest rate options (assuming the originator offers such options). It is required that the two options be actual offers available to the borrower when he or she made the choice of interest rate and points for which the GFE is filled out. (See Section II.D of this chapter for a full discussion of the trade-off table.)

## **VI.C. Opportunity to Cure**

The March 2008 proposed rule provided that HUD would deem violations of the requirements for the GFE in 24 CFR 3500.7 to be violations of section 5 of RESPA. This would include instances where the charges listed on the GFE are exceeded at settlement by more than the tolerances permitted under § 3500.7(e). In similar fashion, the proposed rule provided that HUD would deem violations of the requirements for the HUD-1/1A in § 3500.8 to be violations of section 4 of RESPA.

HUD invited comments on whether a provision should be added to the RESPA regulations that allow a loan originator, for a limited time after closing, to address the failure to comply with tolerances under the proposed GFE requirements, and if so, how such a provision should be structured. HUD sought comments on whether such a provision would be useful, and if so, what the appropriate time frame would be for finding and refunding excess charges. HUD also invited comments on whether the potential for abuse of such a provision would be harmful to consumers. Comments were also sought on whether the ability of prosecutors to exercise enforcement discretion would obviate the need for such a provision.

Many comments were received on the advisability of allowing loan originators to cure potential violations of the tolerances on the GFE. Lenders and trade groups representing lenders and some settlement service providers strongly supported the addition of a provision allowing loan originators to cure potential violations of the tolerances. Several lenders reiterated their previous comment that HUD lacks authority to impose tolerance requirements on the GFE, but that if a tolerance provision were authorized by statute, they would support the inclusion of a cure provision. Among the lenders and lender trade groups that supported inclusion of a cure provision, the comments were almost evenly divided between those suggesting a 60-calendar-day period to cure potential violations of the tolerances, and those suggesting a 90-calendar-day

period. Another commenter recommended that HUD consider adding a cure provision for the HUD-1 and closing script.

Consumer groups were generally supportive of stronger enforcement of RESPA's disclosure requirements, including enactment of statutory changes that would include civil money penalties for violations of those requirements. A consumer group that responded to HUD's question regarding a cure provision expressed its opposition to adding such a provision. Consumer groups, generally, raised the possibility that a cure provision could be abused by offering only partial reimbursement to a borrower. These commenters suggested that loan originators would have an incentive to cure violations even without a specific provision exempting them from liability if a potential violation is cured.

Based on the comments received in response to the proposed rule and further consideration of this issue by HUD, HUD has determined that a cure provision is essential to allow loan originators to more effectively manage any uncertainty in costs associated with the required tolerances on the GFE. By including a cure provision, HUD recognizes that some errors are inevitable when handling large numbers of complex transactions, and HUD does not intend for the tolerance requirements to create liability for inadvertent errors.

As described in more detail above, HUD has built an opportunity to cure violations of the tolerances into the requirements establishing the tolerances. The final rule also makes allowances for inadvertent or technical errors in filling out the HUD-1/1A. The settlement agent would have an opportunity to cure any violation of section 4 of RESPA by providing a revised HUD-1/1A to the borrower and/or seller within 30 calendar days of settlement. This opportunity to cure errors on the HUD-1/1A is consistent with HUD's longstanding policy permitting settlement agents to provide revised HUD-1/1A settlement statements where errors are discovered after settlement.

#### **VI.D. Delaying Implementation of the New GFE**

In the March 2008 proposed rule, HUD stated that it intended to include a 12-month transition period in the final rule. During the 12-month transition period, settlement service providers and other persons could comply with either the current RESPA requirements or the revised requirements of the amended provisions. HUD invited comments on whether such a transition period is appropriate.

**Comments on the 2008 Proposed Rule.** Consumer representatives generally favored a 12-month implementation period. While lenders and their trade associations sought a longer implementation period on the basis that 12 months is insufficient time to prepare for compliance with the new requirements. According to one major lender, a 12-month period is far too short given the extensive nature of the changes. This lender estimated that an 18-24 month period will be required for implementation of the proposal as published on March 14, 2008. According to other major lenders, the proposed rule would require significant systems and operational changes

well beyond the complex forms changes, and would take a minimum of 2 years to implement. A lender association stated that requiring the industry to implement changes to RESPA disclosures and then to later implement changes to TILA disclosures would result in significant and duplicative costs for systems changes, training, and staffing that would ultimately be borne by consumers. This association expressed support for an implementation period beginning 18 months after the effective date of the rule, or 18 months after the implementation period for the Federal Reserve Board's TILA rule, whichever is later.

**Response to Comments.** HUD has determined to proceed with adoption of a 12-month implementation period. HUD recognizes that operational changes will be required in order to implement the new rule, in addition to training staff on the new requirements. However, the need for a standardized GFE with relevant information about the loan and settlement charges is critical in light of the problems in the current market and further delay is not warranted. HUD believes that a 12-month implementation period will provide sufficient time for systems changes and training to occur. Therefore, use of the new GFE and the new HUD-1/1A will be required as of January 1, 2010. During the transition period, the current RESPA requirements with respect to the GFE and the HUD-1/1A remain in effect and settlement service providers may choose to proceed under either the current GFE and HUD-1/1A requirements or may choose to proceed under the new GFE and HUD-1/1A requirements. However, any settlement service provider who delivers the required GFE prior to January 1, 2010 will be subject to all of the requirements of the required GFE, including compliance with the tolerance provisions and use of the required HUD-1/1A. .

Other provisions of the rule, including average cost pricing, required use and the technical amendments are implemented immediately upon the effective date of the rule.

## **VI.E. Other GFE Topics**

**Prepayment Penalty.** Prepayment penalties can be used to the borrower's advantage as a technique that allows a borrower to avoid paying a loan fee upfront. A lender might be willing to accept a higher monthly payment as an alternative to a higher upfront fee if there were some protection from not recouping the fee in the event of an early payoff. A prepayment penalty can do that if it approximates the remaining unpaid part of that fee. Sometimes, however, prepayment penalties are used for other purposes. For example, they can be designed to be a severe deterrent to paying off a loan made at a very unfavorable interest rate. The disclosure is designed simply to alert the borrower that there is a prepayment penalty and if so, its maximum amount. If there is a prepayment penalty, the borrower certainly should be aware of it.

**Splitting of Title Insurance.** Many commented that the breakout of title charges into the pure insurance premium and the title agent compensation was of little value. Title insurance prices are divided into two components. One component goes to the salesperson as a commission. The other goes to the title insurance company to cover all the other costs of running an insurance company, including making claim payments. The salesperson receiving the commission often does other settlement work as well. For example, the salesperson might be the

settlement agent in the transaction. If true, the salesperson might get paid as the settlement agent and the person receiving the commission. But the commission is hidden income from the borrower's perspective. This breakout in the final rule is designed to shed light on this otherwise hidden, sometimes large, sales commission often received by the settlement agent who might be charging additional fees in the transaction. It might put competitive pressure on the sum of all fees received by the title insurance salesperson. This requirement is included in the final rules for the HUD-1 to avoid complicating the GFE, and because the other competitive pressures established in this rule should be sufficient to drive down title-related costs. HUD also believes that the relevant figure for borrowers to shop and compare is the total price, not a component price. This is done at the recommendation of a Government Accountability Office Report on the title insurance industry. It is a disclosure intended to be used for enforcement purposes, to ensure that title insurance agent commissions are put toward other title expenses.

**Splitting of Lender and Broker Fees.** Also, the form does not break down the lender and broker charges because HUD believes that the final form presents the best depiction of the service charge of the broker and the lender, and is also the proper figure for the borrower to focus on.

**Private Mortgage Insurance.** Private mortgage insurance comes in two main forms – upfront premiums and monthly premiums. There is zero tolerance on the monthly payment once the borrower locks in his or her interest rate. The ten percent tolerance applies to the upfront premium for lender-selected or lender-referred third-party services.

## **VI.F. Required Use**

Generally, required use is a situation in which a borrower's access to some distinct service, property, discount, rebate or other economic incentive, or the borrower's ability to avoid an economic disincentive or penalty is contingent upon the borrower using or failing to use a referred provider of settlement services. Under the current rule, penalizing a borrower for not obtaining a loan or settlement service from an affiliate is a violation of RESPA. The final rule changes the definition of required use to include the withdrawing of a positive incentive for not doing business with an affiliate. This change clarifies that withholding a positive incentive is equivalent to imposing a negative incentive.

The offering by a settlement service provider of an optional package or combination of *bona fide* settlement services to a borrower at a total price (net of the value of the associated discount, rebate, or other economic incentive) lower than the sum of the prices of the individual settlement services does not constitute a required use. Lenders and settlement service providers will be allowed to package settlement services but not make a discount contingent on the purchase of anything that is not a settlement service from an affiliate.

An example of a required use violation is the imposition of a penalty from real estate developers who have affiliate business arrangements with lenders and title insurance companies.

In one recent case (described by Harney, November 18, 2006), which was resolved without any public action by HUD, “a builder canceled a sales contract and seized an \$11,845 good-faith deposit when a buyer refused to use the builder’s affiliated mortgage company.” Refusing to sell, and seizing the good faith deposit in more extreme cases, is only one strategy used to compel a borrower to use an affiliate or subsidiary. Other typical penalties include raising the price of a home and requiring an additional escrow deposit. Such actions are anti-competitive and are violations of RESPA.

Many large builders offer positive economic incentives to home buyers in order to encourage them to either borrow from an affiliated lender, obtain settlement and title services from an affiliate, or both. This alternative strategy to imposing a penalty is currently permitted by RESPA. The incentive may be a financial one such as a discount on the price of the house, a reduction of settlement costs, or payment of home association fees for a limited time. An incentive may also take the form of a physical upgrade to the home, such as additional landscaping, finishing a patio or basement, a wide-screen TV, or granite kitchen counter tops. RESPA requires that the builder discount represent true savings for the consumer. Raising the price of the house or any other charge in order to compensate the builder for the cost of the incentive constitutes a violation of RESPA.

Under the March 2008 proposed rule, the current definition of “required use” in 24 CFR 3500.2 would be changed so that consumers would be more likely to shop for the homes and home features, and the loans and settlement services, that are best for them, free from the influence of deceptive referral arrangements. Through this proposed change, HUD sought to establish that in a real estate transaction covered by RESPA, incentives that consumers may want to accept and disincentives that consumers may want to avoid should be analyzed similarly for compliance with RESPA.

The proposed change would have made clear that HUD views economic disincentives that a consumer can avoid only by purchasing a settlement service from particular providers or businesses to which the consumer has been referred to be potentially as problematic under RESPA as are economic incentives that are contingent on the consumer’s choice of a particular settlement service provider. The modifications in the proposed rule were not intended to prevent discounts that are beneficial to consumers, however. The proposed definition stated that the offering by a settlement service provider of an optional package or combination of bona fide settlement services to a borrower at a total price lower than the sum of the prices of the individual settlement services would not constitute a “required use.”

The proposed revision to the “required use” definition would have continued to apply in two sections of the regulations: the affiliated business exemption in 24 CFR 3500.15, and the prohibition on the seller requiring the buyer to purchase title insurance from a particular company in § 3500.16. However, in light of the other changes that would have been made by the proposed rule, the term “required use” would no longer have applied as it does currently in § 3500.7 (e).

**Comments on the 2008 Proposed Rule.** NCLC stated that the proposed change to the “required use” definition does not go far enough to protect consumers. NCLC stated that the settlement services to obtain a home loan are only a small part of the costs of the loan. According to NCLC, the interest rate, the term of the loan, and whether a prepayment penalty is permitted, or a balloon payment is required, are all more important elements of the costs of the home loan than are the costs of settlement services. NCLC stated that “(i)t does not make sense for the settlement services to be capped in return for a required use, while the more critical components of the costs of the loan are not limited, especially where the service itself could be discounted while the loan terms are increased.” NCLC proposed to define “required use” to include the total cost of the loan in addition to the total of settlement services. CRL commended HUD’s efforts in this area and agreed with NCLC that the definition of “required use” should include the total cost of the loan in addition to total settlement services.

The California Reinvestment Coalition supported the proposed change to the definition of “required use” and stated that the proposed change will “benefit the borrower by leveling the field.”

Generally, lenders expressed opposition to the proposed change to the definition of “required use” on the grounds that the proposal is difficult to understand, is overbroad, and would eliminate the ability of builders and others to offer legitimate consumer discounts. MBA stated that it would be sufficient for HUD to indicate that under its current rules it may scrutinize discounts to assure that they are bona fide rather than risking depriving borrowers of discounts altogether.

The ABA stated that the proposed change to the required use definition is “flawed and unreasonable” because HUD cited only anecdotal evidence that incentives have been abused by some companies to steer customers to affiliated vendors with high prices and inferior service, but offered “no empirical evidence to support this assertion.” ABA also stated that the proposal runs counter to the plain meaning of the words in the statute because defining “required use” to mean any incentive offered to use an affiliated company contradicts the unambiguous meaning of the statutory word “required.” It stated that the Department should not confuse legitimate incentive arrangements among affiliated entities with undue influence or required use of a product or service.

NAMB, the Maryland Association of Mortgage Brokers (MAMB) and the Idaho Association of Mortgage Brokers (IAMB) expressed support for the proposed change in the definition of “required use.” NAMB stated that the proposed revision should resolve the problems with tying and required use. NAMB recommended that the new definition avoid setting a threshold higher than zero for determining what constitutes an economic incentive or disincentive. NAMB, MAMB and IAMB all stated that the threshold for determining incentives and disincentives should be “any thing of value.”

Builders and builder-affiliated mortgage companies opposed the proposed change to the “required use” definition. CTX Mortgage Company asserted that the proposed change would “provide a significant road block for future customers to benefit from the streamlined mortgage

and title services that Centex offers.” The National Association of Home Builders (NAHB) asserted that the change would eliminate bona fide incentives, denying consumers significant savings in their home purchases. NAHB characterized the Department’s examples of “required use” problems as “ambiguous and incomplete.” NAHB asserted that home builders with affiliated lenders have business incentives to ensure that home buyers are pleased with the experience of obtaining loans from their affiliated lenders. NAHB noted that studies of builder-affiliated mortgage companies conducted by an independent research firm have found that such firms have lower per-loan operating costs as compared to outside lenders. According to NAHB, while the savings from these economies and the other affiliate benefits are difficult to quantify, they are significant and are passed along to consumers in the form of incentives for use of a builder affiliate. NAHB stated that home builders in general do not increase the selling price of homes to offset these incentives and asserted that the vast majority of builders who provide incentives for buyer use of affiliates do so in a responsible manner that brings substantial benefits to consumers. NAHB and other commenters also suggested alternative language to the proposed definition to ensure that consumers are presented with the option to select an incentive that is bona fide.

RESPRO objected to the proposed change to “required use” and stated that it would “prohibit many consumer incentives offered by home builders and real estate brokers in today’s marketplace that provide consumers with lower costs and/or better service; is based on unsubstantiated and anecdotal evidence about alleged abuses; attempts to address violations that already are prohibited under RESPA, and is based on an inaccurate reading of anti-trust laws.” RESPRO asserted that consumer incentives are offered to ensure that sales transactions close as quickly and as efficiently as possible. RESPRO recommended that the current definition of “required use” be retained.

NAR opposed the proposed change and stated that it would have at least two unintended consequences. According to NAR, the rule authorizes discounts only on the prices of the recommended provider and this would limit the kind of non-price/services promotions that joint venture owners currently and permissibly offer to promote affiliates. NAR noted that real estate agents and brokers offer a variety of inducements to clients to promote their services, such as by offering a gift certificate to a local business or a free home inspection, and indicated that it does not believe that HUD intended to eliminate a practice which benefits consumers. In addition, according to NAR, the proposal would allow a discounted combination of settlement services only to a borrower, and NAR believes that sellers should not be precluded from receiving discounts as incentives as sellers often pay the majority of settlement costs in a real estate transaction.

The Laborers’ International Union of North America (LIUNA) supported the proposed change to the “required use” definition, stating that it “will promote more comparison shopping by borrowers and achieve HUD’s intended goal of protecting consumers from unnecessarily high settlement costs.”

LIUNA further stated that the “cost to the builders of incentives has already been built into the sales price, so that it is not a true discount, but a penalty for using another company.”

According to LIUNA, its research indicates that the effect of incentives “dissuade customers from comparison shopping for lenders.” Rather, “customers are steered to loans that are very often more expensive, despite the incentives.” LIUNA asserted that builders have improperly used “related business relationships at the expense of consumers” that “resulted in higher costs for homebuyers . . . and have played a large part in creating the current housing crisis.” LIUNA provided statistics indicating that in February 2006, the average rate for a 30-year fixed-rate mortgage was 6.25%. In contrast, LIUNA noted that although the main benefit of an ARM is that it has a lower starting interest rate than the equivalent fixed-rate loan, approximately half of the mortgages made by certain builders in February 2006 were ARMs that had starting rates of 6.25% or higher. LIUNA stated that builders “have an incentive to sell their inventory at the highest possible price, and in-house mortgage units provide the financing to make it possible. There is evidence that during the housing boom in 2004-2006 builders were only able to sell homes at such inflated prices because of the collaboration with their mortgage subsidiary and an affiliated appraisal company. This resulted in large numbers of homeowners who were “underwater,” owing more than the value of their home, from day one.”

CSBS, AARMR and NACCA supported the proposed change to the “required use” definition. However, these commenters recommended that the definition of “required use” be expanded to incorporate situations where the originator fails to give a required Affiliated Business Arrangement disclosure, or provides a misleading disclosure that facilitates steering of the borrower to an affiliate. According to these commenters, absent information necessary to make the best decision, the borrower has effectively been required to use a particular provider.

The FTC staff recommended that HUD reconsider the proposed change to the definition of required use. The FTC staff stated that the expanded definition could deprive customers of the lower prices that can result from bundling related services.

After reviewing comments about HUD’s proposal to change the definition of “required use” and re-examining aspects of the proposed revised definition, HUD has determined to retain the concepts in the definition of “required use” set forth in the proposed rule, but with some revisions that better reflect HUD’s intent in applying the definition. The new definition makes it clear that economic disincentives that are used to improperly influence a consumer’s choices are as problematic under RESPA as are incentives. The revisions made in the definition subsequent to the proposed rule clarify how the definition will apply in the context of the affiliated business exemption under Section 8 (c ) of RESPA and § 3500.15 of HUD’s regulations, and similarly frames the definition to apply to “persons” rather than only “borrowers.”

The change to the definition of “required use” will not eliminate the ability of anyone to offer legitimate consumer discounts. HUD does not interpret RESPA as preventing a settlement service provider or anyone else from offering a discount or other thing of value directly to the consumer. The only limitation is on tying such a discount to the use of a particular settlement service provider. HUD believes that consumers will utilize affiliated and preferred businesses if the costs of using those businesses are lower than the costs associated with similar services from other providers.

Under the final rule, builders will not be allowed to offer positive economic incentives for the homebuyer to use an affiliated lender or settlement service provider. An incentive would have to be general, i.e., applicable to any lender or settlement service provider. It would be allowable for a builder to offer to pay a portion of the buyer's closing costs, but that offer could not depend on whether the buyer uses an affiliated lender or settlement service provider.

#### **VI.F.1. Arguments for Changing Definition of Required Use**

The average consumer faces the two largest and most complex financial transactions that he or she has ever encountered when buying a house and obtaining a mortgage loan for the first time. There is a danger that the consumer is not able to shop as effectively for the cheapest loan when the choice of the home and lender are tied to one another. According to the National Association of Mortgage Brokers (NAMB), affiliated lenders tend to offer interest rates one-eighth to one-quarter percent higher than what borrowers could get from an independent lender (see Harney, April 29, 2005). For the average home price (\$192,000) used in this economic analysis, an extra quarter point above par would increase the value of the loan by approximately \$1,200. In this particular case, the builder will gain (and the borrower will lose) if the economic incentive is worth less than the additional yield spread premium. Frequently, there will be more than \$1,200 at stake. New homes are more expensive than average and that the distribution of new home prices are skewed upwards. For such homes, a difference of a fraction of a percentage point could increase the costs for borrowers by thousands of dollars.

Deals involving economic incentives are difficult to evaluate. The borrower would have to shop for comparable loans to discover whether and to what extent the loan that they are being offered is more expensive. If it is, then they would have to value the incentive that they are being offered to take the deal. An example is of a consumer, who was offered a "free" morning room addition to the house in return for obtaining a loan from the builder's mortgage affiliate. The borrower was informed that the addition was worth \$13,400 and that the loan was very competitive. Upon researching the mortgage market, the borrower found that the subsidiary's fees were extremely high (an origination fee of \$5,400). The consumer appealed to HUD, upon which the builder waived the origination fee (see Harney, November 18, 2006).

One major argument against builder discounts is that assessing the value of a non-financial incentive upgrade (such as a finished basement) may pose challenges that inhibit effective shopping for loans and settlement services by consumers. As long as the homebuyer is not able to properly compare the yield spread premium and the market value of the builder discount, then the builder may gain from a buyer's confusion. Another major argument against allowing builder discounts is that some builders may pay for the economic incentive by surreptitiously raising other charges beyond the market price. Such behavior is a violation of the current rule: discounts must be legitimate and not built into the price of the house or the cost of the loan. This is nevertheless difficult to monitor and enforce. Prohibiting builder discounts altogether is more effective. A third argument, advanced by the NAMB, is that the builder discount is an anti-competitive practice (see Harney, June 24, 2006). Independent brokers have an interest in encouraging consumers to shop further for mortgages. The NAMB maintains that

the incentives from builders are illegal kickbacks under RESPA and that they violate anti-trust laws (the Federal Trade Commission’s Magnuson-Moss Act, which prohibits “tie-in sales”).

### **VI.F.2. Arguments against Changing Definition of Required Use**

One could argue that the builder discounts for contracting with an affiliate are beneficial for both builders and consumers. Thus, in specific circumstances, the prohibiting of builder discounts could prevent mutually beneficial trades between the builder and consumer from occurring. Consider the claim that an affiliated business arrangement could reduce the average cost of origination or settlement, an efficiency that would be shared by the consumer. For example, a lender saves on advertising costs when a consumer is referred by a builder. If the lender is an affiliate, then the builder would be able to pass on some of those savings in the form of a builder discount. In addition, there may be economies of scale. According to the NAHB, “affiliated business arrangements also lower costs to consumers by allowing diversified companies to streamline administrative expenses and offer discounts and rebates on packages of services.”<sup>38</sup> Thus, there may be true cost savings that can be legitimately passed on, in the form of a builder discount, to homebuyers who do business with an affiliate.

### **VI.F.3. Conclusion**

HUD maintains that the average consumer will gain by formally separating the home purchase and loan decisions. There is evidence that many consumers do not gain from so-called builder discounts. Evaluating the deal that they are being offered is a formidable and costly task. Builders and lenders, who normally have the advantage of being better informed, can cloud borrowers’ decisions by offering extraneous incentives. HUD believes that most affiliated businesses are able to offset the cost of the incentive by charging a higher interest rate, home price, or closing costs. HUD recognizes the possibility that some affiliated business arrangements may reduce the average origination and settlement costs. However, we argue that the competitive pressure that will result from simplifying the shopping process will benefit the average consumer. The agency believes that, more often than not, consumers do not gain from, and can be misled by, deals involving economic incentives from a builder to obtain a loan or settlement services from an affiliate.

HUD also recognizes the builders’ argument that there is the potential for builder-affiliated mortgage companies to have lower per-loan operating costs. More importantly, builder-affiliated lenders have an incentive to offer acceptable loans to consumers. The builder gains by selling its properties and closing the loans promptly, as well as by ensuring that the loan is sustainable and does not lead to foreclosure. The final rule reflects this understanding by easing the qualification for the affiliated business exemption.

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<sup>38</sup> See Ledford, David. “Mortgage Lending.” National Association of Home Builders, <<http://www.nahb.org/generic.aspx?genericContentID=79479>>.

In the final rule, to qualify for the affiliated business exemption under § 3500.15, a settlement service provider may offer a combination of bona fide settlement services at a total price (net of the value of the associated discount, rebate, or other economic incentive) lower than the sum of the market prices of the individual settlement services and will not be found to have required the use of the settlement service providers as long as: (1) the use of any such combination is optional to the purchaser; and (2) the lower price for the combination is not made up by higher costs elsewhere in the settlement process.

Consumers will still have the liberty to choose the best loan regardless of who offers it. The rule does not prohibit the borrower from financing through a builder's affiliate; it prohibits the builder from offering a discount for doing so. To attract business, the affiliated lender only has to offer a competitive loan. Indeed, the affiliated lender may have inherent advantages over independent lenders such as greater convenience for the borrower, a greater likelihood of loan approval, and flexibility concerning the closing. A recent study by J.D. Power found that the majority of borrowers surveyed who finance through a builder's affiliate were satisfied with the experience (see Sichelman, 2007). According to J.D. Power, borrowers claimed that they chose to borrow from builder affiliates because the interest rates were competitive and that the process was easier. The final rule does not remove the real economic advantages of financing with (or purchasing settlement services from) a builder's affiliate. The final rule continues to allow the offering by a settlement service provider of an optional package or combination of *bona fide* settlement services to a borrower at a total price lower than the sum of the prices of the individual settlement services. The final rule will also allow an unaffiliated builder to offer a discount to a borrower for choosing a preferred lender or settlement service provider. Expanding the definition of required use simply limits the builder's capacity to steer the consumer away from actively shopping for the best loan terms and least expensive settlement services.

#### **VI.F.4. Economic Effects of Required Use**

The predicted consumer savings from changing the definition of required use are not estimated separately from the aggregate consumer savings (estimated to be \$8.35 billion in the base case). In conjunction with other parts of this rule, the change in required use will lead to lower prices due to improved shopping for both originator and third-party services. The benefits of expanding the definition of required use represent transfers from affiliated lenders and settlement services to borrowers. The sector of the industry affected is not likely to be large compared to the total market: only lenders and settlement service providers affiliated with builders of new homes could lose from the change in required use. Approximately one-sixth of home sales are new homes. Industry data concerning the proportion of builders that have affiliated lender or settlement service providers do not exist. However, one can reasonably assume that only large construction companies could afford to have affiliates. One-third of the single-family homes in 2002 were built by establishments with over 500 starts (see Chapter 5 for a description of New Single Family Contractors and New Housing Operative Builders). Assuming that all large construction firms have affiliated business arrangements, the change in required use will affect approximately five percent of the market. In all likelihood, this proportion will be smaller since only an unknown fraction of builders have affiliated lenders and settlement service providers.

The only compliance cost imposed by the change in required use will be the one-time cost of the legal consultation necessary to understand the consequences for affiliated business arrangements. Builders, lenders, and settlement service providers may require additional legal consultation to check whether the discounts that they are offering consumers violate RESPA. The legal compliance costs from the change in required use are treated as a part of the total legal costs described in Section VII of Chapter 6.

The impact on small business of the change in required use is not expected to be proportionally different than the impact of other parts of the rule. The well-known examples of affiliated business arrangements, such as Centex Homes and Pulte Homes, consist of nationwide operations building and financing thousands of single-family homes. However, affiliated business arrangements also include smaller-scale operations: an individual mortgage broker could be an affiliate of a local developer. For this reason, we assume that the share of the transfers resulting from the change in required use is identical to the overall small business share of 49.5 percent.

## **VII. Market Effects: Consumer Shopping and Benefits**

The various market effects of the rule are discussed in this and the next section. This section (VII) describes consumer shopping benefits while the next section (VIII) describes competitive impacts on brokers, lenders, and third-party service providers, with an emphasis on small business impacts. The various changes that HUD is making to the GFE will lead to more effective consumer shopping and better prices of both loan origination services and third-party settlement services, as well as a better consumer understanding of discount points, yield spread premiums, and loan options. Sections A-C briefly summarize the benefits of the rule in the context of the literature review provided in Chapter 2 about problems that consumers face when shopping for mortgages, while Section D examines whether benefits from the rule will be passed through to borrowers. Section E provides quantitative estimates of the consumer savings under the rule.<sup>39</sup>

### **VII.A. Consumer Shopping: Problems and Issues**

Chapter 2 discusses numerous issues important for understanding HUD's objectives with respect to using the new GFE to improve shopping and lower fees. Readers are referred to Chapter 2 for a detailed treatment of those issues. Chapter 2 offers two convincing conclusions: (1) borrowers can find it difficult to comparison shop in today's mortgage market; and (2) borrowers are often overcharged in today's mortgage market.

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<sup>39</sup> Readers not interested in the overview of the shopping and other market benefits of the new GFE may want to proceed directly to Section VII.E, which provides quantitative estimates of the consumer benefits.

The mortgage process can be complex and can involve rather complicated financial trade-offs, which are often not fully and clearly explained to borrowers. Less informed and unsuspecting borrowers are particularly vulnerable in this market. But given the fact that a borrower may be more interested in the main transaction (the home purchase), even more sophisticated borrowers may not shop aggressively for the mortgage or may not monitor the transaction very closely. Price dispersion and price discrimination characterize the mortgage market, which is surprising given that there are more than 40,000 brokers and lenders supplying mortgages in this market (suggesting that a competitive market outcome should be obtained). Most observers believe that the market breakdown occurs in the relationship between the consumer and the loan originator -- the ability of the loan originator to price discriminate among different types of consumers leads to some paying more than others, and to excessive fees being charged to originate a loan.

Staff from the Federal Trade Commission (FTC, 2002) notes that the dispersion of prices in the mortgage market suggests that there could be large savings from more effective consumer shopping. Specifically, FTC staff recognizes the potential benefits of HUD's increasing consumer awareness in the mortgage area: "HUD's characterization of substantial competition on the supply side of the market also suggests that consumers who engage in information search should be able to find competitively priced loan products...." (p. 6). In other words, if consumers could increase and improve their shopping, there are many suppliers of funds (more than 40,000 brokers and lenders) in the market that would compete for their business. Thus, the complexity of the origination process, combined with the fact that consumers have limited experience taking out mortgages, places a premium on having a process that is simple, easy to understand, and clear about the various mortgage options available to the consumer.<sup>40</sup> The current mortgage shopping process is often characterized as confusing and providing little useful information to guide the consumer in making a final decision. The new GFE is intended to remedy this situation.

## **VII.B. The New GFE: Improved Ability to Shop**

The new GFE approach seeks to increase consumer shopping and to improve the quality of consumer shopping. More effective shopping will lead to reductions in the fees charged to borrowers. The earlier sections of this chapter have provided several reasons to believe that shopping will be enhanced by this rule. They are as follows:

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<sup>40</sup> The FTC staff also note that empirical studies indicate (a) that price dispersion is common in retail markets, even markets where entry is relatively easy and economic profits are rare; and (b) that the extent to which consumers shop for low prices helps to explain why some consumers pay less than others. They go on to note that if the mortgage market is characterized by easy entry and little economic profit, then price dispersion in the mortgage market is probably explained by imperfect information and a lack of consumer search. Their insights reflect the situation in today's mortgage market, where consumer shopping is made difficult by the complexity of the mortgage process and the inadequacy of current disclosure rules (such as the existing GFE).

1. The presentation is simpler, with a summary page that provides the essential information. In addition, cost figures are combined into functional categories, so that borrowers are less likely to be overwhelmed by detail.
2. Consumer testing of the GFE form indicates that consumers are comfortable with the clarity of the form and the breakdown of the various cost categories. They can use it to select the cheapest loan.
3. The new GFE with its treatment of yield spread premiums and its trade-off table will increase the shopper's understanding of different interest-rate options and the trade-off involved in accepting a higher interest rate loan (with a yield spread premium) to offset settlement charges, or paying discount points in order to get a lower interest rate loan. Borrowers (particularly less sophisticated and less informed ones) are being overcharged because they do not fully understand these transactions and because originators are not always presenting the full set of options to borrowers.<sup>41</sup> In the consumer testing of the GFE, consumers rated the "trade-off table" as the most useful part of the GFE.
4. The estimates on the GFEs are more reliable which will make it more likely that decisions based on this information will make the borrower better off. This reliability is ensured by changes to the HUD-1 to make it more directly comparable to the GFE, and by the closing script addendum to the HUD-1, which will be prepared by a knowledgeable party (the closing agent) and alert the borrower to deviations from the GFE tolerances.

**Additional Considerations.** But there is an additional effect beyond the benefits realized by the individual borrowers who can shop more effectively. With more borrowers shopping more effectively in the mortgage market, the originator who sought to exploit the badly informed borrower will find fewer victims in the market. Originators whose prime purpose is to engage in such activities will find their efforts rewarded to a smaller extent than prior to this rule since it will be harder and more costly to find victims. Targeting these victims will become a less profitable strategy since fewer of their applicants will take loans with more costly terms. There will be a tendency for these lenders to leave the industry or change their marketing tactics to try and get the borrowers who are more in the mainstream. Other originators who engage in this activity less frequently, only when targets of opportunity present themselves, may find their hit rates falling. They may decide the business lost is not warranted by the gains from above-market offers and abusive lending. In both cases, there will be a reduction in resources used by originators to search for potential victims. This increases the chances that even a poorly informed borrower who could easily become a victim would get more competitive offers when searching for a loan. So shopping has direct benefits to the shopper and indirect benefits to all other borrowers, whether shoppers or not. In either case, there is pressure for prices to fall and the result is transfers from originators to borrowers.

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<sup>41</sup> In addition, there is also the potential for significant gains in information with the trade-off table -- so long as the borrower has had even one originator explain the relationship between the interest rate and net fees, the borrower will be aware of this and expect that any other loan offer would reflect the tradeoff.

The increased ease of shopping will benefit both the prime and subprime markets. In the prime market, the uninformed borrower can be taken advantage of by an aggressive originator who tries to get the borrower to agree to costly terms. The uninformed borrower who does not shop is a potential victim. As mentioned above, the increase in shopping should benefit both those who increase their shopping and have spillover benefits to others by decreasing the likelihood that they will run into an aggressive lender looking for victims.

The subprime market has an additional complication. Most prime borrowers correctly assume their credit status and shop on that assumption. Prime loan information is easy to access in the market and that facilitates comparison shopping. Subprime borrowers have a more difficult time comparison shopping. First, subprime borrowers do not know exactly what their credit status is without going through underwriting. Second, even if they know their credit status as evaluated by one originator, that status could be different with another originator due to a lack of standardized underwriting criteria. So, in today's subprime market, the borrower who wants to comparison shop must go through underwriting for each originator from whom he gets a loan quote. This could be very burdensome for the borrower and deter shopping. Under the new GFE, comparison shopping should be much easier because the loan terms offered on the GFE are based on at least some underwriting. While the cost in time and money may not fall to the level of the prime market, the new GFE is an improvement over the current scheme available in the subprime market.

### **VII.C. The New GFE: Benefits from Tolerances**

The rule includes a zero tolerance on the originator's own fees and an overall 10 percent tolerance in the cases where the lender selects the third-party provider or where the borrower asks for a referral and uses the provider to whom he was referred. Those third-party services that are required by the lender but chosen by the borrower without a referral have no tolerance protection. There is a zero tolerance on government recording fees and transfer taxes.

Chapter 2 explains that it is not clear how closely consumers shop for and monitor third-party costs. Consumers often rely on recommendations for third-party services, but there may not be any incentive for the referring party (the loan originator, real estate agent, etc.) to direct the consumer to the lowest cost provider, and because settlement services may be a secondary consideration to the consumer (rather than the primary one of buying a home), the consumer may not closely monitor settlement costs, much less engage in some intensive search for them. As the FTC staff (2003) concluded, consumers may not obtain low-cost settlement services.

The limited tolerances under the enhanced GFE are intended to improve on today's current practices where consumers rely on referrals that may or may not be in their best interests. The tolerances will lead to well informed market professionals either arranging for the purchase of the settlement services or at least establishing a benchmark that borrowers can use to start their own search. Under either set of circumstances, this should lead to lower prices for borrowers than if the borrowers shopped on their own since the typical borrower's knowledge of the settlement service market is limited, at best. In addition to lower prices, the prices quoted are

likely to be more reliable, without surprises at settlement. The result of tolerances will be lower prices for third-party settlement services.

Tolerances are aimed at controlling third-party fees as well as origination fees. In addition, RESPA reform offers a framework that will encourage competitive negotiations, discount arrangements, and average cost pricing, all of which will lower third-party settlement prices. The discounting arrangements of the new GFE complement the tolerance requirements. Both seek to increase competition in the market for settlement services and to obtain lower settlement costs for the consumers.

#### **VII.D. Obtaining the Benefits through Shopping in a Competitive Mortgage Market**

One issue that underlies much of the RESPA policy discussion is the extent to which there is competition in the mortgage market. The consumer benefits from this rule depend importantly on the various cost reductions being passed through from lenders to consumers. This issue of whether lower costs will be passed through to consumers has been a particularly controversial one -- for that reason, Chapter 2 included an extensive discussion of the competitiveness of the mortgage market. This section briefly highlights competitive issues with respect to the benefits of the new GFE in the subprime as well as the prime part of the market.

Except for the price discrimination issue discussed in Chapter 2 (which concerns the relationship between a mortgage originator and a consumer), the mortgage market is highly competitive, as discussed in Chapter 2. On the industry side, there are many firms that originate mortgages and there seems to be little in the way of significant barriers to entry. The potential for successful collusion among the large number of originators is remote, as it is also among the "mega" wholesale and retail lenders.<sup>42</sup> With these conditions one would expect to see entry and exit until economic profit is zero: firms would earn only normal profit. Thus, there is nothing about the structure of the industry that leads to a breakdown in competition.

On the borrower's side, there are a large number of borrowers and collusion among them is nil. But, as explained in Chapter 2, there is an asymmetry in the information in the hands of some borrowers relative to the lenders: some borrowers are poorly informed and the nature of the information gathering and application process makes some borrowers (even sophisticated ones but surely unsophisticated ones) susceptible to noncompetitive loans. While lenders have good information about the market for mortgages, some borrowers do not. As a result borrowers can wind up with terms above the competitive level. This can happen under two different sets of circumstances. First is the case where firms post prices and borrowers either take them or leave them: there is no individual haggling over terms. A borrower who does not shop and takes the first offer will either be lucky and get competitive terms or be unlucky and get a more costly loan. Borrowers simply taking the first loan without much shopping will most likely pay more.

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<sup>42</sup> As Woodward (2003a) notes, the "wholesale lending market is highly competitive and well informed on both sides" (page 38). Also see LaMalfa (2002) and Joint Center for Housing Studies (2002).

The borrower who shops will get the lowest terms. Even if half the lenders are non-competitive, the borrower who shops as few as three lenders has only a 12.5% chance of getting no competitive offers (.5 to the third power). It is argued that some lower income areas have higher proportions of noncompetitive originators so that a given amount of shopping provides less protection from a noncompetitive offer.<sup>43</sup>

Second is the case of non-posted prices, where each loan is the result of individual negotiation. The extent to which the originator will go in offering high terms is one important factor. The strength of the borrower's negotiation and shopping skills are also important. The unsophisticated borrower who conveys that notion to the originator and who does not shop is at greatest risk here.

Shopping is the borrower's first line defense. But shopping is more difficult for some segments of the market than others. Those borrowers who have "A" credit can shop using the newspaper, phone, Internet, and other easy-to-access sources of information. In a short period of time, the borrower would have a sense of what competitive terms were at any point in time for "A" quality credit. The same is not true for subprime borrowers. There are many gradations of subprime credit and the borrowers are unlikely to know which standard they fit. This is especially true since different lenders would grade borrowers differently even using the same information. The only way to find out is for the borrower to go through complete underwriting. As discussed earlier, that means it is very costly in terms of money and effort for a subprime borrower to shop. That implies less shopping, which in turn implies that it is more likely that a subprime borrower will not get competitive terms for his or her quality of credit, that is, a "B" borrower may get the terms of a "B-minus" loan, or worse.

Another way for the market to break down is through misleading or fraudulent behavior. For a purchase loan, if the truth is discovered before closing, the borrower may have only two choices: take the abusive loan or lose the house. Many would take the abusive loan despite the additional fees. In the case of a refinance, the choices are take the abusive loan, keep the old loan, or negotiate another new loan at current rates. If rates have risen enough since the lock, the borrower may still take the abusive loan with the additional fees since the higher interest rate on a newly negotiated loan could be more costly than the additional fees on the abusive loan, and the abusive loan could still be less costly than the existing loan.

General strategies that are suggested by this analysis are to make it easier for borrowers to shop and to make the numbers they shop with more reliable. This is accomplished with a simpler and easier-to-comprehend GFE, given earlier in the process, with more reliable numbers that are easier to verify. This rule is an attempt to do just that to the maximum extent possible -- to place borrowers in a position so that they can effectively shop for mortgage loans.

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<sup>43</sup> If the probability of finding a bad deal increases from .5 to .6 for any given originator, then shopping with three originators leaves the borrower with a 21.6% (.6 to the third power) chance of a bad deal, which is greater than the 12.5% chance if the probability of a bad deal is .5 for any given originator.

## **VII.E. Estimation of Consumer Benefits from the Rule**

The above sections have outlined two important types of consumer benefits, one associated with improved shopping with the new GFE and one associated with lower costs from tolerances. This section quantifies these benefits by providing estimates of consumer savings, or transfers from originators and third-party settlement service providers to consumers. Estimates of the transfers from small originators and small third-party providers are also provided. The specific steps in deriving the various estimates are numbered below. Steps (1)-(9) in subsection E.1 derive the estimates of consumer savings. Steps (10)-(15) in subsection E.2 derive the estimates of small business revenue impacts. Step (16) in subsection E.3 summarizes the previous steps. And Steps (17)-(25) in subsection E.4 provides several sensitivity analyses examining the effects on consumer savings and small business impacts of alternative assumptions about important parameters (such as the projected savings in third-party costs). The sensitivity analysis allows readers to gauge the range of dollar savings and transfers that are possible with the rule

**Chapter 5: Further Industry Information.** The analysis below disaggregates the sources of consumer savings into the following major categories: originators with a breakdown for brokers and lenders, and third-party providers with a breakdown for the title/settlement industry and other third-party providers. Readers are referred to Chapter 5 for a more detailed examination of the various component industries as well as for the derivations of many of the estimates presented below. Information on individual sectors of the originator and third-party industries can be found in the following sections of Chapter 5:

### **Originators:**

Mortgage Brokers: Section II.

Mortgage Lending -- Commercial Banks, Savings Institutions, Mortgage Banks and Credit Unions: Section III.

### **Third-party Providers:**

Settlement and Title Services -- Direct Title Insurance Carriers, Title Abstract and Settlement Offices, Lawyers, and Escrow Companies: Section IV.

Real Estate Appraisers: Section V.

Surveyors: Section VI.

Pest Inspectors: Section VII.

Credit Bureaus: Section VIII.

Chapter 5 reports data from the Bureau of the Census on each of the component industries listed above -- for example, basic characteristics (number of firms and employees, revenue, payroll, average firm size, etc.) of each industry are provided and estimates of the number of small businesses and their share of industry revenues. Estimated transfers due to the GFE are reported for each of the component industries. For the major industry sectors, such as brokers, lenders, and title and settlement firms, Chapter 5: discusses the nature of the industry; supplements the Bureau of Census data with information from industry and other sources; examines various methodological issues associated with estimating the revenue impacts of the rule; presents methodologies for estimating small business impacts in cases where the Bureau of the Census data are inadequate; presents sensitivity analyses of transfer and small business estimates; where possible, expresses transfer estimates as a percentage of industry revenues.<sup>44</sup> Where necessary for understanding the savings and transfer estimates, information from Chapter 5 is incorporated into the discussion below, particularly in the technical footnotes.

**Nature of Estimates.** Before presenting the estimates, it should be acknowledged that there is uncertainty in this analysis, but this uncertainty is unavoidable, for the simple fact that it is very difficult to predict impacts that depend on a market structure that does not yet exist. Sensitivity of the results to reasonable deviations in key assumptions will be provided, but it is recognized that a new business model is being put in place for mortgage originations. Even though the impact of this rulemaking cannot yet be tested in a market setting, this economic analysis has demonstrated the potential for significant consumer savings with the changes being made. In addition, the economic analysis has demonstrated that the rule has been responsive to legitimate concerns voiced by various segments of the market.

The success of this rulemaking depends critically on three things: the new forms are better shopping tools than today's GFE, the various tolerances associated with the new GFE will lead to a reduction in non-competitive third-party fees, and retail lending is competitive, which means that any cost savings will be passed through to the borrower. Chapter 2 describes considerable evidence that a single mortgage lender has virtually no pricing power in the current borrower market. This means that most settlement cost savings negotiated by lenders will likely be passed through to consumers. Section II of this chapter describes the many rounds of consumer surveys that have shown conclusively that the structure of the new forms is transparent and useful to shoppers. Consumers say the forms are well written, user-friendly, and can assist them in shopping for a mortgage. With the new forms, consumers can identify the cheaper loan in over 90 percent of the cases.

Establishing a GFE form that is a good shopping tool and providing incentives for experts (e.g., lenders) to negotiate price savings for consumers will lead to consumer benefits – this provides a reasonable basis for this rulemaking. Executive Order (EO) 12866 and the Regulatory Flexibility Act (RFA), however, require further analysis. They require that agencies estimate the cost and benefits of their rulemaking, and the impact of their rulemaking on all small entities if the agency does not certify that the rulemaking does not have a substantial effect

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<sup>44</sup> Important background information on these major industries, and particularly brokers, is also provided in Chapter 2. The competitive impacts of RESPA rule on these industries are discussed in Section VII below for the GFE.

on small entities. EO 12866 further specifies that costs and benefits include both quantifiable measures (to the fullest extent that these can be usefully estimated) and qualitative measures that are difficult to quantify but are nevertheless essential to consider. Finally, EO 12866 requires that agencies will propose and adopt a regulation only upon a reasoned determination that the benefits of the intended regulation justify the costs. HUD does conclude that the benefits of this rulemaking justify the costs. Chapter 6 conducts the RFA analysis while Chapter 3 conducts the required 12866 cost-benefit analysis. In order to estimate the actual impacts of the rulemaking. This chapter uses the best available data and analysis to establish the domain of potential savings, and to estimate the actual monetary impacts of better consumer shopping and more aggressive negotiation of third-party fees.

### **VII.E.1 Steps in Deriving the Savings**

**(1) Total Mortgage Volume.** The projections of consumer savings are annual projections that depend on the volume of mortgage originations. Total single-family mortgage origination volume is assumed to be \$2.4 trillion. This is the average 2008 projection for Fannie Mae, Freddie Mac, and the Mortgage Bankers Association of America (MBAA). It assumes a more normal home purchase environment than existed during the 2002-04 period.<sup>45</sup> The refinance rate is projected to be 40 percent, much lower than the approximately 70 percent refinance rate for 2003. Of course, different annual origination volumes can easily be incorporated into this analysis by adjusting the various annual savings estimates based on the origination volume assumed. Step (25) below shows the effects on consumer savings and revenue transfers of higher mortgage origination volumes.

**(2) Mortgage Volume by Originator Type.** As explained in Section III.E of Chapter 2, David Olson (2002, 2005) estimates that brokers, in the broad sense of the term, originated 55-68 percent of mortgages over the past few years.<sup>46</sup> Applying 60 percent to the \$2.4 trillion yields \$1,440 billion for brokers, leaving 40 percent for non-brokers or lenders (\$960 billion). It is assumed that half of the brokers (under Olson's broad definition) are HUD-defined brokers (\$510 billion), leaving \$510 billion in loans originated by non-HUD-defined brokers.

**(3) Total Origination Costs -- Direct and Indirect.** There are varying estimates of the origination fee percentage. Olson (2002) estimated that brokers collect approximately 2 percent of the origination amount as fees and that 45 percent of that comes from yield spread premiums. In his more recent study of the 2004 market, Olson estimated brokers collect approximately 1.71 percent of the origination amount as fees; this study assumes 1.75 percent as the baseline. Olson also estimated that 55 percent of brokers' origination fee income comes from yield spread premiums (Wholesale Access, 2005). However, in his 2003 study of lenders, Olson estimated that only 31 percent of lenders' origination fees came from the yield spread premium (Wholesale

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<sup>45</sup> Freddie Mac projects \$1.856 trillion (36 percent refinance rate) in 2004 and \$1.748 trillion (29 percent refinance rate) in 2005.

<sup>46</sup> As explained in Chapter 2, the broker's share of the origination market has varied recently, from 55 percent in 2000 to 65 percent during the refinance-dominated year of 2002 to 68 percent in 2002.

Access, 2004). Adding (a) the brokers' YSP share (0.553) times the brokers' projected share (0.60) of the market and (b) the lenders' YSP share (0.31) times the lenders' projected share (0.4) of the market yields 0.456 for the weighted average YSP share of total origination charges. Thus, this study assumes 45 percent of origination income is derived through the YSP. Applying these assumptions to the entire market of \$2.4 trillion in originations would yield the following: \$42 billion in total origination fees for brokers and lenders, of which \$18.9 trillion is paid by borrowers indirectly through yield spread premiums and the remaining \$23.1 trillion is paid by borrowers directly through origination charges. HUD has seen different estimates of origination percentages than 1.75 percent.<sup>47</sup> Therefore, Step (21) conducts sensitivity analyses using origination fees of 1.5 percent and 2.00 percent.

**(4) Savings in Origination Costs.** Section IV.D.2 of Chapter 2 presents evidence of the substantial variability in origination fees and broker compensation found in studies by Jackson and Berry (2001), Jackson (2002), Woodward (2003a), the Urban Institute (2008), as well as the analysis of Guttentag (2002). The findings of Jackson, Berry, Woodward, and the Urban Institute present a picture of a market characterized by excessive fees, price dispersion, and price discrimination -- with some borrowers getting market-rate deals but others getting bad deals. Jackson and Berry (2001) found evidence of troubling price dispersion, which suggested to them that brokers used yield spread premiums as a device "to extract unnecessary and excessive payments from unsuspecting borrowers" (p. 9). Findings from the study by Woodward (2003a), which used the same data as Jackson and Berry, confirmed that shopping for a mortgage is not easy, particularly for borrowers attempting more difficult shopping strategies involving a tradeoff of interest rates and points (see below). According to Woodward, less educated borrowers pay an additional \$1,500 in broker fees, compared with more educated borrowers and after controlling for other factors that might affect broker fees. Woodward finds the size of this differential "disheartening" (p. 39). On average, African-Americans pay brokers an additional \$500 and Hispanic borrowers, \$275, compared to other borrowers, after accounting for education and other characteristics.<sup>48</sup>

The increase in good information made available to the borrower by the new GFE should put fees of all originators under more competitive pressure, and given the substantial variability in prices noted above and in Chapter 2, there should be substantial savings from the new GFE and its disclosure requirements. The extent of the savings to borrowers will depend importantly on the effect of the new GFE disclosures concerning alternative interest rate/up-front cost

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<sup>47</sup> The recent Bankrate.com survey reported origination fees of \$3,337, or 1.67 percent of the assumed 200,000 loan. It should also be noted that some have reported origination fees greater than 2.0 percent in home purchase transactions. A table on page 2 of a paper by the Progressive Policy Institute (2003) reports \$3,800 as the "typical cost under the current system" for "mortgage costs", which include the costs associated with loan origination, application processing, and underwriting. Applying the \$3,800 to the assumed \$150,000 purchase price yields 2.53 percent; assuming a 90 percent loan-to-value ratio, the \$3,800 origination fee would represent 2.82 percent of the loan amount (\$135,000). The Progressive Policy Institute does not indicate the source of their data.

<sup>48</sup> Guttentag (2002) reaches similar conclusions to those of Jackson and Berry, Woodward, and the Urban Institute. As explained in Section IV.D.4 of Chapter 2, Guttentag finds a very large dispersion in gross profits per loan, which leads Guttentag to state: "it is clear that brokers take advantage of the inability of borrowers to shop effectively by extracting more from those who can afford to pay more." (p.138). Guttentag emphasizes that consumers don't shop effectively for mortgages.

combinations and the effect of reporting the yield spread premiums and discount points on the GFE form. As discussed in Section II.B of this chapter, the new GFE requires HUD-defined brokers to report both discount points and yield spread premiums derived from the sale price of the loan, which means that borrowers in these transactions will be fully informed of these two amounts. But as also discussed in Sections II.D and III of this chapter, the trade-off table of the new GFE will improve borrower understanding of the financial trade-offs between interest rates and points (discount points and yield spread premiums) and should lead to a better understanding by all borrowers of their loan options. As explained in Section II.F, many rounds of consumer tests demonstrate that consumers can choose the cheapest loan with the new GFE. This increase in comprehension by borrowers should put fees of all originators under more competitive pressure. Notice that this step does not limit the shopping savings to just those consumers who used a HUD-defined broker. Other brokers might not appear any different to the borrower than a HUD-defined broker who uses table funding.

In fact, the only difference to the borrower today is that the broker who does not fit the HUD definition does not even report the yield spread premium as “POC” (paid outside of closing), so that the borrower is even more in the dark on this matter. It could be argued that since these non-HUD brokers still do not have to report any yield-spread premiums, they will be under less pressure to use it to offset closing costs. But under the new GFE approach, any borrower who has had the explanation of the trade-off from any originator, and any borrower who has gone to a HUD-defined-broker and seen the reported yield spread premium and is told where it comes from, should have improved awareness of the yield spread premium principle. So borrowers seeking loans from non-HUD-defined brokers might well be as aggressive as those seeking loans from HUD-defined brokers. In fact, since there is no disclosure at all of yield spread premiums in this portion of the market today, the amount returned might be an even greater portion of any yield spread premiums. Similar comments apply to the remaining lender (or non-broker) part of the market. Again, the borrower may have no idea about the “broker” status of an originator. And the improved awareness effect discussed in this paragraph will apply to all loan originators, not just HUD-defined mortgage brokers.

The remainder of this section describes the method for estimating potential savings in origination costs from this new GFE. A range of estimates will be provided. The following analysis is based on the studies summarized in Section IV.D of Chapter 2. Readers are referred there for background and the details of the various studies.

**Woodward (2003a) Study.** A starting point is the study by Woodward (2003a), which is reviewed in much detail in Chapter 2. Important for the estimations in this section are Woodward's insights about different mortgage shopping strategies of consumers. Woodward classifies the borrower's strategy for paying for closing costs as follows: (1) pay all closing costs, including the broker's fee and possibly additional discount points to reduce the interest rate, in cash, and shop on broker fee, discount points and rate; (2) pay some closing costs with cash, and some with a payment from the lender for a premium interest rate (i.e., yield spread premium); (3) incorporate the entire broker's fee into the rate, pay other closing costs with cash, and shop on rate; and (4) incorporate the broker's fee and some, or even all, closing costs into the rate and search for a loan with the lowest rate (includes (5) and (6) below). According to Woodward, (1) and (2) are the two most difficult. Both of these strategies require skill in evaluating the

rate/point tradeoff. Woodward expects that mortgage brokers will be much better at gauging the rate/point tradeoff on mortgages than consumers are. Brokers have more experience and they have the wholesale lenders' prices in the form of rate sheets, which are not shown to consumers. The straightforward capture of present value in the rate sheets assures that brokers get the trade-off right, according to Woodward.

Thus, borrowers who pay part of their closing costs in cash and pay for the rest with a yield spread premium -- as well as borrowers who pay discount points -- (strategies (1) and (2)) have a more complicated shopping task, because they must have an idea of appropriate compensation for the broker and other settlement providers (like those borrowers who pay all closing costs in cash), but they also must be able to compare rates and points. If they could examine the wholesale lender's rate sheets, which are available to the broker, their task would be easier, but still not easy.<sup>49</sup> Since many shoppers following strategy (1) are trying to reduce monthly payments by paying discount points, they understand the rate/point tradeoff and are likely to be better shoppers, but still face a complicated task.

For the borrower, the simplest transaction to understand is the no points, or no-cost loan. The borrower seeking a no-cost loan can simply shop for the best interest rate (similar to how they shop for a car loan). If a borrower has chosen to shop on the basis of rate, her shopping difficulty is greatly reduced compared to the borrower who is trying to evaluate rate/point tradeoffs. In addition, the borrower's comparative informational disadvantage to the broker is reduced because the broker is not in a position to offer the borrower rate/point choices that lure her towards the mortgage choice with a lower present value for her, but higher value to the broker.

Woodward conducted a regression analysis of broker compensation, which was defined to include both direct origination fees paid to brokers and indirect fees paid the brokers (i.e., yield spread premiums). This regression analysis relates the broker fee negotiated between the borrower and broker to a "borrower's confusion" variable, defined as the ratio of YSP to the broker fee. Woodward identifies the "no-cost" as loans with the YSP/broker fee ratio greater than one. For loans with a ratio greater than one, the YSP is sufficient to cover the broker's fee plus at least some other closing costs as well. Table 3-4 lists the coefficients on the ratio of YSP to Broker Fee in her regression explaining broker compensation.<sup>50</sup>

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<sup>49</sup> Woodward also emphasizes, that in the negotiations between the mortgage broker and borrower over the broker's compensation, the broker has many more advantages than the borrower. The broker has the rate sheets, plus certified financial information about the borrower, but also, the broker has far more practice and skill with the transaction. The broker can use these advantages both to charge consumers direct fees and also to place consumers in high interest rate loans, thus collecting lucrative yield spread premiums from wholesale lenders.

<sup>50</sup> Because the actual ratio can be affected by the difference in interest rates on the date the borrower's rate was locked and the day the loan was sold, few loans in the database have exactly the YSP to Broker Fee ratios shown. Loans are classified according to which ratio they are closest to.

**Table 3-4 Coefficient of Ratio of YSP to Broker Fee**

Shopping Strategy Category Number	Definition	Coefficient
(1)	0.0 Ratio (the par loans and loans where borrowers paid discount points)	-\$617
(2)	0.5 Ratio (maximal rate/point confusion -- most difficult shopping)	+\$68
(3)	1.0 Ratio (where the broker's fee is paid entirely by the lender in the form of a YSP)	-\$847
(4)	1.5 Ratio (where at least some closing costs are rolled into the rate)	-\$1,038
(5)	2.5 Ratio (where nearly all closing costs are rolled into the rate -- easiest shopping)	-\$2,731
(6)	4.0 Ratio (where even more closing costs are rolled into the rate -- also easiest shopping)	-\$2,071

Source: Woodward (2003a)

Obviously, these results show that different groups pay substantially different amounts of origination fees. According to Woodward, her results confirm the relative difficulty of different shopping strategies. The above coefficient values at 1.0, 1.5, 2.5, and 4.0 (groups 3-6) show that that broker fees fall as borrowers roll more and more of their closing costs into the rate and the ratio of YSP to broker fee rises. The loans on which borrowers are struggling hardest to evaluate the rate/point tradeoff (group 2 at ratio = 0.5) have the highest fees – for example, the fees for group 2 are \$915 [(\$68 – (- 847))] more than the fees for group 3 and they are \$685 [\$68 – (-617)] more than the fees for group (1). Again, according to Woodward, borrowers in group (1) pay the broker more because they are pursuing a strategy where the broker's informational advantage is greater -- the highest broker fees are those on which both the borrower and the wholesale lender (by paying a yield spread premium) bring substantial cash to closing.

The objective of RESPA reform is to reduce the above variation in fees and bring the groups paying excessive fees down to those groups paying lower fees – for example, bring the prices paid by group (2) above down to the prices paid by group (3). The test results reported in Section II.F showing that consumers can identify the cheapest loans using the new GFE form suggest that this is possible. In fact, the treatment of YSP in the new GFE and the trade-off table are specifically aimed at those borrowers who have difficulty evaluating the interest-rate-points trade-off – and during the tests conducted, consumers rated the trade-off table as one of the most helpful features of the new form. Thus, one measure of potential savings from the new GFE form would be the savings from moving group (2) closer to the other groups. For example, it may be that the new GFE, by simplifying the fee discussion and including a tradeoff table that is very effective in educating consumers on the point-fee tradeoff, reduces the difference between the loans in Woodward's analysis that require knowledge on the point-fee tradeoff (the group 1 loans) and the otherwise hardest to shop loans that do not require knowledge of a point-fee tradeoff (the group 2 loans). If under RESPA reform, group (2) obtained the results of group (1), the weighted average savings would be \$219 (0.32 times \$685), assuming that group (2)

represented 32 percent (its sample weight) of borrowers. As noted above, further improving the shopping of group (2) so that it matched group (3) would save that group \$915, resulting in average overall savings of \$293 (0.32 times \$915). RESPA reform would also reduce the differential between group (1) and group (3), offering additional savings. And RESPA reform would also improve the shopping of the low-cost groups 3-6, leading to even further savings (this “benchmark effect” is discussed below).

Conducting analyses such as the above provides a basis for estimating potential consumer savings from the new GFE form. If the new GFE resulted in groups (1) and (2) obtaining the results of group (3), there would be a weighted average savings of \$342, representing 14.1 percent of total origination fees.<sup>51</sup> These are the savings in fees that can be obtained even if there are no other shopping improvements (such as moving groups 1 and 2 closer to group 4, or even moving group 3 closer to group 4). It is useful to point out some further adjustments that could be made to this estimate of consumer savings under the new GFE form.

A first issue concerns how representative Woodward’s sample is. In some ways it resembles what one might consider a representative sample – the average origination fee is approximately 2.0 percent and yield spread premiums are 51.5 percent of closing cost – both figures similar to the figures reported by Olson in Step (3) above. This is not unexpected, because the defendant lender in the lawsuit was operating in many markets and competing successfully against many other lenders. Its prices and practices had to be representative of the market in order for it to remain competitive.

In addition, the Defendants sample, which accounts for three-fourths of Woodward’s overall sample, is considered the most random and the most representative of her data. Still, it is unclear whether the weights across the six groups are representative of the nation as a whole or if there are other biases. One means of hedging against biased estimates, as well as being conservative, is to lower the estimated savings by one-half of the coefficient standard errors to account for non-representative (and possible upward bias) of the sample. (Of course, other adjustments could possibly be made.) Doing this reduces the estimated savings to \$309, representing 12.8 percent of origination fees. A further possible adjustment would be to align Woodward’s YSP share of total origination fees (51.5 percent) with that (45 percent) estimated

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<sup>51</sup> Several pieces of information from Woodward’s data were used to make this calculation. The six groups were distributed as follows: (1) 19.9 percent, (2) 32.4 percent, (3) 40.7 percent, (4) 5.6 percent, (5) 1.2 percent, and (6) 0.1 percent. This distribution is based on the 2,009 loans in the so-called Defendant’s sample, which is the more representative of the samples used by Woodward. Woodward’s total sample for the regression analysis was 2,624; Woodward states the additional 600 loans over-weighted par value loans (e.g., group 1 represented 30.1 percent of the overall sample of 2,624, compared with only 19.9 percent of the Defendant’s sample). Whether this sample is under representing group (2), which has only a 32.4 percent share, is an open question. Obviously, groups (5) and (6) have a low weight (only 1.3 percent). Other key data from Woodward that are used in the calculations in this section include the following: \$1,250 average yield spread premium; \$2,425 average broker fees (including both direct and indirect fees); \$4,050 average total closing costs; and \$130,000 average loan amount. The \$342 savings figure in the text was calculated as follows: (a) group 1 differential from group 3 of \$230 times weight (.199) of group 1 yields \$45.78 plus (b) group 2 differential from group 3 of \$915 times weight of group 2 (.324) yields \$296.46 – adding \$45.78 and \$296.46 yields \$342.24. Dividing 342.24 by \$2,425 yields the 14.1 percent reported in the text.

by Olson (see Step 3). Doing this reduces the savings percentage to 11.1 percent. Thus, in this case, the estimated savings from reforming the GFE would range from 11 to 14 percent.

The above analysis ignores the possibility of savings due to an overall improvement in shopping by all groups in the market, an effect that goes beyond the YSP issue. That is, the groups that are getting the best deals in today's market would likely get even better deals with the new shopping form. Thus, savings under the new GFE could be increased by an additional amount, over that noted above. If one added just 2 to 3 percent to the above estimates, the 11 to 14 percent range would increase to 13 to 17 percent. In addition, the 11 to 14 percent range does not take into account other possible improvements, such as moving groups 1 and 2 closer to group 4, which could provide additional savings.

There is a second (and related) methodology that could be used to estimate savings under the new GFE – this is to rely on studies that have directly estimated the average impact of YSPs on consumer costs. As discussed in Chapter 2, different estimates of the impact of yield spread premiums on broker compensation and closing costs have been produced by these studies, with Jackson (2002) concluding that yield spread premiums offset approximately 25 percent of closing costs and Woodward (2002), in an earlier study, concluding, 75 percent. Or conversely, the studies find that from 25 percent (Woodward) to 75 percent (Jackson) of the yield spread premium goes to enhance broker compensation, rather than to reduce consumer costs. As discussed in Chapter 2, estimates by Benson (2001) fall mainly in the 30 to 40 percent range, although Woodward (2002), Jackson (2002), and Jackson and Berry (2001) have done the more extensive work on this issue. Woodward's recent analysis (reviewed above) suggests a larger impact than her initial estimate of 25 percent. Woodward has indicated to HUD staff that her recent view on this issue is that the effect is approximately 38 percent.<sup>52</sup> Under this approach, one would proceed as follows to estimate savings in origination fees from the new GFE. If the features (simpler presentation, summary sheet, YSP calculation, trade-off table, etc.) of the new GFE resulted in savings equal to 25 percent of YSPs (a low-end estimate), then savings in overall origination costs would be 11.2 percent.<sup>53</sup> If the YSP savings is increased (reduced) to 30 percent (20 percent), the overall savings in origination costs is 13.5 percent (9.0 percent). Again, these estimates ignore any savings due the benchmark effect discussed above.

Based on the work of Woodward (2003a), it appears that 14 percent savings in origination fees is a reasonable starting point for examining the benefits of the new GFE; sensitivity analysis will show the effects of an 11 percent savings rate. As discussed above, this

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<sup>52</sup> Some rough calculations from Woodward's recent work suggest the "YSP effect" is larger than her initial estimate of 25 percent. In this case, the "YSP effect" refers to the increase in total origination costs (both direct fees paid by the borrower and the YSP) associated with a one-dollar increase in YSPs. Ideally, one would want to see a zero impact, meaning that the form of financing (cash or YSPs or both) does not affect the total origination costs to the borrower. Based on Woodward's estimates presented in the text, if groups (1) and (2) improved their results to the weighted average of groups (3)-(6), there would be overall savings of 15.7 percent in total origination fees. Using the other regression methodology, a "YSP effect" of 35 percent would yield similar savings relative to total origination fees (direct fees plus YSPs).

<sup>53</sup> This is calculated as follows: percentage savings (25 percent) in YSP times the YSP share of total origination costs (45 percent from step 3) yields 11.2 percent

range of 11 to 14 percent in potential savings is also consistent with the low-end of estimates from those studies that have estimated the average effect of YSPs on origination fees. The recent analysis of FHA data by the Urban Institute also points to the potential for large reductions in origination charges from an improved shopping system. As reported in Chapter 2, that study found that originators (brokers and lenders) substantially overcharged consumers in loans having yield spread premiums.

**(5) Savings in Total Origination Costs: Summary.** Projected savings of 14.0 percent translates into \$5.88 billion<sup>54</sup> of the \$42.0 billion in total origination costs.<sup>55</sup> Again, given improved consumer shopping, increased information about financial trade-offs, improved disclosure of yield spread premiums, and zero tolerance on the originator's direct fees, this 14.0 percent figure is a reasonable amount of savings to expect from the rule, and is probably a conservative estimate. The more conservative case of 11.0 percent savings translates into \$4.62 billion in savings. Findings of non-competitive fees by studies reviewed in Chapter 2, the results of consumer tests showing that the new GFE can be used to identify the cheapest loans, and the analysis in Step (4), support this 11 to 14 percent range in potential savings of origination costs from the new GFE.

**(6) Individual Third-party Fees.** The potential savings on third-party fees would come mostly from the services already ordered by the originator: (a) appraisal, (b) credit report, (c) tax service, (d) flood certificate, (e) pest inspection, (f) survey, and (g) title insurance and settlement agent charges. This economic analysis relied mainly on average cost data from a sample of FHA loans, although different estimates will be examined throughout the discussion and during the sensitivity analysis.<sup>56</sup> The main results are reported in Table 3.1 The following mean values (calculated over all loans even when the particular service is not required and in some cases reporting round numbers for simplicity) are used: (a) \$350 for appraisal, (b) \$25 for credit report, (c) \$70 for tax service, (d) \$15 for the flood certificate, (e) \$26 for pest inspection,<sup>57</sup> (f) \$58 for

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<sup>54</sup> The projected consumer savings can be disaggregated by mortgage channel (see Section III.D of Chapter 2). The \$4.62-\$5.88 billion in potential savings would be distributed as follows: (a) \$1.386-\$1.764 billion from HUD-defined brokers (who account for 30% of the total mortgage market, or one-half of the 60 percent share for the broadly-defined broker market); (b) \$1.386-\$1.764 billion from non-HUD-defined brokers (who also account for 30% of the total mortgage market, or one-half of the 60 percent share for the broadly-defined broker market); and (c) \$1.848-\$2.352 billion for lenders (who account for 40% of the mortgage market).

<sup>55</sup> If origination fees were 1.50 percent (instead of 1.75 percent), then total origination fees would be \$36 billion (instead of \$42.000 billion) and consumer savings in origination fees would be \$5.04 billion (instead of \$5.88 billion). If origination fees were 2.00 percent (instead of 1.75 percent), then total origination fees would be \$48 billion (instead of \$42.000 billion) and consumer savings in origination fees would be \$6.72 billion (instead of \$5.88 billion). See Step (21).

<sup>56</sup> See discussion of the FHA data based in Chapter 2. For an earlier analysis of FHA closing costs, see Office of Policy Development and Research (HUD), "Closing Costs", U.S. Housing Market Conditions, May 2000, pp. 4-8.

<sup>57</sup> In the cases where there was a pest inspection, the average price was \$60; the reduction to \$26 is explained as follows. Only 55 percent of the FHA sample included a pest inspection. The FHA sample included only home purchase loans. It was assumed that refinance loans would require a survey at half the rate as home purchase loans, or 27.5 percent. In the projection year, home purchase loans were assumed to account for 60 percent of all loans and refinance loans, 40 percent of all loans. With these assumptions, the following calculations were made: [0.60 (home purchase rate) times 0.55 (proportion of home purchase loans that need a pest inspection)] plus [0.40 (refinance rate)

survey,<sup>58</sup> and (g) \$1,435 for title insurance and settlement agent charges.<sup>59</sup> <sup>60</sup> Combined, these charges come to \$1,979.<sup>61</sup> The average price of the first six items is \$544 per loan, or 31.5 percent of total third-party fees. The title insurance and settlement agent charges average \$1,435, or 72.5 percent of third-party fees.

**(7) Total Third-party Fees.** From Step (6), the average third-party fee is \$1,979. Multiplying this figure by the number of loans (12,500,000) yields approximately \$24.738

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times 0.275 (proportion of refinance loans that need a pest inspection)], which yields 0.44 as the overall proportion of times a pest inspection is needed. To derive the \$26 in the text, the following additional calculation was made: 0.44 times \$60 equals \$26.40, which is rounded to \$26.

<sup>58</sup> In the cases where there was a survey, the average price was \$200; however, only 48 percent of the sample included a survey. In the projection year, home purchase loans are assumed to account for 60 percent of all loans. Assuming that surveys are mainly completed for home purchase loans, the following calculations were made: 0.60 (home purchase rate) times 0.48 (proportion of home loans that need a survey) times \$200, which yields \$96 in text.

<sup>59</sup> The recent Bankrate.com survey reported the following third-party charges: (a) appraisal -- \$343, (b) credit report -- \$22, (c) tax service -- \$67, (d) flood certificate -- \$14, (e) pest inspection -- \$60, (f) survey -- \$144, and (g) title insurance and settlement agent charges -- \$1,256.

<sup>60</sup> Earlier surveys can also be referenced. A report by the Progressive Policy Institute (2003) reports the following “typical” third-party fees: \$300 for appraisals, \$30 for credit report, and \$1,650 for title and settlement. The Institute combined survey and pest inspections with government taxes and also did not report separate data for flood certification or tax services. The source of the Institute’s data is not stated. Orange Mortgage (ING DIRECT) posted what it labeled “national averages” for third-party fees; they were as follows: \$269 for appraisals, \$37 for credit report, \$22 for flood certification, \$88 for pest inspection, and \$1,099 for title and closing-related work (\$374 for attorney/settlement fee, \$220 for title work, \$460 for title insurance work, and \$45 for postage/courier fees). Again, it is not clear what the source of these data are (the data can be found at [www.home.ingdirect.com/products/mortgage\\_fees\\_popup](http://www.home.ingdirect.com/products/mortgage_fees_popup)). Brian Peart, owner of Nexus Financial Group Inc. and the author of “The RESPA Survival Guide” reports that title charges in 2003 were \$1,000 (1.0 percent) on a \$100,000 refinance loan in Florida; see “Contending with the GMPA,” *Origination News*, July 2003, p. 4. Also see the earlier Bankrate.com data as reported by Holden Lewis, “Closing Costs: Highs, Lows, and Averages,” at Bankrate.com. Lewis reports data from a survey of 306 good faith estimates (6 per state and D.C). He shows averages of \$327 for appraisal, \$29 for credit report, \$17 for flood certification, \$68 for pest inspection, and \$174 for a survey

<sup>61</sup> The average price for all third-party fees in the proposed rule was \$1,583, but that did not include pest inspections (\$18) and surveys (\$66). Including these two latter figures yields \$1,667, and multiplying that figure by 1.045 yields the \$1,742 figure in the text. The average prices used in this economic analysis were increased by 4.5 percent from those used in the proposed rule; this is the 2000 to 2002 total increase in the consumer price index (CPI). Another option would have been to increase the original 1997-based FHA data by the 14.6 percent, which was the percentage increase in the CPI between 1997 and 2003. However, doing that resulted in appraisals being priced at \$331, which was higher than the \$300 reported by the Progressive Policy Institute (2003); also, given the trend toward automated valuation models, the overall weighted average of appraisal costs may be even lower. Using the full 14.6 percent adjustment would have increased title and settlement fees by \$115, from \$1,185 to \$1,300. The effects of different estimates of title fees will be noted.

billion in third-party fees. Third-party fees represent 1.031 percent<sup>62</sup> of total mortgage originations (\$2.4 trillion).<sup>63</sup>

**(8) Third-party Savings.** While there is evidence related to title fees (discussed below), there exists much less data for third-party settlement charges, as compared with the recent analyses of yield spread premiums and origination costs. Thus, there are two complimentary approaches that can be taken for estimating the potential third-party savings from the GSE. One is to analyze the magnitude of the likely impacts of the GFE on third-party fees, drawing from the changes under the GFE and from the analysis of origination fees discussed above – are third-party-fee impacts likely to be of the same order of magnitude as the origination-fee effects. Will the tolerances and other cost-savings opportunities (discounting and average cost pricing) associated with the GFE place competitive pressure on third-party fees, along the same lines as improved consumer shopping with the GFE will place on origination fees? A second and complimentary approach focuses on available information, particularly data from the title industry. Both approaches will be considered here.

Just as origination fees will be lower with shopping under the rule, third-party costs should be lower with shopping. Lenders tell HUD that there is not enough incentive in today's market to negotiate lower prices for third-party services – rather, higher third-party costs are too often simply passed through to the consumer. Sections V and VII.C of this chapter explain how the new GFE with its tolerances will reduce third-party fees. In addition to reducing or eliminating surprises at closing for any charge subject to them, tolerances will lower prices because the originator will be arranging for the third-party service or providing the borrower with a good benchmark from which to begin his own search. Tolerances should lead to more competition among third-party providers, with the result being lower prices for consumers. As discussed in Step (7), third-party fees are projected to be \$24.7 billion. This is the amount that would come under the effects of tolerances, allowing originators to seek out discounts on behalf of borrowers, and the simplified GFE.

There is some evidence that third-party prices can be reduced using techniques such as discounting arrangements and more competitive negotiations. Statements by early users of packaging, for example, can offer some guidance. ABN-AMRO, the first lender to offer one-fee packages, reported average savings in closing costs of \$563 on the first 100,000 loans its OneFee program. ABN-AMRO said OneFee loans were taking 25 percent less time to process. First American rolled out a “single-fee package” that was expected to cut costs to homebuyers by 25 percent. First American's product for lenders was a fixed, discounted-price loan closing

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<sup>62</sup> These costs do not include government fees and taxes and escrow items.

<sup>63</sup> From Step (3), origination costs were estimated to be 1.75 percent of total mortgage originations, or \$42.0 billion. Thus, total settlement costs (origination costs and third-party fees) are estimated to be \$66.738 billion, or 2.78 percent of the mortgage amount. (The \$66.738 billion includes yield spread premiums paid indirectly by the borrower.) If origination fees were 1.50 percent (instead of 1.75 percent), then total settlement costs (origination costs and third-party fees) would be \$60.738 billion, or 2.531 percent of the mortgage amount. If origination fees were 2.00 percent (instead of 1.75 percent), then total settlement costs (origination costs and third-party fees) would be \$72.738 billion, or 3.031 percent of the mortgage amount.

package consisting of appraisal, flood certification, title search and insurance, home warranty policies, credit and settlement services – all obtained from First American subsidiaries.<sup>64</sup> Given the significant shopping and competitive benefits of the new GFE, and the high variability of these costs, it seems reasonable to project that they would lead to at least a decline of 10 percent in third-party fees. Thus, the analysis of third-party savings for the GFE will assume a 10 percent savings, with a sensitivity analysis of 7.5 percent. Savings of 10 percent translates into \$2.47 billion in consumer savings of third-party fees, while savings of 7.5 percent translates into \$1.86 billion of third-party fees. The next section examines additional information on potential savings, with a focus on the title industry, where evidence of excessive fees is most conclusive.

**Title Fees.** Section V.B of Chapter 2 discussed available evidence (both anecdotal and statistical) suggesting that third-party fees, and particularly title and settlement service fees, can be reduced in both refinance and purchase money transactions. Consistent with the discussion above, the material presented in Chapter 2 suggests that tolerances, the encouragement of discounting, average cost pricing, and other shopping benefits of the rule can have a significant impact on third-party costs, but particularly title costs, which is also the largest third-party category. Some of the main points from Chapter 2 are as follows:

- Industry representatives (such as Wells Fargo and Fannie Mae) and consumer advocacy groups (such as the National Community Reinvestment Coalition) believe that title fees are excessive and have been that way for some time. Fannie Mae’s vice president for credit policy, Joe Biegel, also sees a potential for reduced fees. Speaking in reference to title insurance premiums Biegel states, “it’s safe to say that prices, in many respects, are higher than they ought to be.”<sup>65</sup>
- Title and closing costs have been the subject of litigation across the country. Cases in New York claim that title and settlement service providers overcharge refinancing borrowers by charging them standard rates, rather than the lower reissue rates.<sup>66</sup> State and local officials from California reached a settlement with title insurers and their affiliates in a case concerning deceptive business practices. The California case was based on a Consumers Union survey that found evidence that borrowers were paying too much for title insurance when they refinance their homes. Norma Garcia, a senior attorney for Consumers Union’s West Coast Regional Office declared, “Californians are

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<sup>64</sup> Statement by Landon Taylor, Vice President at First American. Taylor also says “There would be no eleventh-hour surprises on settlement costs for these home buyers.” See “Help Is Coming for Buyers With Little Credit History,” *Washington Post*, October 25, 2003, p. F01 (story written by Ken Harney).

<sup>65</sup> Ruth Simon, *Wall Street Journal*, December 18, 2002, p. 1. In addition, Forbes magazine has taken the editorial position that the title insurance industry is a “racket” and a “cartel.” Ira Carnahan, *Forbes Magazine*, September 2, 2002. In its analysis of the title industry, Standard and Poor’s concluded that HUD’s 2002 proposed RESPA rule “could place downward pressure on title rates.” Standard and Poor’s, *Industry Report Card: U.S. Mortgage and Title Insurers*, 2003, page 2.

<sup>66</sup> The idea behind discounted reissue rates for title insurance on a refinancing is that there may be no need to pay the full price for a complete title search on a property that had received a complete title search a few years earlier as part of the initial home purchase or an earlier refinancing.

paying too much for title insurance. We believe the high cost of a refinance title insurance policy would be substantially lower if there were more competition in the industry.”<sup>67</sup> As a result of the Consumers Union survey, the California Attorney General reached a \$50 million settlement against six major title companies and their affiliates, charging them with deceiving Californians with hidden fees and costs while providing routine residential escrow.<sup>68</sup>

- Title and closing costs have been the subject of investigation and litigation across the country by HUD as well as by the courts. HUD and state regulatory agencies have initiated many investigations identifying allegedly illegal activities in which realtors, lenders and builders have been compensated for consumer referrals to title agencies in apparent violation of provisions of RESPA. As explained in Chapter 2, HUD has identified and addressed a number of illegal activities related to the marketing and sale of title insurance.
- Chapter 2 provides additional discussion of reissue rates, which are the discounts off standard premiums charged on title insurance policies. An article by Ken Harney<sup>69</sup> reported that while the discounts vary from State to State and from title insurer to title insurer, they average 50-60 percent.<sup>70</sup> While reissue rates are normally available on refinancings, in some areas they can be obtained on home resales where a title search was performed relatively recently. Harney’s article focused on the fact that this concept of discount pricing is not widely known to consumers nor is it widely promoted by the industry. Harney quotes James R. Maher of the American Land Title Association (ALTA) as saying he is aware that “not all of our [ALTA] members disclose” the existence of reissue rate discounts. Harney also notes that while some mortgage brokers routinely ask the title or closing agent for reissue rates on refinancings, others admit that unless an applicant asks, they don’t mention the reissue rate option. With respect to title agents or closing attorneys disclosing reissue rates, some do but there are financial incentives against them doing so. This is because the title agent or attorney receives most of the insurance premium back from the insurance company; thus, the smaller the premium that is charged for the insurance coverage, the smaller the compensation to the title agency or settlement attorney. Harney quotes Maher as saying the average national “split” of the premium charged at closings is 70-72 percent to the title or settlement agency, and the balance to the title insurance company. The splits go as high as 92.5 percent to the agent or attorney and just 7.5 percent for insurance, according to Maher.

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<sup>67</sup> Norma Garcia, Consumers Union news release, April 2, 2003.

<sup>68</sup> Office of the Attorney General, State of California, Press Release dated October 8, 2002.

<sup>69</sup> See Kenneth R. Harney, “How to Save 50 to 60 Percent on Title Insurance When Refinancing,” *Realty Times*, June 17, 2002.

<sup>70</sup> According to Mike Finnerman, a senior title officer with the American Title Company, deeply discounted reissue rates are usually available on refinances, typically ranging from 30-50 percent of the normal premium fee. Finnerman also notes “these discount opportunities seem to be a deep, dark secret in today’s marketplace.” See “Trimming the Cost of Title Insurance,” *South Coast Today: The Standard Times*, June 29, 2002, page T3.

Title insurance company financial statements suggest the split averages about 80 percent to agents, 20 percent to the insurance companies.

- Chapter 2 discusses an alternative title insurance product (Radian Lien Protection or RLP) that had the potential to reduce the costs of title insurance; estimates of fifty percent savings on title insurance for refinancing borrowers are provided (ranging from \$275-\$600). Although RLP was disallowed, the fact that one of the major title insurers (Fidelity National Financial) considered offering a low-price product similar to RLP suggested that when confronted with the possibility of competition title insurers can indeed lower their prices.
- Wholesale Access Mortgage Research & Consulting, Inc. also sees a potential for savings in title fees. In their letter commenting on the 2002 rule, they write: “Perhaps total savings might be as much as \$5 billion, but that assumes states allow average pricing of title insurance.”<sup>71</sup>
- An article "Cutting A Better Title Deal: Money-Back Settlement Programs Put Cash in Buyers' Pockets" by Kenneth R. Harney<sup>72</sup> provided support that title and settlement fees can be excessive and in many cases reduced, by as much as \$525-\$1,525 in the Washington, D.C. area. The article explored the "little-publicized joint venture arrangements between real estate brokerage companies and title insurance agencies." According to Harney, these joint ventures funnel hundreds, and sometimes thousands, of dollars from homebuyers' settlement fees (e.g. fees purportedly for title insurance) back to subsidiary companies formed by large real estate brokerage firms. Industry executives say that consumers rarely understand that their payments are flowing back to the realty company. One executive stated that as a general rule, "a substantial percentage" of the title premium paid by consumers at real estate settlements often goes to the title agency or settlement company performing the closing, but the title agents may have joint venture arrangements with large real estate brokerage firms, and share the total fees generated by every client with those firms. Under the arrangements described in the article, the bulk of title insurance premiums are often paid to the title agency that does the closing with only a fraction to the title insurance company for actual insurance coverage against title problems. Harney reported that industry officials say that title agents can receive 70-85 percent of the title premium, depending upon the amount of business the agents direct to a specific title insurance underwriter. Those same title agents may have joint venture arrangements with large real estate brokerage firms and shares with the real estate brokers the total fees generated by every client the firm brings in for a settlement

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<sup>71</sup> See comments from Tom LaMalfa and David Olson, Wholesale Access Mortgage Research & Consulting, Inc., to Rules Docket Clerk, HUD, regarding “Proposed Rule on Real Estate Settlement Procedures Act (RESPA); Simplifying and Improving the Process of Obtaining Mortgages To Reduce Settlement Costs to Consumers; Docket No. FR-4727-P-01; 67 Fed. Reg. 49134 (July 29, 2002),” September 30, 2002.

<sup>72</sup> Kenneth R. Harney, "Cutting a Better Title Deal: Money-Back Settlement Programs Put Cash In Buyers' Pockets," *The Washington Post*, January 24, 2004, p. F01.

transaction.<sup>73</sup> Jerry Boucher, president of Monarch Title, says his firm avoids such deals with real estate firms, but he reports a case of a settlement company paying a brokerage \$800 to \$1,000 per transaction.

- The lenders involved in the programs mentioned in the Harney article provide some insights into the types of cost savings that can result from volume-based discounting. According to Harney, the lenders in these programs appear to be "bundling" -- appraisals, credit reports, flood certifications, process and origination charges -- into a guaranteed cost package. The title firms taking part appear to be cutting their own net fees in exchange for expected higher volumes of business from individual buyers and their realty agents. Larry Pratt, president and chief executive of First Savings Mortgage said there are two separate levels of cost reductions built into his firm's program: First Savings is reducing or putting lids on cost items such as appraisals, credit reports and other origination services, and then guaranteeing home buyers that the costs will not exceed a specific amount at settlement. A second level of savings is the lower total fee for title and settlement services by virtue of not having to split the money with a real estate broker via an affiliated business relationship.
- An article on the practice of lenders creating vendor management companies as subsidiaries expressed similar sentiments about the title industry as the Harney article (Shenn, 2004a). A big reason vendor management subsidiaries have been lucrative for their lenders is that they are created as title agencies; Shenn (2004a) notes that "title premiums, which often are set by states, are among the most expensive pieces of the settlement pie, and are often split on a negotiated basis between title agents and insurers." In these cases, Terry Wakefield, president of a Wisconsin consulting firm, notes that "the ability to make some extra money on each loan as a title agent is a big benefit"(Shenn, 2004a).
- Evidence from a variety of sources indicates title and settlement service fees vary widely within specific geographic areas, suggesting some consumers are paying too much. Analysis of Consumers Union survey data (see above) suggests that settlement and title service fees can be significantly reduced. The Consumers Union data indicate the fees quoted by escrow agents vary widely for the same sized loan within metropolitan areas. For example, quoted fees for title insurance and all other settlement related expenses for a \$250,000 refinancing in the Los Angeles metropolitan area ranged from \$1,000 to \$1,590, placing the highest price quote almost 60 percent higher than the lowest price quote. The average quoted price in the Los Angeles area was \$1,286, or 28.6 percent greater than the lowest quoted price. The percentage difference between the highest (average) and lowest quoted price was 60 percent (26 percent) in Fresno, 30 percent

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<sup>73</sup> Harney outlined two new industry products in the Washington, D.C. area that purport to reduce overall settlement and title costs by: (1) reducing costs for items such as appraisals, credit reports and other origination services; and (2) avoiding joint venture arrangements under which title fees are paid back to the brokerage or real estate firms' subsidiaries. These programs also provide some insights into the types of cost savings that can result from packaging. The lenders in these programs appear to be "bundling" fixed or discount-cost loan fees -- appraisals, credit reports, flood certifications, process and origination charges -- into a guaranteed cost package.

(16 percent) in Sacramento, 24 percent (12 percent) in San Francisco, and 24 percent (10 percent) in San Diego.

- Data on title and settlement fees analyzed by Woodward (2003b) indicated substantial dispersion in fees, suggesting the feasibility of significant savings.<sup>74</sup> In her sample, the cost of title insurance averaged \$910 with a standard deviation of \$550, an enormous amount of variability. Woodward also finds that the total *amount* of title charges increases with the *number* of separate title charge line items.
- Analyses by the Urban Institute (2008) and HUD of title and settlement fees charged FHA borrowers showed substantial variation in these fees, both across and within states and metropolitan areas. Title and settlement fees also exhibited wide variation within states and metropolitan areas for the same loan amount. The metropolitan area charts in the Appendix B to Chapter 2 show clearly how much title fees vary within an area for the same mortgage amounts. As explained in Chapter 2, this study of FHA closing costs represents the first major study of these fees, and the results show that they vary all over the place.
- The recent report by the GAO and the academic literature review of the title industry provided in Chapter 2 both paint the same picture of an industry characterized by non-competitive conditions and one where it is difficult for consumers to shop for the lowest price.

In addition to the more comprehensive analysis described earlier that projects 7.5 to 10 percent savings in third-party fees, the analysis will also be conducted assuming that savings from the rule occur only in the title industry. As indicated above, there is much more evidence available on the potential for cost reductions in the title and settlement industry than in the other third-party industries, and the title and settlement industry accounts for 72.5 percent of third-party fees. While estimates of potential cost reductions vary, a \$400-\$500 range appears feasible to some observers; savings of this magnitude translate into at least 25 percent savings.

Based on the above data and industry information, this chapter projects savings in title and settlement fees from the GFE of \$200. Therefore, under the “title approach”, title and settlement savings from the new GFE are projected to be \$200 with sensitivity analysis conducted for savings of \$150. There are no additional cost savings from the other industries under this approach. Thus, under this approach, total third-party savings are \$200, or \$2.50 billion, assuming 12,500,000 in loan originations, with sensitivity analysis at \$150 savings per origination, or \$1.875 billion in total.

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<sup>74</sup> In addition, a 1996 Media General surveyed 489 settlement service providers in Virginia and found that attorneys who acted as settlement agents charged 65 percent more than non-attorneys for the same service. See Media General, *Residential Real Estate Closing Cost Survey*, September 1996.

The other industry with a significant closing revenue share is the appraisal industry, which accounts for 17.7 percent of third-party fees. Thus, together, the title and appraisal industries account for most (90.2 percent) of third-party fees. As part of sensitivity analysis, potential cost savings are also provided for the appraisal industry as well. It is recognized there is not as much evidence of non-competitive prices in this industry, but competitive pressure under tolerances, discounting, and average cost pricing will lead to pressure to all costs. The variability in appraisal prices was noted by Timothy Schools, who heads National Commerce Financial Corp.'s vendor management subsidiary. His company found that appraisals ordered by 10 different employees at one of its bank branches ranged in cost from \$150 to \$350 -- all from the same appraiser.<sup>75</sup> Schools was noting the advantages of more centralized ordering of third-party services. Vendor management is designed to eliminate such wide dispersions in pricing. According to Mr. Schools, by centralizing the ordering of a portion of its settlement services, National Commerce has found \$7 million a year in savings from improved efficiency and negotiated discounts (Shenn, 2004a). Thus, the competitive pressure to reduce all third-party fees may involve many avenues, for example, discount arrangements, more aggressive negotiation of fees, originators examining their practices to ensure consistency in appraisal changes (see above example), and even larger use of automated valuation models. Sensitivity analysis showing the effects of \$35 dollars in appraisal savings will be presented below.

The more comprehensive approach (7.5-10 percent savings) incorporates the remaining third-party industries (e.g., pest, survey) into the analysis. One reason for considering the remaining third-party industries is to allow a complete analysis of the impacts on small businesses – many of the firms in these industries are small businesses and, even though it is difficult to estimate the impact on them, there will be pressure to reduce all third-party costs under the new GFE tolerances and discounting provisions of the rule. While evidence of non-competitive prices is not available in these industries, they will be subject to the more aggressive shopping by originators for their services. This should lead to reductions in prices. As noted earlier, under this more comprehensive approach, third-party prices are projected to decline by 10 percent, saving borrowers \$2.47 billion (of the \$24.738 billion in third-party fees). Sensitivity analysis will show the effects of a 7.5 percent reduction in prices, which translates to savings of \$1.86 billion in third-party fees. This 7.5 to 10.0 percent range in savings could be a conservative projection -- the new GFE could lead to a greater than 10 percent reduction in third-party fees.

**(9) Total Dollar Savings for the Consumer from the Enhanced GFE.** Under the title approach, total estimated price reduction to borrowers comes to \$8.38 billion, or 12.6 percent of the \$66.74 billion in total charges (i.e., origination fees, appraisal, credit report, tax service, flood certificate, pest inspection, survey, and title insurance and settlement agent charges).<sup>76</sup> Under the more comprehensive approach, projected savings are similar at \$8.35 billion, or 12.5 percent of

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<sup>75</sup> Flood determinations ranged from \$6 to \$25.

<sup>76</sup> The exact consumer savings figure is \$6.696 billion, consisting of \$4.760 billion in savings of origination charges (including yield spread premium savings) and \$1.936 billion in savings of third-party fees. Dividing this figure (\$6.696 billion) by total origination and third-party fees (\$53.356 billion) yields 12.5 percent.

all fees. Thus, there is an estimated approximately \$8.4 billion in transfers from firms to borrowers from more and better shopping with the improved GFE, from a better understanding by consumers of financial trade-offs and yield spread premiums, from the price-reducing effects of tolerances on both originator and third-party fees, from cost-reducing discount arrangements between originators and third-party providers, and from average cost pricing. The \$8.4 billion figure (representing about 12.5 percent of total charges) is a reasonable if not conservative estimate of consumer savings. Still, sensitivity analyses with lower savings are conducted; for example, one scenario projects \$6.5 billion in consumer savings, representing 9.7 percent of total charges.

### **VII.E.2. Steps in Deriving the Small Business Transfer Estimates**

While results from the title approach will be presented, the small business discussion will initially focus on the comprehensive approach, as that shows a wider range of small business impacts.

**(10) Dollar Transfers to Consumers from Major Providers.** Of the \$8.35 billion in consumer savings, originators contribute \$5.88 billion of this (see Step 5) and third-party settlement service providers, \$2.47 billion (see Step 8). [Under the title approach, the figures would be practically the same -- \$8.38 billion, \$5.88 billion (exactly the same since originators are treated the same under the two approaches to cost savings), and \$2.50 billion, respectively. However, as discussed below, the small business share does significantly differ under the title approach.]

**(11) Dollar Transfers to Consumers from Originator Groups.** As explained in Step (2), it is estimated that approximately 60 percent of mortgages will be originated by brokers (in a broad sense of the term), leaving 40 percent to be originated by lenders. This analysis assumes that total origination charges (i.e., direct origination fees and yield spread premiums) are distributed in a similar manner as mortgage origination activity. Thus, \$25.2 billion of the \$42.0 billion in total origination charges is due to brokers and the remaining \$16.8 billion is due to lenders. The transfers to consumers are distributed similarly, which means that \$3.53 billion of the \$5.88 billion in consumer savings comes from brokers and the remaining \$2.35 billion comes from lenders.

**(12) Dollar Transfers to Consumers from Third-Party Groups.** The \$2.47 billion in third-party savings can also be distributed among the various third-party providers (under the comprehensive approach). Based on the average third-party fees for each individual provider from Step (6), the \$1,979 in total third-party fees is distributed as follows: (a) 17.7 percent for appraisal, (b) 1.3 percent for credit reporting, (c) 3.5 percent for tax service, (d) 0.8 percent for the flood certificate, (e) 1.3 percent for pest inspection, (f) 2.9 percent survey, and (g) 72.5 percent for title insurance and settlement agent charges. These percentages indicate the distribution of revenues among the third-party providers. It is assumed that transfers to consumers (or consumer savings) are distributed among third-party industries according to these

revenue shares.<sup>77</sup> Thus, to obtain transfers to consumers from specific third-party industries, one multiplies the \$2.474 billion in transfers by the just-listed revenue shares, which yields the following: (a) \$438 million for appraisal, (b) \$31 million for credit reporting, (c) \$88 million for tax service, (d) \$19 million for the flood certificate, (e) \$33 million for pest inspection, (f) \$73 million survey, and (g) \$1,794 million for title insurance and settlement agent charges. These figures highlight that the largest source of consumer savings is the title insurance and settlement industry, which would experience a \$1.794 billion reduction in revenue. Under the title approach, \$2,500 million, or 100 percent, of the savings is drawn from the title industry. A related approach assumes savings (totaling \$440 million) would also come from the second largest third-party industry, the appraisal industry.

**(13) Small Business Revenue Impacts: Originators.** Step (11) reported that \$3.53 billion of the \$5.88 billion in consumer savings in originator costs came from brokers. Section II of Chapter 5 reports that approximately 70 percent of broker revenues are due to small brokers (as defined by the Small Business Administration). Thus, small brokers account for \$2.47 billion of the \$3.53 billion in consumer savings that comes from brokers. The remaining \$2.35 billion of the \$5.88 billion comes from lenders (non-brokers), which include commercial banks, savings institutions, and mortgage banks. In addition, the small percentage of loans originated by credit unions is included with the lender category.<sup>78</sup> The share of revenue due to small lenders is estimated to be 23 percent<sup>79</sup>; but, as explained in Section III of Chapter 5, there is some uncertainty around this estimate so sensitivity analyses are provided below (varying the small lender percentage from 20 percent to 26 percent). Readers are referred to Chapter 5 for a detailed discussion of the estimation of the small business percentage and for an analysis of the

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<sup>77</sup> For the non-title industries in the comprehensive (base) approach, this is a practical assumption. Otherwise, one would have to hypothesize that the shopping and tolerance features of the GFE would have differential impacts on the various non-title industries, or that the various industries currently have different propensities to overcharge consumers. It may be the case that an activity (say the flood determination) will not be as affected by the new GFE as other industries; however, an activity such as flood determination is such a small percentage of the new overall costs that the more practical assumption used here should not distort the results in any significant manner. Thus, this practical assumption is also likely a reasonable one. The title approach takes the opposite perspective – that, based on available evidence, most of the potential savings will come from title and settlement firms, not the other industries where there is less evidence of non-competitive prices. In some of the sensitivity analyses of the title approach, the appraisal industry is included in order to account for most of the third-party industry. The appraisal industry has only a small impact on the results; and the data for the appraisal industry will be presented separately, allowing it to be excluded from the title approach if the reader thinks it should be.

<sup>78</sup> Section III of Chapter 5: (a) describes difficulties in estimating the small business percentage for lenders; (b) explains the reasons sensitivity analyses are needed due to the uncertainty with the estimates; (c) presents and critiques the estimates of small lender revenue from the Bureau of Census data; (d) estimates the number of banks, thrifts, mortgage banks, and credit unions affected by the RESPA rule; (e) explains the HMDA-based methodology used to derive the small business share of lender revenues; (f) allocates (with some uncertainty) the lender transfers and small lender transfers among the various lender groups; and (f) expresses the bank and thrift transfers as a percentage of bank and thrift revenues. If the small business percentage for lenders had been based on the Census data, it would have been lower (see Chapter 5). The economic analysis of the proposed rule, which relied heavily on the Census data, assumed that small lenders accounted for 12 percent of lender revenues. This analysis projects the small lender share to be 20 to 26 percent, with the base case being 23 percent (or 22.8 percent to be exact, as discussed in Chapter 5).

<sup>79</sup> The analysis uses 22.8 percent, for reasons discussed in Chapter 5.

transfers among the various lender groups. Compared with the broker market, small businesses account for a much smaller share of the lender market. Small lenders account for \$0.54 billion of the \$2.35 billion in consumer savings that comes from lenders. Combining the small business figure for brokers (\$2.47 billion) with that for lenders (\$0.54 billion) yields \$3.01 billion for transfers by small originators to consumers. Thus, small originators account for 51.1 percent (\$3.01 billion of \$5.88 billion) of the transfers that are going from loan originators to consumers. The 70 percent figure from Chapter 5 is based on more complete data for non-employer broker firms, so it is probably the more accurate figure; however, the sensitivity analysis in Step (24) below will consider estimates higher than 70 percent. As explained in Section III of Chapter 5, the 23 percent figure for the revenue percentage of small lenders used here incorporates additional data from HMDA and other sources, and more systematically incorporates bank and thrift data into the analysis. Along with the 20 to 26 percent range examined below, the 23 percent base case could be too high, but that seems more appropriate than having a low estimate of the small lender share.

**(14) Small Business Revenue Impacts: Third-Party Providers.** Step (12) reported the distribution of the \$2.47 billion in third-party transfers to consumers by industry; for convenience it is reproduced here as follows: (a) \$438 million for appraisal, (b) \$31 million for credit reporting, (c) \$88 million for tax service, (d) \$19 million for the flood certificate, (e) \$33 million for pest inspection, (f) \$73 million survey, and (g) \$1,794 million for title insurance and settlement agent charges. Using data from Chapter 5, the share of each industry's revenue that goes to small businesses is estimated to be the following: (a) 83.1 percent for appraisal, (b) 10.5 percent for credit reporting, (c) 0.0 percent for tax service,<sup>80</sup> (d) 0.0 percent for flood insurance, (e) 53.9 percent for pest inspection, (f) 81.3 percent for survey, and (g) 38.1 percent for title insurance and settlement agent charges. For each industry, multiplying the transfer amount by the small business percentage yields the following transfers from small businesses: (a) \$364 million for appraisal, (b) \$3 million for credit reporting, (c) \$0.0 for tax service, (d) \$0.0 for flood insurance, (e) \$18 million for pest inspection, (f) \$59 million for survey, and (g) \$683 million for title insurance and settlement agent charges.<sup>81</sup> Combined, small businesses account

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<sup>80</sup> There are basically three large tax service companies in the country and the tax service companies do at least some of the flood determinations. Similar to the economic analysis of the proposed rule, tax services and flood certifications are assumed to be done by large businesses.

<sup>81</sup> As explained in Chapter 5, the title and settlement industry has four components, with varying small business shares: (a) Direct Title Insurance Carriers (4.8 percent); (b) Title Abstract and Settlement Offices (49.8 percent); (c) Offices of Lawyers (47.8 percent); and (d) Other Activities Related to Real Estate (86.9 percent). To obtain an overall small business percentage, one has to weigh the relative importance of these four industries, which is particularly difficult given that single-family real estate activities may represent a small percentage of an industry such as (c), and that the single-family-real-estate-related firms in such an industry may have a different small business make-up than the other firms in that industry. There is also the problem of the double counting of title insurance commissions, rendering it difficult to estimate the revenue of Direct Title Insurance Carriers. Because Direct Title Insurance Carriers (DTIC) industry is dominated by large businesses, their treatment in the analysis can significantly affect the overall small business percentage for the title and settlement industry. The reader is referred to Chapter 5 for a detailed discussion of these issues. Section IV of Chapter 5: (1) explains the difficulties in estimating the share of industry revenues going to large insurers (i.e., the DTIC sector); (2) presents several sensitivity analyses of the small business share of the settlement and tile industry, depending different revenue projections of the DTIC sector and different splits in revenues among the remaining sectors, **b**, **c**, and **d**; (3) presents estimates of the number of small title and settlement firms based on the Bureau of Census data; (4) allocates transfers due to the GFE among the various industry sectors and their small business components; and (5) expresses

for \$1.127 billion of the \$2.474 billion in third-party transfers, or 45.5 percent of all third-party transfers. Again, the dominant industry is the title insurance and settlement industry, which contributes 62 percent (\$0.683 billion of \$1.127 billion) of the transfers from small businesses. As noted above, small businesses account for 38.1 percent of the revenue of the title insurance and settlement industry.<sup>82</sup> This percentage, which is the subject of much analysis in Chapter 5, depends importantly on the role assigned to large title insurers, or the Direct Title Insurance Carriers (DTIC) industry. A smaller (larger) share for the DTIC sector of the settlement and title industry increases (reduces) the small business share for the overall title and settlement industry. Section IV of Chapter 5 conducts several sensitivity analyses examining different revenue shares for large insurers; these analyses suggest that the small business share of the overall title and settlement industry could vary from 34 percent to 43 percent. Therefore, in addition to the 38.1 percent used above, additional analyses will be conducted later assuming these alternative small business shares for the title and insurance industry.

**(15) Small Business Revenue Impacts: Combined.** From Step (13), small originators account for \$3.01 billion of \$5.88 billion in transfers from loan originators to consumers. From Step (14), small third-party providers account for \$1.13 billion of \$2.47 billion in transfers from third-party providers to consumers. Thus, in total, small businesses account for \$4.13 billion of \$8.35 billion in transfers from originators and third-party providers to consumers. In percentage terms, small businesses account for 49.5 percent of all transfers.

### VII.E.3. Summary of Above Steps

**(16) Summary of (1)-(15).** The estimated price reduction to borrowers comes to \$8.35 billion, or 12.5 percent of the \$66.7 billion in total charges (i.e., origination fees, appraisal, credit report, tax service and flood certificate and title insurance and settlement agent charges). Thus, there is an estimated \$8.35 billion in transfers from firms to borrowers from the improved disclosures and tolerances of the new GFE. Originators contribute \$5.88 billion of this and third-party settlement service providers, \$2.47 billion. It is estimated that \$4.13 billion of the \$8.35 billion comes from small businesses -- \$3.01 billion from small originators and \$1.13 from small settlement service providers. Sensitivity analyses will be presented below that focus, among other things, on the results for the approach where most of the consumer savings comes from the title industry, and for the base approach with a smaller rate of consumer savings.

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the transfers as a percentage of industry revenues and small business revenue. Also see next two footnotes for more details of the analysis of the title and settlement industry.

<sup>82</sup> The base case in Chapter 5 that produces the 38.1 percent estimate is represented by the following three sets of industry shares (listed first) and small business percentages (in parentheses): (a) 43 percent for DTIC (4.8 percent); (b) 38.0 percent for Title Abstract and Settlement Offices (49.8 percent); and (c) 19.0 percent for a combined lawyers-escrow sector (90 percent). Combining these industry shares and small business percentages gives the overall small business percentage of 38.1 percent for sector (g), the title and settlement industry. Because of the uncertainty surrounding these estimates, Chapter 5 conducts sensitivity analyses varying the DTIC share and the split between (b) and (c). These analyses suggest that the overall small business percentage could vary from 34 percent to 43 percent.

#### VII.E.4. Sensitivity Analyses

This section provides several sensitivity analyses examining the effects on consumer savings and small business impacts of alternative assumptions about important parameters, such as the projected savings in originator and third-party costs. This analysis allows readers to gauge the range of dollar savings and transfers that are possible with the new GFE.

**(17) Base Case.** The above steps for the comprehensive approach will be called the “base case.” The base case, which is taken from the above summary in Step (16), can be characterized by the following key figures:

	<u>Consumer Savings</u>	<u>Small Business</u>
<b>Origination Services</b>	<b>\$5.88</b>	<b>\$3.01</b>
a. Brokers	3.53	2.47
b. Lenders	2.35	0.54
<b>Third-party Services</b>	<b>2.47</b>	<b>1.13</b>
c. Title and Closing	1.79	0.68
d. Other Third-party	0.68	0.44
<b>Total Settlement (\$ billion)</b>	<b>8.35</b>	<b>4.13</b>

There are \$8.35 billion in consumer savings representing 12.5 percent of the \$66.7 billion of projected settlement costs. \$4.13 billion of the transfers to consumers are projected to come from small businesses, with small originators contributing \$3.01 billion and small third-party firms, \$1.13 billion.<sup>83</sup> Within the small originator group, most of the transfers to consumers come from small brokers (\$3.01 billion, or 83 percent); this is because small firms account for most of broker revenues but for only a small percentage of lender revenues. Within the small third-party group, most of the transfers come from title and closing agents (\$0.68 billion, or 60 percent); this is mainly because the title and closing industry accounts for most third-party fees.

**(18) Results for Title Approach.** As explained in Step (8), one approach for estimating consumer savings under RESPA reform focuses on the title industry, as there is much more evidence available on the potential for cost reductions in the title and settlement industry than in the other third-party industries. Savings of \$200 per loan are projected for title costs. The aggregate dollar effects are as follows:

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<sup>83</sup> The small business share of transfers to consumers is somewhat smaller in this economic analysis compared with the economic analysis of the proposed rule (49.5 percent versus 55.6 percent). Steps (13)-(15) explain reasons for the lower small business share.

	<u>Consumer Savings</u>	<u>Small Business</u>
<b>Origination Services</b>	<b>\$5.88</b>	<b>\$3.01</b>
a. Brokers	3.53	2.47
b. Lenders	2.35	0.54
<b>Third-party Services</b>	<b>2.50</b>	<b>0.95</b>
c. Title and Closing	2.50	0.95
d. Other Third-party	0.00	0.00
<b>Total Settlement (\$ billion)</b>	<b>8.38</b>	<b>3.96</b>

In the title approach, the title industry accounts for \$2,500 million of the transfers. In this case, small title companies account for \$952 million (38.1 percent). In this case, consumer savings in the title industry are 40 percent higher than in the base case (\$2.50 billion versus \$1.79 billion). Lower estimates of consumer savings were also considered -- \$150 dollars per loan savings in title costs. In this more conservative case, aggregate consumer savings in title costs total \$1,875 million, with \$714 million (or 38.1 percent) of the savings coming from small title companies.

**(19) Results for Title and Appraisal Approach.** As explained in Step (8), another approach for estimating consumer savings under RESPA reform focuses on both the title and appraisal industries. Savings of \$200 per loan are projected for title costs and \$35 per loan for appraisal costs. The aggregate dollar effects are as follows:

	<u>Consumer Savings</u>	<u>Small Business</u>
<b>Origination Services</b>	<b>\$5.88</b>	<b>\$3.01</b>
a. Brokers	3.53	2.47
b. Lenders	2.35	0.54
<b>Third-party Services</b>	<b>2.94</b>	<b>1.32</b>
c. Title and Closing	2.50	0.95
d. Appraisal	0.44	0.36
<b>Total Settlement (\$ billion)</b>	<b>8.82</b>	<b>4.32</b>

In this case, the title industry accounts for \$2,500 million of the transfers and the appraisal industry, the remaining \$440 million. Small title companies account for \$950 million (38.1 percent) and small appraisal firms, \$360 million (83.1 percent). Combined, the small business transfers for these two third-party industries total \$1.32 billion, or 45 percent of total transfers.

**(20) Lower Origination Fees with Constant Overall Fees.** The above analysis (i.e., Steps 1-19) assumed that origination fees were 1.75 percent of the loan amount, or \$42 billion if total mortgage originations are \$2.4 trillion. Adding third-party fees of \$24.7 billion (or 1.03 percent of total originations) yielded total settlement costs of \$66.7 billion, or 2.78 percent of the total originations. This and the next step examine the effects of lower percentages for origination

fees. First, the origination fee is reduced to 1.5 percent (or \$36.0 billion) but the overall settlement cost percentage (2.78 percent) remains the same. So in this case, third-party fees are assumed to rise to 1.28 percent (from 1.03 percent), or to \$30.738 billion (from \$24.738 billion). Thus, this scenario allows one to examine the effects of shifting the mix between origination fees and third-party costs.

	<u>Consumer Savings</u>	<u>Small Business</u>
<b>Origination Services</b>	<b>\$5.04</b>	<b>\$2.58</b>
a. Brokers	3.02	2.12
b. Lenders	2.02	0.46
<b>Third-party Services</b>	<b>3.07</b>	<b>1.40</b>
c. Title and Closing	2.23	0.85
d. Other Third-party	0.84	0.55
<b>Total Settlement (\$ billion)</b>	<b>8.11</b>	<b>3.98</b>

In this case, the estimated price reduction to borrowers falls slightly to \$8.11 billion, or 12.2 percent of the \$66.7 billion in total charges. Compared with the base case, there are fewer savings from originator fees (\$5.04 versus \$5.88 billion) but more savings from third-party fees (\$3.07 versus \$2.47 billion) -- not unexpected given that this sensitivity analysis shifts fees from originators to third-party providers. It is estimated that \$3.98 billion (or 49.0 percent) of the \$8.11 billion comes from small businesses -- \$2.58 billion from small originators and \$1.40 billion from small settlement service providers. The next step examines a more intermediate case.

**(21) Lower Origination Fees with Constant Third-party Fees.** In this case, origination fees are assumed to be 1.50 percent, or \$36.00 billion, while third-party fees are kept constant at \$24.7 billion. Thus, total settlement costs are reduced from \$66.74 billion (2.78 percent) to \$60.74 billion (2.53 percent). In this case, the following results are obtained:

	<u>Consumer Savings</u>	<u>Small Business</u>
<b>Origination Services</b>	<b>\$5.04</b>	<b>\$2.58</b>
a. Brokers	3.02	2.12
b. Lenders	2.02	0.46
<b>Third-party Services</b>	<b>2.47</b>	<b>1.13</b>
c. Title and Closing	1.79	0.68
d. Other Third-party	0.68	0.44
<b>Total Settlement (\$ billion)</b>	<b>7.51</b>	<b>3.70</b>

**(22) Lower Origination and Third-party Savings Rates.** In the base case, the GFE was projected to reduce the \$66.74 billion in settlement costs by 12.5 percent, or \$8.35 billion. In this sensitivity analysis, the following changes were made that lower projected savings to consumers: (1) the rate at which the new GFE would save origination costs was reduced from 14.0 percent (\$5.88 billion) to 11 percent (\$4.62 billion), as explained in Step (4); and (2) the

projected savings for third-party fees was reduced from 10 percent (or \$2.47 billion) to 7.5 percent (or \$1.86 billion). Thus, savings under these changes total \$6.48 billion (or 9.7 percent), instead of \$8.35 billion (or 12.5 percent) in the base case. The key figures from this analysis are as follows:

	<u>Consumer Savings</u>	<u>Small Business</u>
<b>Origination Services</b>	<b>\$4.62</b>	<b>\$2.36</b>
a. Brokers	2.77	1.94
b. Lenders	1.85	0.42
<b>Third-party Services</b>	<b>1.86</b>	<b>0.84</b>
c. Title and Closing	1.35	0.51
d. Other Third-party	0.51	0.33
<b>Total Settlement (\$ billion)</b>	<b>6.48</b>	<b>3.21</b>

There are reasons to believe that the savings rate of 12.5 percent is conservative, although it is recognized that some would disagree. The above-listed changes producing a somewhat lower savings rate of 9.7 percent are even more conservative than the base case (e.g., only 7.5 percent savings in third-party fees), and yet there remains \$6.48 billion in savings for consumers. Thus, the 9.7 to 12.5 percent savings rate is consistent with approximately \$6.5-\$8.4 billion in consumer savings.

**(23) Different Small Business Percentage Estimates for Lenders and Brokers.** Step (13) above noted the uncertainty with estimating the small business percentage for lenders. Section III.B.5 of Chapter 5 develops the 23 percent share used in the base case but suggests that the percentage could range from 20 percent to 26 percent. If the share is 20 percent, transfers from small lenders fall by \$70 million, from \$540 million to \$470 million. If the share is 26 percent, transfers from small lenders increase to \$610 million.

As explained in Section II of Chapter 5, data from the Census Bureau suggest that small brokers account for almost 70 percent of that industry's revenue. If small brokers accounted for 80 percent of industry revenue, then transfers from small brokers would increase by \$350 million, from \$2.47 billion (base case of 70 percent) to \$2.82 billion. If small brokers accounted for 75 percent of broker originations, then transfers from small brokers would total \$2.65 billion. These impacts are large because brokers account for 60 percent of market originations.

It is also possible that the small business share of revenues on broker loans could be less than the 70 percent figure. In the case of broker loans, the base case assumes that the entire 1.75 percent in origination fees goes to brokers; hence, the analysis assumes that all the savings due to lower origination fees (both direct and indirect) come from reductions in broker revenues. But part of the origination fee could go to the purchasing lender (i.e., the wholesale lender) for specific services such as underwriting. Competition under the RESPA reform will lead to lower

origination fees for both brokers and their wholesale lenders.<sup>84</sup> To the extent that the consumer savings on broker originations are due to price reductions of the wholesale lender (such as a lower underwriting fee charged on a broker loan), then the broker and small business share of consumer savings on broker loans are overstated in the above analysis. For example, assume that wholesale lenders' services account for 10 percent of origination fees on broker loans (or 0.175 percent of the 1.75 percent in origination fees), leaving brokers the remaining 90 percent of origination fees (or 1.58 percent of the 1.75 percent). In the base case, consumers save \$3.53 billion in origination fees on broker loans, with small brokers contributing \$2.47 billion of the \$3.53 billion. In other words, 70 percent of the savings come from small brokers. If part of the consumer savings were from wholesale lenders (as described above), then brokers would have instead contributed \$3.18 billion of the savings, and small brokers, \$2.22 billion. (The numbers are obtained by simply multiplying the initial broker numbers by 90 percent, which is the broker share of origination fees in this example.) Wholesale lenders contribute the remaining \$0.35 billion savings in origination fees in this example. Since wholesale lenders are not likely to be a small business, the small business share of the \$3.53 billion in transfers is 63 percent -- the \$2.22 billion in transfers from small brokers divided by the \$3.53 billion in total transfers on broker loans. This is lower than the 70 percent small business (small broker) share of the base case. Thus, to the extent that part of the 1.75 percent origination fee on broker loans goes to wholesale lenders for their services (rather than being earned by the broker), the small business share of origination fees on broker loans will be lower than the 70 percent share used in the base case. This example suggests that using the 70 percent figure (which is the share of broker revenue that is due to small businesses) could overestimate the small business impact of the RESPA rule. However, the overestimate, if any, is probably not much and it seems reasonable to use the 70 percent figure for the estimate of the small business share on broker loans. Still, readers should interpret the term "Brokers" underneath "Origination Services" in the above tables as indicating the consumer savings and small business transfers on broker loans. To the extent that wholesale lenders receive a portion of the origination fees on broker loans, the fees are not going to "brokers", as the above example illustrates.<sup>85</sup>

**(24) Different Small Business Percentage for Title and Settlement Services.** As discussed in Step (14) and in Section IV of Chapter 5, there is also some uncertainty with respect to the small business percentage of the title and settlement industry. Given that this industry accounts for 72.5 percent of third-party fees, it is important to have good information on the small business share of this industry. The driving factor is the market share that one assigns to large title insurance companies, a higher (lower) share reducing (increasing) the small business share of the overall title and settlement industry. Chapter 5 discusses this issue in some detail,

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<sup>84</sup> However, as discussed throughout this economic analysis, wholesale lenders are viewed as being highly competitive, which means that there may not be much excess in the fees that they charge their brokers and loan correspondents. (On the other hand, with respect to their retail operations, there is no reason to believe that they do not overcharge borrowers as much or more than brokers.)

<sup>85</sup> The Fannie Mae study, Mortgage Focus (2003), provides some origination-related cost data for wholesale lenders for different methods of originating a loan. The costs ranged from \$164-\$205 for the correspondent channel and \$470-\$513 for what appears to be the broker channel (labeled "wholesale" on page 5). For the 101 lenders included in the Mortgage Focus sample, the report also indicated that, on average, brokers received \$1,586 in fees in 2002; there were additional costs of \$916 to originate a loan, yielding a total cost of \$2,502.

examining several market estimates for large title companies. The results of that analysis are the base case, which projects that large title companies account for 43 percent of industry revenue, and a suggestion to vary that percentage between 35 percent and 50 percent. If the large title companies account for 35 percent of industry revenue, then the small business share of transfers would increase, as follows:

	<u>Consumer Savings</u>	<u>Small Business</u>
<b>Origination Services</b>	<b>\$5.88</b>	<b>\$3.01</b>
a. Brokers	3.53	2.47
b. Lenders	2.35	0.54
<b>Third-party Services</b>	<b>2.47</b>	<b>1.21</b>
c. Title and Closing	1.79	0.77
d. Other Third-party	0.68	0.44
<b>Total Settlement (\$ billion)</b>	<b>8.35</b>	<b>4.22</b>

In this analysis, a reduction in the share of industry revenues accounted for by large insurers means that a greater portion of consumer savings will come from smaller firms (title agents, closing attorneys, escrow companies). In this specific case (a reduction in the large insurer share from 43 percent to 35 percent), transfers from small businesses in the title and settlement industry increase by \$90 million, from \$680 million to \$770 million. On the other hand, if large insurers account for 50 percent of industry revenue, then transfers from small title and settlement firms fall by \$70 million, from \$680 to \$610 million.

**(25) Different Mortgage Origination Estimates for Market.** As explained in Step (1), mortgage volume projection of 12,500,00 loans, or \$2.4 trillion, is much lower than recent mortgage volume. Projected consumer savings and transfers would be much higher in market environments with 15-17 million originations (as in 2001-02 or 2004-05) or over 24 million as in 2003. To illustrate the shifts, mortgage originations were increased by 3,000,000 to 15,500,00 loans. The following results were obtained.

	<u>Consumer Savings</u>	<u>Small Business</u>
<b>Origination Services</b>	<b>\$7.29</b>	<b>\$3.73</b>
a. Brokers	4.37	3.06
b. Lenders	2.92	0.67
<b>Third-party Services</b>	<b>3.07</b>	<b>1.40</b>
c. Title and Closing	2.22	0.85
d. Other Third-party	0.84	0.58
<b>Total Settlement (\$ billion)</b>	<b>\$10.36</b>	<b>\$5.12</b>

There are \$10.36 billion in consumer savings representing 12.5 percent of the \$82.755 billion of projected settlement costs; this compares with \$8.35 billion in consumer savings in the base case, which assumed a lower volume of mortgage originations (12.5 million originations). In this case, \$5.12 billion of the transfers to consumers are projected to come from small

businesses, with small originators contributing \$3.73 billion and small third-party firms, \$1.40 billion.

It is possible that costs may be lower in a high volume year, particularly one characterized by more refinances (for example, less expensive automated appraisals and reissue rates on title insurance are more likely on refinance loans than they are on home purchase loans). If third-party costs were 80 percent of those in the above projection, and origination fees were only 1.50 percent, then total consumer savings would be \$8.70 billion (instead of the \$10.36 billion above) and transfers from small businesses would be \$4.31 billion (instead of the \$5.12 billion above).

#### **VII.E.5 Comments on Estimates**

Few comments were submitted on the estimated consumer savings of the proposed rule. The National Association of Realtors renewed their questioning of the benefits of the proposed rule in the 2008 report by Ann Schnare<sup>86</sup>. The NAR cites a study<sup>87</sup> by Mark Shroder as evidence that “bait and switch” is not a widespread phenomenon. Such a conclusion can not be based on Shroder’s study. The sample in the study suffers from a selection bias that limits its usefulness in investigating the “bait and switch” phenomenon. Mark Shroder examined 146 FHA insurance binders. The GFE was present in only 47 of the 146 FHA binders. FHA does not require lenders to include GFEs in case binders. It is natural to suspect that those lenders that voluntarily submitted a GFE had nothing to hide. One can only speculate about those GFEs that are not present, but would a lender that purposefully tried to mislead a borrower knowingly report their activity to the FHA? HUD concludes that it is not likely that one would be able to detect “bait and switch” behavior from a study where disclosure by the lender is voluntary.

The primary purpose of the rule is to limit the practice of charging excessive fees, regardless of whether this is achieved through “bait and switch” or any other misleading business practice. *A Study of Closing Costs for FHA Mortgages*<sup>88</sup> analyzes all loan and other closing fees, primarily title fees, associated with FHA purchase mortgages. The data were obtained from the HUD-1s on thousands of FHA loans made in May and June of 2001. HUD is able to distinguish brokers from lenders and look at each group separately. The results strongly indicate that HUD’s RESPA reform efforts are aimed directly at very serious problems in the market for these loan origination and other settlement services.

The YSP problem is worse than previously thought. Ideally, each dollar of YSP generated by a higher interest rate would result in a one dollar reduction in upfront fees, or total fees (upfront fees plus YSP) should not increase as the YSP increases. The reality is that this is

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<sup>86</sup> *The Estimated Costs of HUD’s Proposed RESPA Regulations*. National Association of Realtors, June 3, 2008, Washington, D.C

<sup>87</sup> Mark Shroder, “The Value of the Sunshine Cure: The Efficacy of the Real Estate Procedures Act Disclosure Strategy,” *Cityscape: A Journal of Policy Development and Research*, Vol. 9, Number 1, 2007

<sup>88</sup> Susan E. Woodward, *A Study of Closing Costs for FHA Mortgages*, Urban Institute, May 2008.

not even close to being true for either brokers or lenders. On average, borrowers see nearly dollar-for-dollar increases in total fees on *brokered* loans when loans are made at the higher rates that generate YSPs (total fees increase by 93¢ for every \$1 of YSP). For loans made by large mortgage banks, total fees increase by 78¢ for every \$1 of YSP. On average, borrowers save only 20¢ in up-front cash for every \$1 they pay in yield-spread premium, for a net loss (or extra cost) of 80¢. These results are awful for borrowers. Clearly, the average FHA borrower has no idea that a higher interest rate can be used to reduce upfront charges. The GFE is designed to promote understanding of the trade-off between the interest rate and upfront charges with the combination of the trade-off table on page 3 and the YSP disclosure at the top of page 2.

Total loan fees can vary by thousands of dollars from borrower to borrower even for the same loan amount. In addition, African-Americans pay an average of \$313 to \$532 more than non-minorities while Latinos pay an extra \$290 to \$450. Those with less education pay more than those with more. Loan charges vary considerably from state to state even for similar sized loans. Brokers charge more than lenders by an estimated \$300.<sup>89</sup> This is not what we would expect from a highly competitive market.

The total charges on “no cost” loans, where the YSP is used to pay all loan originator fees, are estimated to be \$1200 lower than for loans where loan originator fees are paid by a combination of YSP and up-front fees. These are the easiest loans to shop for because there is only one loan cost, the interest rate. The ease of shopping for this kind of loan would be consistent with a more competitive outcome. A borrower might call three lenders, get three interest rates, and pick the lowest one. Lenders realizing this might be more likely to offer more competitive rates for the no-cost loans because of market necessity.

The cost savings for these no-cost loans might be a good indicator of the savings consumers could obtain for any loan if the market became more competitive. The standardization of the presentation of the GFE and the grouping of fees, the use of the front page as a simple summary page, and the shopping chart are all designed to simplify comparison shopping and exploit the gains available from an increase in competition.

Title charges are analyzed as well. Title fees vary widely both within states and among states. Even holding property values constant, those in the highest four states pay more than \$1,000 more for title services than those in the lowest state. A comparison of Texas and North Carolina, where home prices were the similar, shows no Texan paid less than \$1,000 and only seven North Carolinians paid more than \$1,000. The question that sticks out is why this difference exists.

Thousand dollar differences in total title costs within a given state and for similar loan amounts are not uncommon. Given that most of the title insurance premium is a commission to

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<sup>89</sup> This result may stem from an inherent identification problem bias in classifying broker loans. Broker loans are identified as those having YSPs. Only loans with higher interest rates are likely to have YSPs. For all loans in the dataset, total origination fees (upfront plus YSP) increase with the interest rate. Therefore, identified broker loans are likely to be measured as costlier than non-broker loans.

the title agent, there is not a good explanation for this variation in charges within a given state. It is not what we would expect in a competitive market. The tolerances on the GFE title costs give the lenders an incentive to search out lower priced title companies. It reduces the lender's or broker's bottom-line cost figure presented to the borrower and protects them from tolerance violations. The large variation in total charges paid by borrowers indicates that consumer savings could be substantial by having a knowledgeable shopper procure these services rather than the consumer who is an amateur.

As with loan fees, minorities pay more for title services and the better educated pay less. More competition should reduce these effects as well.

## **VII.F. Additional Shopping Benefits From the GFE and Other Market Impacts**

**Efficiencies.** In addition to the above consumer benefits, there will also be efficiencies associated with the shopping incentives of the new GFE. Borrowers will save time shopping for loans. If the new forms save the average applicant one hour in shopping time, borrowers will save \$935 million.<sup>90</sup> Originators will save time as well. If half the borrower time saved comes from less time spent with originators, then originators spend a total of half an hour less per loan originated talking to borrowers for a saving of \$774 million.<sup>91</sup>

**Impact of RESPA Reform on Increased Homeownership and Refinancing.** There are other potential shopping efficiencies that are anticipated from the rule that are difficult to estimate. As discussed in Section VII.A, many people (and particularly low-income and minority families) feel that the process of getting a loan to buy a home is complicated, mysterious, and intimidating.<sup>92</sup> All of these features will be reduced under the new rule. Many of those who have the financial resources and credit along with the desire to own a home shy away from the process as a result of these negative features. These people may decide to become homeowners under the new schemes as these deterrents to homeownership are reduced (see above discussion). While there is good reason to believe the new scheme will be viewed more positively by potential homebuyers, we see no way to quantify this beneficial impact and the time it takes to occur. But the new GFE approach outlined in this chapter should increase the certainty of the lending process and, over time, should reduce the fears and uncertainties expressed by low-income and minority families about purchasing a home.

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<sup>90</sup> This calculation is based on applicants, rather than borrowers. It is assumed that the number of applicants (21,250,000) is 1.7 times the number of borrowers (12,500,000). The average applicant income is \$92,000, or \$44 per hour based on 2,080 hours per year. Multiplying the 21,250,000 applicants times \$44 yields the \$935 million reported in the text.

<sup>91</sup> This assumes \$72 per hour for originator's time (or \$150,000 per year). Multiplying \$72 times 0.50 times 21,250,000 yields the \$774 million reported in the text.

<sup>92</sup> For example, studies indicate that one impediment to low-income and minority homeownership may be uncertainty and fear about the home buying and lending process. See Donald S. Bradley and Peter Zorn, "Fear of Homebuying: Why Financially Able Households May Avoid Ownership," Secondary Mortgage Markets, 1996.

The lower upfront costs and the user-friendly nature of the new GFE will lead to additional homeowners entering the market, as well as making it more likely that existing homeowners will refinance their loans when market rates fall below their contract rates. Therefore, there should be an increase in both home purchase and refinance business as the lending process becomes more palatable to the average borrower. There will be an increase in access to the capital market, and the relatively low mortgage rates at which mortgages are made.

Previous sections have established that the RESPA reforms will both simplify the process and reduce the cost of obtaining a mortgage loan. The volume of home purchase and refinancing would be expected to increase with mortgage finance made more consumer-friendly and less costly. The new GFE will result in mortgage pricing and settlement cost information being readily available to shoppers in simple, easy-to-understand terms – this increase in information will improve the mortgage shopping part of the home buying process. Home purchase would increase as households who although qualified for home purchase have remained renters out of fear of the mortgage finance process move forward in the new more consumer-friendly environment to purchase a home. The same would be true for refinancing as the apprehension keeping many homeowners locked into above market rate mortgages dissipates with reform. Moreover, the reduction in costs resulting from reform would enable renter households just on the cusp of home purchase to cross over the threshold or accelerate their purchase ahead of the time they would otherwise qualify. The reduction in refinancing costs would also lead to more refinancing as homeowners with more modest levels of present value payment savings could thereby offset and justify the cost of refinancing.

While there can be no doubt of the qualitative impact of reform outlined above, assessing its quantitative impact is more difficult, particularly given the most recent extended period of very low interest rates. Nevertheless, past research and analysis that follows using data from periods prior to the latest low interest period suggests that the quantitative impact, particularly over the longer run, will not be trivial.

Bradley and Zorn (1996) conducted focus group studies that found many renter households who were financially capable of becoming homeowners remained renters out of fear or lack of information about the lending process.<sup>93</sup> And, a study by Galster and others (1999) confirmed that there is a significant fraction of renter households that appear attractive prospects for homeownership with low credit risk and high probabilities of transitioning to homeowner status but who nonetheless remain renters.<sup>94</sup> They estimated that approximately 9.6 percent or 2.7 million of renter households (excluding individuals) represented in the 1990 Survey of Income and Program Participation (SIPP) who remained renters over an 18-month period had estimated probabilities of transitioning to homeownership in excess of the median probability for renters who actually became homeowners over the same period while having no greater likelihood of default.<sup>95</sup> Hence, the rule might be expected to bring about an increase of a half

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<sup>93</sup> Donald S. Bradley and Peter Zorn (1996) "Fear of Homebuying: Why Financially Able Households May Avoid Homeownership," *Secondary Markets* 13(2):1, 24-30.

<sup>94</sup> George Galster, Laudan Aron, and William Reeder (1999) "Encouraging Mortgage Lending in 'Underserved' Areas: The Potential for Expanding Home Ownership in the US," *Housing Studies* 14(6):777-801.

million more homeowners if only 20 percent of that group (2 percent of renter households) transitioned to homeownership as a result of more consumer-friendly reforms.<sup>96</sup>

In addition to a more consumer-friendly environment, RESPA reform will reduce closing costs thereby reducing home acquisition costs and releasing a corresponding amount toward a prospective homebuyer's equity down payment. Hence, one might expect this cost savings to provide some increased number of renter families with the assets necessary to be able to cross over the threshold to become homeowners or otherwise accelerate their home purchase ahead of the time they might otherwise qualify. It was estimated earlier that the impact of the new GFE would on average provide an up-front borrower savings of 0.37 percent of the loan amount financed.<sup>97</sup> That amounts to a savings of approximately \$463 for a \$125,000 loan or 1/6<sup>th</sup> of the required 2.25 percent down payment for a high LTV FHA mortgage.<sup>98</sup>

Insufficient savings to pay required up front down payment and closing costs has long been understood to be the single greatest obstacle to buying a home. Research studies by Linneman and Wachter (1989), Savage and Fronczek (1993), Savage (1997), Haurin and others (1997), Listokin and others (2002), and most recently Herbert and Tsen (2005) have consistently found a lack of sufficient wealth to pay down payment and closing costs is a significant limitation on the ability of renter households to become homeowners.<sup>99</sup>

The Listokin (2002) study estimated the proportion of renter families that might qualify for financing to purchase a modestly priced home at various levels of down payment assistance. By applying an overlay of various underwriting criteria to SIPP data, they found that 9.2 percent of 25.8 million renters in 1993 could qualify to purchase a modestly priced home at the 25<sup>th</sup>

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<sup>95</sup> Galster and others (1999), 798-799.

<sup>96</sup> As noted above, Galster and others limited their analysis to renter households excluding individuals.

<sup>97</sup> Estimated consumer savings range from \$6.48 billion to \$8.35 billion for the new GFE. As a percentage of total origination and settlement costs (\$66.7 billion), consumer savings range from 9.7 to 12.5 percent for the new GFE. There are 12,500,000 loan originations. The average savings per loan would range from \$518 to \$705. As a percentage of the average loan amount (\$192,000), consumer savings range from 0.27 to 0.37 percent, which is the figure in the text.

<sup>98</sup> The saving represents a somewhat lower proportion of a high LTV conventional mortgage requiring a minimum down payment of 3 percent.

<sup>99</sup> Peter D. Linneman and S.M. Wachter (1989) "The Impacts of Borrowing Constraints on Homeownership," *Journal of the American Real Estate and Urban Economics Association* 17:389-402. Howard Savage and Peter Fronczek (1993) "Who Cannot Afford to Buy a House in 1991," *Current Housing Reports*, U.S. Bureau of the Census. Howard Savage (1997) "Who Cannot Afford to Buy a House in 1993," *Current Housing Reports*, U.S. Bureau of the Census. Donald R. Haurin, Patric Hendershott, and Susan Wachter (1997) "Borrowing Constraints and Tenure Choice of Young Households," *Journal of Housing Research* 8:137-154. David Listokin, Elvin K. Wyly, Brian Schmitt, and Ioan Voicu (2002) "The Potential and Limitations of Mortgage Innovation in Fostering Homeownership in the United States," *Housing Policy Debate* 12(3):465-513. Christopher E. Herbert and Winnie Tsen (2005) *The Potential of Downpayment Assistance for Increasing Homeownership Among Minority and Low-Income Households* (Washington, DC: Office of Policy Development and Research, U.S. Department of Housing and Urban Development, pp. 1-30).

percentile of the home price distribution without any additional assistance, and with a cash grant of \$1,000, 9.9 percent of renters could purchase the modestly priced home. Roughly half those proportions could qualify to purchase the *target* home each renter family was individually estimated to choose. Thus, Listokin and others estimated an increase of 0.035 to 0.7 percent of renters--that is, 90,300 to 180,600 renters--could purchase homes depending on the price of the home with an additional \$1,000. However, the authors caution that these estimates are conservative and that the impact could be substantially higher given that their analysis would have understated the number of renters who actually transitioned to homeownership over the course of the survey period. They caution that SIPP data may understate the resources available to renters and renters electing to become homeowners frequently bootstrap themselves financially—i.e., accelerate savings in the year prior to purchase.

Herbert and Tsen (2005) utilized data from the 1996 SIPP Panel that followed 11,000 renter households for a period of 3 years from fourth quarter 1996 through February 2000 recording their income and assets every year and their tenure status (renter/homeowner) every 3 months. Over that period, 18 percent of the renter sample became homeowners where house values in the markets studied were about \$120,000. The authors estimated a parametric proportional hazard model of transitions to homeownership based on demographic and financial characteristics as well as some market conditions and then simulate the impact of cash grants varying size on the probability of becoming a homeowner over time. They find that a modest increase in liquid assets of \$1,000 provides the greatest impact, increasing the number of homebuyers by an estimated 943,000 overall, including 708,000 low-income buyers, 152,000 black buyers, and 143,000 Hispanic buyers.<sup>100</sup>

Hence, one might expect the reduction in closing costs of roughly half the \$1,000 grant employed in both the Listokin and Herbert analyses to increase the number of homeowners by approximately half their estimates. Thus, the rule's resulting cost savings could at a minimum bring about anywhere from 100,000 to 400,000 additional homeowners beyond those responding to the more consumer-friendly environment and the increase could range significantly higher.<sup>101</sup>

As mentioned above, the reduction in closing costs would also lead to more refinancing as homeowners with more modest levels of present value payment savings could thereby offset and justify the cost of refinancing. Given the major refinancing opportunities of 2002 through 2005, analysis was conducted using the 2001 American Housing Survey in order to estimate an a more long term steady state order of magnitude of this effect. Table 3-4 shows the distribution of mortgage loans outstanding broken by remaining balance and interest rate interval and grouped by term of less than 5 years remaining to maturity, 5 to 15 years, and more than 15.

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<sup>100</sup> See Herbert and Tsen (2005), pp. v-vi, and 25-26.

<sup>101</sup> The estimated increase is from the stock of renter households measured at a point in time and as such represents a one time change, but one might expect a continuing steady state effect as population dynamics usher new renter households into existence.

For each balance and rate combination, a potential net present value (NPV) savings that could be obtained over the average remaining term forward after refinancing at a lower rate and paying \$1,500 in closing costs could be calculated producing a wide range of potential savings depending on the remaining balance and difference between the coupon and refinance rate. Clearly, few would refinance for no savings and closing costs are not likely to keep mortgagors with substantial net savings in excess of several thousand dollars from refinancing and securing the savings. Hence, the mortgagors most likely to refinance as a result of the reduction in closing costs are those whose net saving would cross a threshold justifying the time and trouble of refinancing which is assumed here to be \$2,000. Others with higher NPV well in excess of \$2,000 would have reason to refinance without the reduction in closing costs and so a \$500 dollar savings in closing costs could not be presumed to be the inducement to refinancing. Calculating the potential savings at varying refinance rates ranging from 5 percent through 8 percent and netting out \$2,000 inclusive of a \$500 reduction in closing costs produced estimates of potential refinancers ranging from 500,000 to 3,000,000. This would remain a large effect if only a third of these homeowners refinanced. On the other hand, there might be an even larger increase to accompany public awareness of a simplified process.

## **VIII. Loan Originators and Third-Party Providers: Small Business Impacts**

This section summarizes the effects of the rule on different industries, including brokers (Section A), lenders (Section B), and third-party service providers such as title and closing agents (Section C). Each section reviews HUD's response to concerns raised by industry comments and provides an overall conclusion with respect to competitive impact on the industry. The effects of the rule on small businesses are emphasized. As has already been explained in this chapter, HUD took several steps in the rule to lessen the adverse effects of the rule on small businesses. These major changes and alternatives considered are summarized below. This section presents a qualitative analysis of the competitive and other impacts of the rule on industry actors and small businesses. See Section VII above for the estimates of the dollar impacts on small businesses. Readers are also referred to Chapter 5 for a more detailed description of the various component industries and their small business characteristics.<sup>102</sup>

### **VIII.A. Mortgage Brokers: Small Business Impacts and Competitive Issues**

This section summarizes the key competitive issues that have been discussed in this chapter with respect to the impact of the rule on the broker industry. Most of their comments (as represented by those of the National Association of Mortgage Brokers) were directed toward the 2008 proposed rule's treatment of yield spread premiums. The YSP issue is discussed first, followed by issues related to tolerances and other aspects of the rule related to brokers.

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<sup>102</sup> The individual industries are covered in the following sections of Chapter 5: brokers (Section II); commercial banks, thrift institutions, mortgage banks, credit unions (Section III); large title insurers, title and abstract firms, lawyers, and escrow firms (Section IV); and appraisers (Section V.A), surveyors (V.B), pest inspectors (V.C), and credit reporting firms (V.D).

Section III of Chapter 2 and Section II of Chapter 5 provide information on the nature and growth of the broker industry.<sup>103</sup> The number of brokers increased to approximately 30,000 during the 1990s, with some industry observers placing the number at over 40,000 and even over 50,000 during the past few years. It is estimated that brokers originate at least 60 percent of all mortgages and in some recent years as high as 68 percent.<sup>104</sup> As an industry, brokers are seen as being efficient, flexible, low-cost mortgage providers that vigorously compete among themselves for the consumer's business. The fact they are not burdened by large fixed costs allows them to offer very competitive rates. They are especially important at the front-end of the mortgage process, assisting consumers in understanding various mortgage products and options available to them. Practically all brokers are small businesses. According to the Bureau of Census, small brokers account for almost 70 percent of industry revenue. See Section II of Chapter 5 for additional characteristics of the industry (number of employees, size of firms, etc.)

As discussed in this section, HUD has made improvements to the GFE form to reduce the potential for any anti-competitive impacts on the broker industry or small businesses within that industry. HUD has designed the final GFE form so as to minimize the potential for confusion over yield spread premiums. The intent is to avoid borrower mistakes on loans with yield spread premiums that would lead the borrower to believe the brokered loan was more costly than it was in fact. Such mistakes would harm the comparison shopper who would make errors in evaluating loans and be biased against brokers. The summary page that has been added to the GFE form includes the key numbers for comparison-shopping and provides identical treatment of lenders and brokers. The Department's goals include making comparison shopping easier for borrowers and maintaining a level playing field between brokers and lenders (see Chapter 2 and Section III above). Tests of the final GFE form indicate that consumers correctly choose the cheapest loan over ninety percent of the time.

Thus, brokers, as a group, will remain highly competitive actors in the mortgage market, as they have been in the past. There will be an impact on those brokers (both large and small) who over-charge consumers, and there is convincing evidence that some do (see Section VII.A above). Improved consumer shopping with the new GFE will lead to reduced revenues of those brokers who are charging non-competitive prices. Thus, the main negative impact on brokers (both small and large) of the final rule will be on those brokers (as well as other originators) who have been overcharging uninformed consumers, through the combination of high origination fees and yield spread premiums.

Section VI.E of this chapter estimates that transfers from brokers could range from \$2.77 billion to \$3.53 billion, or from 11.0 percent to 14.0 percent of their revenues. For small brokers, the transfers are projected to be \$1.94 billion to \$2.47 billion.

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<sup>103</sup> Section II of Chapter 5 examines several topics related to the broker industry: (a) the nature and characteristics of the broker industry (number of firms and employees, size of firms, etc.); (b) various revenue estimates for the broker industry; (c) estimates of the small business share of industry revenues; and (d) consumer savings and transfer estimates under the new GFE for the broker industry as a whole, and for small brokers in particular.

<sup>104</sup> See Section II.B of Chapter 5 for estimates of the number of brokers and their market share.

### VIII.A.1. Treatment of Yield Spread Premiums

The main issue raised by the brokers concerned the treatment in the 2008 proposed rule of yield spread premiums on the proposed Good Faith Estimate (GFE). This was also the main small business issue with the proposed GFE since practically all brokers qualify as small businesses. Mortgage brokers and their trade groups expressed vigorous opposition to HUD's singling out indirect compensation to the broker and disclosing the yield spread premium as a lender credit to the borrower. They maintained that such a characterization is misleading, unfair and anti-small business.<sup>105</sup> Mostly, mortgage brokers and their representatives generally felt that yield spread premiums being disclosed as credits to borrowers would place mortgage brokers at a competitive disadvantage. They said that the broker fee disclosure in the proposed GFE would severely disadvantage mortgage brokers as compared to lenders (i.e., mortgage bankers and conventional lenders) because mortgage brokers would not be able to advertise certain mortgage loans and remain competitive. Section III of this chapter dealt with this issue in some detail; a summary of this issue and HUD's response is provided below.

The 2008 proposed rule and final rule treatment of yield spread premiums fundamentally changes the way in which mortgage broker compensation will be reported by requiring in all loans originated by mortgage brokers, that any payments from a wholesale lender based on an above par interest rate on the loan ("yield spread premiums") be reported as offsets to settlement costs and brokers will have to report their total compensation. The Department believes this is the best way to disclose the existence of yield spread premiums. But Section III of this chapter describes the extensive forms development and testing process that HUD has undertaken to produce the final GFE because of concerns that shoppers could be given a false impression regarding mortgage brokers' fees as compared to lenders' fees. The Department has dealt with the potential for bias in six ways. First, the discussion of the yield-spread premium itself places emphasis on the effect on closing costs. Borrowers are more likely to recognize that it is netted out. Second, is the third option included in "Your credit or charge (points) for the specific interest rate chosen." so that borrowers' suspicions would not be aroused over the difference in the way a broker loan would be presented vis-à-vis a lender loan. This option is for lenders to check if they do not report a figure besides zero for either the credit or discount points. Third, there is a summary page that includes only one summary cost figure along with the loan terms. This summary page is the first page of the form. Yield spread premiums are not disclosed on the first page and otherwise identical loans from a broker and lender would have identical cost figures on the first page. The details of the first page cost figures are on the second page.<sup>106</sup> The summary page limits the chance of borrower error by displaying only the net figure on the most prominent page of the form that borrowers are most likely to use when comparing loans.

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<sup>105</sup> A variety of reasons for opposition were provided including that HUD's proposal: 1) creates confusion for the borrower; 2) will unnecessarily increase HOEPA transactions; 3) will stifle FHA and low/mod lending; 4) unfairly targets brokers; 5) creates an uneven playing field with retail lenders; and 6) may adversely affect tax treatment of borrowers. See Section III of this chapter for a detailed discussion of YSP issues and industry concerns.

<sup>106</sup> For purposes of comparing lender and broker offers, the second page of the new GFE highlights (in bold and larger print) the numbers that the borrower should focus on, which are "Your Adjusted Origination Charges" and "Total Estimated Settlement Charges." For identically priced loan, these numbers will be the same for brokers and lenders.

Borrowers who compare summary pages of different forms are very unlikely to make comparison-shopping errors – lenders and brokers are treated identically on the summary page.

Fourth, the trade-off table also emphasizes how interest rates affect settlement costs. This integration of the yield spread premium discussion and the trade-off table enhances understanding of yield spread premiums. In the trade-off table, shoppers are given detailed examples of how they can reduce their settlement costs by paying a higher interest rate (i.e., the yield spread premium case) or reduce their interest rate by paying higher settlement costs (the discount point case). Language in this table is in line with the language used to describe yield spread premiums and discount points. The presentation of yield spread premiums and discount points combined with the trade-off table should improve borrower shopping and reduce abuses in this area (see Section III.C above). A major objective of the trade-off table is to increase consumer understanding of their mortgage options and of the notion that yield spread premiums are supposed to offset their origination and settlement costs, on a dollar for dollar basis. Studies indicate that borrowers do not understand this trade-off and, as a result, are overcharged on loans with yield spread premiums.

Fifth, a mortgage shopping chart is included on page 3 of the GFE. It has columns for different loan offers and rows for major loan features and the total estimated settlement costs. It is designed to help borrowers comparison shop. All these features to reduce potential errors will benefit all borrowers, as comparison-shopping will work better leading to a more competitive market for mortgages. Sixth, arrows on page 2 highlight the adjusted origination charge and the subtotal for all other settlement charges as well as the total estimated settlement charges at the bottom of page 2, and the mortgage shopping chart. This is designed to focus the borrower on overall charges, rather than one component.

These features of the GFE are designed to make comparison-shopping easier for borrowers and to avoid bias against brokers. The elimination of confusion surrounding yield-spread premiums should do just that. As reported in Section II.F, tests of the new GFE indicate that consumers were able to choose the least expensive loan (when the choice was between a lender's GFE and a broker's GFE) in practically all the cases. Once the improvements suggested by the results of the earlier rounds of testing were incorporated into the forms, borrowers generally identified the cheaper loan with great success. In response to FTC findings based on an abbreviated version of the GFE, HUD engaged in three more rounds of testing and improvement involving 600 subjects per round. The end result on the forms adopted was that borrowers consistently identified the cheapest loan with an overwhelming success regardless of whether the broker or the lender was cheaper. The pattern of the results was quite similar regardless of whether the broker or the lender was cheaper. The Department believes that the forms adopted in the final rule perform well resulting with borrowers having little difficulty identifying the cheapest loan offered in the market whether from a broker or a lender.

## **VIII.A.2. Conclusions**

Brokers operating in today's market are efficient and low-cost providers of mortgages. They are mainly small businesses that assist consumers in applying and obtaining a mortgage

loan. Brokers typically work through wholesale lenders in order to fund loans. Studies indicate that some brokers overcharge consumers, particularly on loans involving yield spread premiums.

The final GFE continues to require that brokers report their total compensation, which is then reduced by the yield-spread premium to arrive at net or adjusted origination fees. HUD includes several features in the GFE form to reduce the potential for any anti-competitive impacts on the broker industry. The GFE in the final rule: (a) places more emphasis on the effect of yield spread premiums on closing costs; (b) includes a summary page that has the key numbers for comparison shopping and provides identical treatment of lenders and brokers (yield spread premiums are not even mentioned on this first, summary page); and (c) improves the presentation of the trade-off table by showing consumers how they can reduce their settlement costs by paying a higher interest rate (i.e., the yield spread premium case) or reduce their interest rate by paying upfront points (the discount point case). These changes should make comparison-shopping easier and minimize any anti-competitive impacts between brokers and lenders. Tests of the final GFE form indicate that consumers correctly choose the cheapest loan over ninety percent of the time.

While there is no evidence to suggest that there would be any anti-competitive impact of the new GFE on the broker industry as a whole, there will be an impact on those brokers who are charging non-competitive prices. There is convincing evidence that some brokers (as well as some lenders) overcharge consumers. As emphasized throughout this chapter, the new GFE will lead to improved and more effective consumer shopping, for many reasons -- the new GFE is simple and easy to understand, it includes reliable cost estimates, it ensures that consumers are shown options, and it explains the trade-off between closing costs and yield spread premiums (as well as discount points). This increased shopping by consumers will reduce the revenues of those brokers who are charging non-competitive prices. Thus, the main impact on brokers (both small and large) of the final rule will be on those brokers (as well as other originators) who have been overcharging uninformed consumers, through the combination of high origination fees and yield spread premiums. As explained in Section VI.E of this chapter, transfers from brokers could range from \$2.40 billion to \$2.86 billion, or from 11.8 percent to 14.0 percent of their revenues. For small brokers, the transfers are projected to be \$1.68 billion to \$2.00 billion.

As emphasized throughout this chapter, it is anticipated that market competition under this final rule will have a similar impact on those lenders (non-brokers) who have been overcharging consumers through a combination of high (effective) yield spread premiums and origination costs.

## **VIII.B. Lenders: Small Business Impacts and Competitive Issues**

### **VIII.B.1. Introduction**

This section summarizes the key competitive issues that have been discussed in this chapter with respect to the impact of the rule on lenders

This chapter and Chapter 4 provide a detailed discussion of the anticipated impacts of the rule on lenders, and the pros and cons of the various policy alternatives that the Department considered.<sup>107</sup> Market impacts on lenders, both large and small, are discussed. It should be noted that lenders did not raise a pressing small business issue such as the yield spread premium (or “level playing field”) issue raised by brokers. There was less concern expressed by lenders about potential anti-competitive impacts on small businesses. This reflects the fact that the GFE in the 2008 proposed rule did not have any anti-competitive impacts against small lenders. The inclusion of a summary page, the trade-off table, and the yield spread premium language should improve consumer shopping, but have no specific anti-competitive impacts on small or large lenders. Small lenders and community banks and thrifts will remain highly competitive actors in the mortgage market. There will be an impact on those lenders (both large and small) who are charging non-competitive prices, and there is convincing evidence that some do. Improved consumer shopping with the new GFE will reduce the revenues of those lenders who are charging non-competitive prices. Thus, as with brokers, the main negative impact on lenders (both small and large) of the new GFE will be on those lenders who have been overcharging uninformed consumers.

As explained in Section VII.E of this chapter and in Section III.B of Chapter 5, transfers from lenders could range from \$1.85 billion to \$2.35 billion, or from 11.0 percent to 14.0 percent of their revenues from mortgage originations.<sup>108</sup> It is estimated that small lenders account for 23 percent of the revenue of all lenders. Thus, the transfers are projected to be \$422 million to \$537 million for small lenders.<sup>109</sup>

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<sup>107</sup> The preamble to the proposed rule also discusses the issues raised by those commenters expressing views concerning the impacts of the 2002 proposed rule on lenders – examples of commenters include the Mortgage Bankers Association (MBAA), American Bankers Association (ABA), American’s Community Bankers (ACB), Consumer Mortgage Coalition (CMC), National Home Equity Mortgage Association (NHEMA), as well as individual firms such as Bank of America, Countrywide, Wells Fargo, World Savings, and Branch Banking and Trust Company (BB&T). This section briefly summarizes the key issues raised by lenders (or groups representing them), and notes the Department’s responses and any major impacts of the rule on lenders. Also, there is no attempt here to list all of the comments raised by lender groups, but rather the main ones dealing with economic and market impacts. For example, there were several comments concerning coordination with the Truth in Lending Act; issues such as this are dealt with in the preamble to the proposed rule.

<sup>108</sup> Readers are also referred to Chapter 5 for a technical discussion of the following topics concerning the transfer estimates for lenders: (a) the methodology for estimating the small business share of lender originations (22.8 percent) and for the range (20 to 26 percent) around that share (Section III.B.2 of Chapter 5); (b) a reporting of the transfers for lenders including various sensitivity analyses related to various consumer savings projections and to different small business estimates (III.B.3); (c) the methodology for disaggregating the overall lender transfers and small lender transfers among the various lender types -- commercial banks, thrifts, mortgage banks (III.B.4); and (d) a reporting and sensitivity analysis of the transfers for commercial banks, thrifts, mortgage banks, and credit unions, including an analysis of transfers as a share of industry revenue (III.B.5).

<sup>109</sup> As explained in Step (23) of Section VII.E.4 of this chapter, it is estimated that the small business share of lender revenue could vary from 20 percent to 26 percent. Thus, in the case of overall lender transfers of \$1.85 (\$2.35) billion, the transfers from small businesses are projected to range from \$370-\$481 million (\$470-\$611 million), around the baseline estimate of \$422-\$537 million.

## VIII.B.2. HUD's Response to Market and Other Issues

Sections V and VI of this chapter discuss numerous issues raised by lenders and HUD's responses to them. Some lenders were concerned about their ability to produce firm cost estimates (even of their own fees) within a three-day period, given the complexity of the mortgage process. Lenders wanted clarification on their ability to make cost adjustments as a result of information they gain during the full underwriting process. Practically all lenders wanted clarification on the definition of application, as well as a provision to allow lenders and other settlement service providers a short period of time in which to correct certain violations of the new disclosure requirements. The principal concern small lenders had with the 2008 proposed rule were the provisions regarding discounts, and that any discounts be passed on to consumers. Some said small lenders would be at a disadvantage relative to large lenders in seeking discounts from third parties, while others said there was no incentive to negotiate discounts if all of the savings had to be passed on to consumers.

Changes were made to tolerances to reflect the fact that unforeseeable events could lead to unanticipated cost changes: the final rule makes clear that “zero tolerance” does not pertain in the case of “changed circumstances” beyond the originator’s control.

Consistent with the above, the rule establishes the new definition of “changed circumstances” to include circumstances that could not be reasonably foreseen at the time of GFE application that are particular to the transaction and that result in significant increased costs – examples include the need for a second appraisal or flood insurance, and boundary disputes or environmental problems that were not described to the loan originator at the time of GFE application. Where a lender (or broker) cannot perform because of changed circumstances, the lender (or broker) must include documentation of the costs occasioned by the changed circumstances. In situations where the borrower changes the loan terms, the borrower should be given a new GFE.

The definition of an application was simplified into a single process, with fees limited to the cost of a credit report until a borrower decides to go forward with a particular GFE. This should alleviate concerns raised by lenders about the 2-stage process in the 2008 proposed rule.

The final rule includes a provision for a 30-day period in which originators can cure violations of the tolerances by refunding to the borrower any amount by which charges covered by tolerances on the HUD-1/1A exceed the tolerances.

Regarding discounts and that they must be passed on to consumers, HUD is merely clarifying existing policy regarding discounts with the final rule; they are not illegal if passed on to consumers in their entirety. Any market effects of discounts would have occurred without the rule because HUD would not have found violations of RESPA for any discount arrangements where the price paid by consumers is the same as the price paid to the third-party provider under either the existing or the new final rule. Any

increase in discount arrangements under the new rule is due to the new GFE and tolerance requirements as discussed above.

The above changes address a number of practical and implementation problems raised by lenders and others about the GFE and tolerances. They particularly make the GFE easier to use for small lenders.

Similar to the situation with brokers, it is important to emphasize that lenders will benefit from a framework that encourages competitive negotiations, discount arrangements, and average cost pricing (thus not having to keep up with every “nickel and dime” in a transaction). Under the new GFE approach, lenders will have the incentive to negotiate lower third-party fees, enter into cost-reducing, discount arrangements with their vendors, and take full advantage of average cost pricing techniques. The rule allows an overall 10 percent tolerance on charges for all of the required third-party services, except for those where the borrower selected the provider without a referral from the originator (and, of course, tolerances do not apply to these borrower selected services since the borrower goes off on his or her own to obtain the service).<sup>110</sup> This final rule will lead to cost reductions by clarifying that lenders and settlement service providers may discounts for settlement services, providing the price charged on the HUD-1 is no more than the price paid to the third-party settlement service provider for the discounted service. This should lead to lower third-party settlement service prices. They will have an incentive to do so to ensure they are offering competitive estimates on their GFEs. In addition, lenders and settlement service providers will be allowed to use average cost pricing for third-party services they purchase so long as the average is calculated using an documented method and the charge on the HUD-1 is no greater than the average paid for that service. This will make internal operations for the lender simpler and less costly and competition among lenders and brokers will put pressure for these cost savings to be passed on to borrowers as well.

### **VIII.B.3. Conclusions**

In general, there was less concern expressed by lenders (as compared with brokers) about potential anti-competitive impacts of the GFE on small businesses. Small lenders -- relative to both brokers and large lenders -- will remain highly competitive actors in the mortgage market, as they are today. Nothing in the final GFE rule changes that. HUD also made several changes that responded to lender concerns about tolerances and implementing the GFE. These changes address day-to-day business problems that are likely to be faced by small lenders, such as the need to adjust for new or changed circumstances. These changes will make the GFE easier to use for small lenders.

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<sup>110</sup> In other words, the 10 percent tolerance now applies to both (a) services where the third-party provider was selected by the originator (e.g., the broker) and (b) services where the borrower utilized a referral from the originator. In the 2002 proposed rule, lender-selected services (a) had a zero tolerance; that has now been relaxed to 10 percent. Also, the 10 percent tolerance in the 2008 proposed rule is an overall tolerance rather than a set of individual tolerances.

There will be an impact on those lenders (both large and small) who are charging non-competitive prices. Improved consumer shopping with the new GFE will reduce the revenues of those lenders who are charging non-competitive prices. Thus, as with brokers, the main negative impact on lenders (both small and large) of the new GFE will be on those lenders who have been overcharging uninformed consumers. Transfers from lenders could range from \$1.85 billion to \$2.35 billion, or from 11.0 percent to 14.0 percent of their revenues from mortgage originations. In the base case, small lenders account for 23 percent of industry revenues. Transfers are projected to be \$422 million to \$537 million for small lenders.

The benefits of the final rule are significant for consumers and the marketplace. The rule provides for originators to use the old GFE for 12 months. This permits some to begin with the new regime within 60 days, but those who prefer to wait (and observe others working with the new system) can do so. This implementation issue, and one-time costs associated with instituting the new GFE form, are discussed in Section III.B of Chapter 6.

### **VIII.C. Title and Settlement Industry: Small Business Impacts and Competitive Issues**

#### **VIII.C.1. Discussion**

The title and settlement industry accounts for the major portion of third-party fees. This section briefly summarizes the key competitive issues for this industry with respect to the final rule. The title and settlement industry consists of large title insurers carriers, title agents, escrow firms, lawyers, and others involved in the settlement process. Section IV of Chapter 5 describes these component industries and estimates the share of overall industry revenue going to small businesses. As noted in Section VII above, small businesses account for approximately half of industry revenue, although there is some uncertainty with this estimate.

American Land Title Association (ALTA) and the Real Estate Services Providers Council (RESPRO), among others, provided comments on the 2008 proposed rule for the title, closing, and other related third-party industries. Most of their comments were directed toward ensuring that average cost pricing was allowable for settlement service providers other than brokers and lenders, and that discounting would be harmful to small providers of settlement services.

Overall, competitiveness within the title and closing industry should be enhanced by HUD's GFE proposal. It is true that increased shopping by consumers, as well as increased shopping by loan originators to stay within their tolerances, will reduce the revenues of those title and closing companies that have been charging non-competitive prices. The reasons why the new GFE and its tolerances will lead to improved and more effective shopping for third-party services by consumers and loan originators have been discussed extensively in this chapter, and need not be repeated in detail here. This rule will lead to cost reductions by clarifying that settlement service providers may seek discounts for settlement services from other providers so long as the price charged on the HUD-1 is no more than the price paid to the third-party

settlement service provider for the discounted service. This should lead to lower third-party settlement service prices. In addition, settlement service providers will be allowed to use average cost pricing for third-party services they purchase so long as the average is calculated using an acceptable method and the charge on the HUD-1 is no greater than the average paid for that service. This will make internal operations simpler and less costly and competition among providers will put pressure for these cost savings to be passed on to borrowers as well. Essentially, excess charges will be reduced and competition will ensure that reduced costs are passed through to consumers.

Because it accounts for almost 73 percent of third-party fees, the title and settlement industry is an important source of the consumer savings associated with the final rule. As explained in Section VII.E above and in Section IV of Chapter 5, transfers from this industry could range from \$1.35 billion (7.5% savings) to \$1.79 billion (10% savings) to \$2.5 billion (\$200 per loan). It is estimated that small businesses account for 38.1 percent of the revenue of the title and settlement industry. Thus, the transfers are projected to be \$0.51 billion to \$0.68 billion to \$0.95 billion, respectively, for small settlement and title agents.<sup>111</sup> As explained in Step (8), one approach to estimating consumer savings is based mainly on price reductions in the title industry. Under this “title approach,” title costs are projected to fall from \$150 to \$200 per loan due to increased shopping, discounting, and the 10% tolerances on third-party fees. In this case, aggregate savings in title costs are estimated to range from \$1.88 billion to \$2.50 billion; transfers for small settlement and title agents would be from \$0.71 billion to \$0.95 billion.

ALTA noted that HUD’s proposals reflect the view that all settlement services, including title and closing-related services, are provided for the lender’s benefit, rather than the consumer’s benefit.<sup>112</sup> ALTA argues that consumers (buyers and sellers) have an interest in the nature and quality of title and closing services and that consumers have a right to select who will provide these services – in other words, consumers, in order to ensure that their interests are protected, should deal directly with the title and closing agents, not work through the lender, as they would under HUD’s GFE.

The issue of itemization was discussed in Section II of this chapter. ALTA noted that at least with regard to the category for title services on the proposed GFE, greater itemization is

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<sup>111</sup> As discussed in Section IV of Chapter 5, there is some uncertainty about the small business percentage for this industry. Also see Section VI.E.3 above for sensitivity analysis using a higher small business percentage for the title and settlement industry. Section IV.B.5 of Chapter 5 discusses several technical topics related to these estimates, including: (a) the methodologies for determining the revenue shares of the component industries and the overall small business share of the title and closing industry; (b) sensitivity analyses of the revenue shares and small business estimates; and (c) total transfers and small business transfers from the component industries (large title insurers, title agents, and escrow agents and lawyers).

<sup>112</sup> According to ALTA, it is HUD’s view that (a) it is therefore appropriate for lenders to bear the responsibility for the selection of settlement-service providers and for the amounts charged; and (b) the consumer’s only interest is getting a low price and completing the transaction. ALTA, as well as others, gave examples how lenders and consumers might have different objectives with respect to title insurance, with lenders possibly accepting a reduced form of title insurance that is appropriate for them but not for consumers.

needed in order for consumers to be able to adequately comparison shop among estimates.<sup>113 114</sup> HUD's view is that the consolidated categories on the new GFE form provide consumers with the essential information needed for comparison-shopping. The new GFE gives an estimate of the services required by the lender to close the loan. Borrowers may purchase additional services at their option. Itemized prices for third-party services would only continue the practice of some today of generating a long list of incomprehensible terms, making it difficult for consumers to comparison shop. It should be noted that this rule does not prohibit any provider from giving more detail (e.g., on a separate document) on services and prices than is required on the GFE.

### **VIII.C.2. Market and Competitive Issues**

Representatives of the title insurance industry have made a lot of claims concerning the mortgage industry that this analysis strongly disagrees with. Specifically, title representatives claimed there is no evidence of "fat" (excess fees) in the system; or if there were any reduction in third-party fees, lenders would not pass the reduced costs through to consumers.

Section V of Chapter 2 analyzed these issues and reached the following conclusions: (a) with respect to consumer shopping for third-party services, it is not clear how closely consumers shop for and monitor third-party costs; (b) on the issue of whether third-party fees can be reduced, most independent observers believe that third-party fees are too high, that is, there is evidence of "fat" in title fees; (c) regarding the question of whether lenders will pass through any fee reductions to consumers, there is substantial evidence that competition will ensure any cost reductions will be passed through to consumers, rather than retained by lenders. Section VII.C above discussed issue (a) when reviewing the shopping benefits of the new GFE. Section V of Chapter 2 includes a detailed discussion of issues (b) and (c). Given that they are so fundamental to any policy analysis of RESPA reform, the main points regarding these latter two issues are restated below.<sup>115</sup>

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<sup>113</sup> According to ALTA, "more information has to be provided to the borrower so that (a) the borrower (and her real estate agent and/or attorney) can determine whether the services the lender is including in the total that will meet the lender's needs for the loan transaction are sufficient to meet the buyer's needs in the sale/purchase transaction, and (b) to avoid confusion and problems at settlement, if as may well be the case, the buyer/borrower has agreed to purchase other 1100 series services beyond those that are needed by the lender and covered by the lender's estimate."

<sup>114</sup> Similar to some lender comments, RESPRO noted that including third-party fees as part of the binding GFE (with 10 percent tolerance) imposes liability risks for those originators who do not control third-party fees. According to RESPRO, these fees are difficult to predict at application. This is the same issue that NAMB and lender groups raised concerning tolerances on fees in the proposed GFE. As discussed in Section V, HUD addressed this issue by increasing the tolerance to a overall 10 percent on lender selected or referred third-party services from the zero or ten percent individual tolerances in the 2002 proposed rule; and by clarifying the "unforeseeable circumstances" under which the tolerances could be exceeded.

<sup>115</sup> In addition, these same commenters predicted that large providers of third-party services (e.g., independent title agents) would replace small providers of these services, thus reducing options available to consumers. Concerning this argument that small independent third-party settlement service providers will be disadvantaged relative to large providers, there is no evidence to support arguments that these "locally-provided" services will shift to larger

### **VIII.C.2.a. Can Title and Closing-Related Fees Be Reduced?**

In their comments on the 2002 proposed rule, the American Land Title Association (ALTA) says there is no comprehensive study (or indeed, no responsible study at all) that supports the conclusion that there is “fat” or unnecessary charges in the title industry.<sup>116</sup> ALTA notes that other than some potential savings in marketing costs and modest operational efficiencies, there are no significant savings in the title-related or closing-related work.<sup>117</sup> HUD finds that there is substantial evidence that title, closing, and other settlement fees can be reduced. This analysis reviews data and studies showing the existence of wide variability of prices in this industry. Section V of Chapter 2 and Step (8) of Section VI.E.1 of this chapter reviews evidence showing that title fees can be reduced; readers are referred to those sections for the details. It is also clear that consumers do not effectively shop for third-party services, often relying on the recommendations of real estate agents and lenders. In today’s market, originators too often simply pass high prices through to consumers, with little effort at controlling them.

Thus, this economic analysis does not agree with conclusions reached by ALTA and others commenting on the 2002 proposed rule from the title and closing industry. This analysis concludes that there are legitimate cost savings that will result from RESPA reform – they are not “artificial” savings as suggested by ALTA, but rather are “real” savings based on a current situation of excess charges in this area. There is evidence suggesting that fees for title and closing-related services can be lowered, providing an important source of savings for consumers.

### **VIII.C.2.b. Will Savings In Third-Party Costs Be Passed Through To Consumers?**

Chapter 2 explained that the mortgage market became more concentrated during the 1990s, with the growth of large lenders that not only originated loans themselves on a retail basis, but also purchased loans from brokers and loan correspondents on a wholesale basis.<sup>118</sup> Most industry observers have concluded that these lenders operate in a highly competitive

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businesses. As noted earlier, large national title companies have to rely on local title companies in order to serve all areas.

<sup>116</sup> See comments from James R. Maher, Executive Vice President, ALTA, to Rules Docket Clerk, HUD, regarding "Proposed Rule on Real Estate Settlement Procedures Act (RESPA); Simplifying and Improving the Process of Obtaining Mortgages To Reduce Settlement Costs to Consumers; Docket No. FR-4727-P-01; 67 Fed. Reg. 49134 (July 29, 2002)," October 4, 2002.

<sup>117</sup> Ann Schnare, who prepared a report for the National Association of Realtors entitled "The Downside Risks of HUD's Guaranteed Mortgage Package" (dated October 24, 2002), expressed similar sentiments. According to Schnare, "there is no theoretical or empirical evidence to suggest that mortgage packaging will lead to lower settlement costs. In fact, one could easily argue just the opposite" (p. 22). However, in the same paper, Schnare suggests that third-party service fees can be reduced when she comments that HUD's enhanced GFE should increase incentives of lenders to seek out low cost service providers as a way of competing for market share. (p. 11)

<sup>118</sup> This increased consolidation of the mortgage market is referring to the growth in large wholesale lenders such as Countrywide and Wells Fargo. As explained throughout this economic analysis, mortgage origination has become dominated by brokers during this period.

market environment.<sup>119</sup> Several of the commenters had a different view about the competitiveness of the mortgage market, arguing that lenders would retain any third-party savings, rather than passing them through to consumers.<sup>120</sup> This economic analysis disagrees strongly with the suggestions that cost savings will somehow be retained by large lenders behaving monopolistically. Analyses of today's mortgage market clearly suggest the reverse. Chapter 2 reviews studies concluding that large as well as small lenders operate in a highly competitive market environment. While there has been increased consolidation of the mortgage market in recent years, this does not mean that large lenders can control prices; these are highly competitive markets. If one firm does not pass on its savings, then another firm reaping the same savings will enter the market and reduce prices. Thus, this economic analysis disagrees strongly with statements that the cost savings from RESPA reform will somehow be retained by large firms behaving monopolistically in the mortgage lending industry. There is simply no evidence to support those statements. There is substantial evidence of price competition in the mortgage market. Readers are referred to Section V.D of Chapter 2 for further discussion.

### **VIII.C.2.c. Volume Discounting**

The 2008 proposed rule encouraged volume discount arrangements, which would lead to more competitive third-party prices, by clarifying that volume discounts are legal as long as the cost reduction is passed along to consumers. The final rule simply clarifies that any type of discount is permissible, so long as the discounted price paid is passed on to borrowers, without changing regulatory language.

**Comment.** One of the primary concerns of small firms was the potential adverse effect of HUD's clarification that volume discounting is legal as long as the savings are passed along to the consumer. ALTA, ICBA, NAMB, and NAR contend that volume discounts will favor large settlement service providers and loan originators/lenders at the expense of small businesses and place them at a disadvantage. The Office of Advocacy formally endorsed this position in their comment letter (June 11, 2008) and predicted that HUD's proposed clarification "may cause small businesses to leave the market and result in higher prices for consumers in the long term."

**Response.** The purpose of HUD's clarification was to set a clearer standard for compliance in the context of the new GFE. Firms that were profitable before the clarification should not be negatively impacted as the change would be superficial for those that understand the law. However, there is some confusion in the industry concerning the legality of discounts

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<sup>119</sup> See LaMalfa (2002), Joint Center for Housing Studies (2002), Guttentag (2002), and Woodward (2003a).

<sup>120</sup> ALTA (2002), for example, argued that HUD's proposals would increase concentration in the mortgage industry and would allow larger lenders to retain any price discounts obtained from third-party providers (p. 28). Similarly, the National Association of Realtors (NAR, 2002) said that under HUD's packaging proposal lenders will have "no obligation to pass along discounts to borrowers" (NAR, 2002, p.4). A NAR-funded paper by Ann Schnare, entitled "The Downside Risks of HUD's Guaranteed Mortgage Package" (dated October 24, 2002) reached similar conclusions, noting that she had "some reason for concern" that packagers will not pass through any savings to consumers but rather retain any savings for themselves. She states "more important, perhaps, there is no reason to conclude that any cost savings that do arise [from packaging] will be passed through to consumers" (p. 10).

and different courts have different interpretations of the law. Thus, the final rule could have had a considerable material impact on business practices.

HUD does not expect the practice of discounting to have the adverse effects advanced by the Office of Advocacy and many industry groups. The importance of local orientation is a fundamental aspect of the real estate industry and one that ensures the continued success of small firms. Nevertheless, if there were to be adverse effects from discounting, they will occur without HUD clarifying that the practice is legal.

HUD will not address volume discounts in the rule. However, the absence of any mention of volume discounting in the rule does not change the department's long-held belief that volume discounts are not a violation of RESPA and will inform the industry how to record these discounted prices so as to avoid RESPA violations: so long as the price charged to the borrower on the HUD-1 is no greater than the discounted price paid to the third party, the discounted price poses no problems.

### **VIII.C.3 Local Orientation of Title Industry**

Another issue that is important when considering the impacts of the final RESPA reform (new GFE, tolerances, volume discounting, etc.) on the title industry concerns the local nature of the industry. The title industry demonstrates a high degree of geographic specialization. Although title insurance companies do not need to be close to the properties insured, until there is widespread use of standardized electronic land record keeping accessible by the Internet, the information-gathering service the industry provides will require proximity to land title records (or the establishment of "title plants," i.e., duplicates of local records, the maintenance of which requires proximity to local government records). ALTA (2002)<sup>121</sup> reports that more than two-thirds of title companies have offices in only one county while only one-sixth have offices in three or more counties. These multi-county title companies averaged only 9 counties each. Further, multi-county title companies are concentrated in the highest-population metropolitan counties. According to the 2000 Census, there are 3,141 counties or equivalent areas in the United States.

Even if a provider is efficient and charges low prices, it will not be able to compete against title and closing firms who are located sufficiently closer to the site in question. Thus, title and closing companies are by economic necessity provided by local firms. Reinforcing the local orientation are the value of local expertise and the importance of personal networks in receiving referrals. ABN-AMRO representatives told HUD that even when they dealt with a national third party intermediary, that firm typically used locally-based firms to do the work (e.g., local title agents, local closers, etc.).

The local orientation of the title industry could change over time. However, it is unlikely that RESPA reform would be the catalyst. The advances in technology that would change

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<sup>121</sup> "ALTA Abstracter and Title Agent Operations Survey 2002," Fetzer-Kraus, Washington D.C.

business practices are independent of what HUD does about RESPA.<sup>122</sup> The only change that the final rule will introduce is that title and closing services may occur at lower prices negotiated between providers and lender originators. There will be no significant change in the local provision of title and closing work. Nor will there be a reduction of the number of these services purchased since this reform will not result in a drop in the number of mortgages that require these services. Large lenders will have to deal with multiple settlement services providers in order to ensure complete geographic coverage, and large multi-jurisdictional title firms have no apparent cost advantages over smaller title firms.<sup>123</sup> In fact, large multi-jurisdictional title firms may have location-related cost disadvantages.<sup>124</sup> There is no reason to believe that small title firms charging competitive prices will be adversely impacted by the changes in this rule.

### VIII.C.3. Conclusions

Sections IV of both Chapters 2 and 4 explain that the title and closing industry is, in general, characterized by local firms providing services at constant returns to scale. Overall, competitiveness within the title and closing industry should be enhanced by the rule. It is true that increased shopping by consumers, as well as increased shopping by loan originators to stay within their tolerances, will reduce the revenues of those title and closing companies that have been charging non-competitive prices. Transfers from this industry could range from \$1.35 billion to \$2.5 billion. It is estimated that small businesses account for 38.1 percent of the revenue of the title and settlement industry. Thus, the transfers are projected to be \$0.51 billion to \$0.95 billion for small settlement and title agents.

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<sup>122</sup> For example, the First American Title Insurance Company launched a new automated title search platform that reduced the time and cost associate with conducting title searches. By linking various data bases and automating the search process, First American reduced the time for the search process in half. See “First American Introduces New Automated Title Search System” at [www.alta.org](http://www.alta.org). There have also been recent efforts to use vendor-management platforms and other technologies to order title and other third-party settlement services, an area that has lagged in the use of technology. According to the Fannie Mae study, *Mortgage Focus* (2003), automated systems are now commonly used to order credit reports (by 93 percent of the 101 lenders sampled in the Mortgage Focus study), flood certifications (by 90 percent), and mortgage insurance (by 88 percent). However use of such technology is much less prevalent for delivering disclosures (by 36 percent), ordering escrow services (by 33 percent), and loan closings (by 23 percent). The Fannie Mae study states that costs should drop as participants turn to vendor-management platforms to order third-party services. (p. 3) Freddie Mac is adapting its Loan Prospector (LP) system to provide a platform for originators to process, underwrite, close and deliver loans. For example, the LP system could be used to order title products and other third-party services such as appraisals and pest inspections. See “Freddie Launches LoanProspector.com,” *National Mortgage News*, December 2, 2002.

<sup>123</sup> As noted in Section VII.A.3, representatives of ABN-AMRO told HUD staff that even when ABN-AMRO dealt with a national intermediary, that firm typically used locals to do the work (e.g., local appraisers, local title agents, local closers).

<sup>124</sup> Much title work is done at the local courthouse either directly or through the maintenance of “title plants.” The transportation cost of visiting individual sites, especially the opportunity cost of the time spent in transit, adds to the cost of providing the service. These transportation costs counterbalance any scale economies that may otherwise exist in the production of title services. These countervailing cost pressures create an effective constant returns to scale production function for the title and closing and explains the wide range of firm size as well as the continued success of small title firms.

The reasons why the new GFE and its tolerances will lead to improved and more effective shopping for third-party services by consumers and loan originators have been discussed extensively in this chapter, and need not be repeated here. Excess charges will be reduced and market competition will ensure that reduced costs are passed through to consumers.

## **VIII.D Other Third-Party Providers : Small Business Impacts and Competitive Issues**

### **VIII.D.1 Introduction**

Other industries affected by the rule are third-party settlement service providers such as the appraisal, surveying, credit reporting, and pest inspection industries. Of these, the appraisal industry accounts for the largest share of third-party settlement costs, an estimated 17.7 percent of all third-party settlement fees, as compared to 2.9 percent for surveys and 1.3 percent for pest inspections.<sup>125</sup> For each industry, Chapter 5 discusses: (a) the nature and characteristics (number of firms, number of employees, revenue, etc.) of the industry; (b) estimates of consumer savings and revenue transfers for the industry under the rule; and (c) the small business share of projected industry transfers. In Chapter 5, readers are referred to the following sections: Section V.A for the appraisers, Section V.B for the surveyors, and Section V.C for the pest inspectors.

The next section provides an overview of the appraisal industry, summarizes comments on the proposed rule by industry groups, and examines anticipated competitive impacts of the RESPA rule for appraisers. Section 0 describes the same for the survey and pest inspection industries.

### **VIII.D.2 Appraisal Industry**

The central task for an appraiser is to prepare a written description of the real property and submit an estimate of its market value. The role of the appraiser in the settlement process is to provide a lender with an estimate that would allow the lender to verify whether the selling price is high enough to justify the loan requested. For this reason, the appraiser plays an important role in the loan qualification and settlement processes. Given the potentially conflicting interests in the appraised value of a property, professional ethics (Uniform Standards of Professional Appraisal Practice) emphasize the appraiser's role as an objective, independent, and unbiased third-party. As discussed in Chapter 5, an emerging trend in the appraisal industry is the use of Automated Valuation Models (AVMs) to provide an objective and statistical estimate of the property value, based on statistical models.

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<sup>125</sup> Government fees and escrow items are excluded from these calculations.

### **VIII.D.2.a Background**

Census data from the year 2004 indicate that the real estate appraisal industry employed a total of 45,021 people at 15,689 employer firms in the U.S. with estimated total annual revenue of \$5.0 billion. Most of these were small firms: the real estate appraisal firms averaged 2.9 employees per firm with estimated revenue of \$316,080 per firm. In addition to the 15,689 employer firms, the Census Bureau reports that there were 49,802 non-employer establishments in 2004, most of which are sole proprietorships. A conservative approximation of the percentage of small businesses in the industry can be calculated from 2002 Economic Census data. Of the total employer firms, 99.0 percent had annual revenue less than \$2.5 million, which approximates the SBA definition of small.<sup>126</sup> These small employer firms accounted for 75.1 percent of revenue, 82.8 percent of employees, and 78.4 percent of annual payroll. Of all firms in the appraisal industry, employer and nonemployer, 99.8 percent are small. These small businesses account for less than 83.1 percent of the revenue earned by the entire appraisal industry. A more in-depth description of the real estate appraisal industry can be found in Section V.A of Chapter 5.

### **VIII.D.2.b Comments**

The comments on the 2002 proposed rule from the appraisal industry, represented by the American Guild of Appraisers and the American Society of Appraisers, highlight the importance of high-quality appraisals for the residential real estate sector and raised some potential negative impacts that packaging will have on the quality of appraisals. Some of their primary objections to the rule are noted below.

First, it was felt that consumers would not benefit from any cost savings due to the rule. According to the American Guild of Appraisers, lenders would charge borrowers more for an appraisal than it would actually cost because RESPA does not place a ceiling on what lenders and brokers can charge borrowers for settlement services.<sup>127</sup> However, while overcharging may be legally possible, it will not be economically possible. Borrower shopping should expose those lenders who ask for noncompetitive prices for what they are when they are compared to mainstream offers. High-priced originators will face pressure to change their ways or leave the market. As discussed earlier this chapter, the shopping and cost-reducing benefits of the rule would lead to lower prices for consumers.

Second, it is argued that the rule would lead to a decrease in the quality of appraisals that would harm borrowers. The American Guild of Appraisers states that: “the incentive to find the lowest price without regard to quality is very likely to lead to poor appraisals, particularly

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<sup>126</sup> Unfortunately, the breakdown of the 2002 Economic Census data by revenue does not allow us to calculate the share of firms earning less than \$1.5 million (the official SBA size standard).

<sup>127</sup> Comments from William Sentner, President, American Guild of Appraisers, to Rules Docket Clerk, HUD, regarding “Docket No. FR-4627-P-01, Real Estate Settlement Procedures Act (RESPA); Simplifying and Improving the Process of Obtaining Mortgage Settlement Costs to Consumers,” October 23, 2002, page 2.

because many lenders have shown that they are less concerned with the quality of the appraisal than with simply ‘papering the file.’”<sup>128</sup> The fear is that the lender will be able to buy lower-quality services because the consumer will not know exactly what they are paying for.<sup>129</sup> Of course, it is obvious that a lender who buys low quality appraisals may be hurt in the long run if the appraisals are not accurate and borrowers default. In addition, most lenders sell their loans on the secondary market and they may be required to buy back a loan that defaults due to poor underwriting and appraisal procedures. This suggests that lenders who do poor quality work would not last long or, at least, they would develop a poor reputation with the firms that purchase their loans. The quality standards of the originators that sell their loans will be governed by the requirements of the investors (Fannie Mae, Freddie Mac, and private conduits), the guidelines of their insurance company (FHA), or the rating agency that rates their mortgage-backed securities. RESPA reform is not going to change that.

Third, there was a concern that many appraisers would be driven out of business. An issue for some is that the tight tolerances could have a harmful impact on the appraisal industry. The ten percent tolerance of the GFE on third-party services is believed to be too restrictive because some appraisals are more costly than others. It is argued by the American Society of Appraisers that not allowing appraisers to recoup the costs of the more difficult appraisals will discourage some from performing appraisals and even from entering the industry.<sup>130</sup> However, under the rule, the provider of a third-party settlement service is permitted to charge an average cost for their service. This allows appraisers to build into their price the occasional appraisal that takes a significantly larger amount of time to complete. In addition, the rule clarifies the situations (such as the need for a second appraisal) where lenders can deviate from their initial estimates. There could be lower prices for appraisals due to the tighter tolerances on third-party costs under the rule and due to allowing settlement service providers to seek discounts for settlement services. Improved shopping for third-party costs and discount business arrangements are encouraged under the rule. The tight tolerances of the new GFE will provide a strong incentive for professionals and experts to shop for appraisal services in order to reduce their costs. But as noted above, it is in their self-interest to ensure that quality appraisals are performed. Thus, probably not unlike their situation today, appraisers will be operating in a highly competitive environment with many opportunities to compete. Traditional appraisers will continue to be affected by technological changes in the industry, such as the use of automated valuation models, which is an ongoing process that is not due to RESPA reform.

#### **VIII.D.2.c Competitive Impacts**

Like surveys and pest inspections, traditional appraisals are provided on-site at the mortgaged property. The transportation cost of visiting individual sites, especially the

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<sup>128</sup> Page 3, *Ibid.*

<sup>129</sup> Comments from Thomas A. Motta, President, Appraisal Institute, and John J. Connolly, President, American Society of Appraisers, to Rules Docket Clerk, “Docket No. FR-4627-P-01, Real Estate Settlement Procedures Act; Simplifying and Improving the Process of Obtaining Mortgage Settlement Costs to Consumers; Proposed Rule,” October 28, 2002, page 3.

<sup>130</sup> Motta and Connolly, *op. cit.*, page 4.

opportunity cost of the time spent in transit, adds substantially to the cost of providing the service. The transportation costs counterbalance, or overwhelm, any scale economies that may otherwise exist in the production of these services. The countervailing transportation cost pressures creates an effective constant returns to scale production function for this industry and can serve to explain the wide range of firm size as well as the continued success of small businesses in the appraisal industry. This explains why approximately 99.8 percent of traditional appraisal firms qualify as small businesses.

Even if an appraisal firm is efficient and charges low prices, it will not have the same advantage as providers who are located sufficiently closer to the site in question. Thus, traditional appraisals are by economic necessity provided by local firms. Reinforcing the local orientation of the appraisal industry is the value of local expertise. A profound understanding of the characteristics of the local real estate market is essential for a successful appraisal. In addition, local appraisal firms maintain local networks of customers and clients, based on their established track records, which should give them a solid business advantage.

There will be no significant change in the local provision of traditional appraisals because of this rule. Nor will there be a reduction of the number of these services purchased since the RESPA reform will not result in a drop in the number of mortgages that require these services. As noted above, traditional appraisers will continue to be affected by the increasing use of automated valuation models, but that is a trend that has already started. Since large lenders will have to deal with multiple appraisal firms in order to ensure complete geographic coverage, and large multi-jurisdictional appraisal firms have no apparent cost advantages over smaller providers (and may have location-related cost disadvantages), there is no reason to believe that small appraisal firms will be excluded from the market by lenders of any size, even those that are seeking volume-based discounts.

The local orientation of the appraisal industry could change over time. As noted above and as discussed in Section V.A.1 of Chapter 5, there has been a trend towards the increasing use of automated valuation appraisals, particularly for appraising properties that are being refinanced and properties that are being used as collateral for home equity loans. The necessity for appraisers to visit all homes in need of an appraisal could be reduced by the AVM, but the data needed to determine that there is water in the basement may not be readily available for AVM models so visits to properties will continue to be important. However, it is unlikely that RESPA reform would be the catalyst for increases in the use of AVMs, as the technological advances are already taking place. While RESPA reform could accelerate the use of AVMs, it will not likely have an impact as to whether AVMs are eventually adopted more broadly by the appraisal industry. The adoption of AVMs will depend on the accuracy of these estimation models and their appropriateness for different types of properties.<sup>131</sup>

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<sup>131</sup> The Fannie Mae study, *Mortgage Focus* (2003), reported that 34 percent of that study's sample of 101 lenders were using AVMs for a variety of reasons throughout the mortgage process, including point-of-sale property valuation, pre-funding validation, post-closing quality control, home equity lender tolerances, and portfolio retention. (p. 8)

The tolerances and incentives for volume-based discounts will encourage originators to seek cost reductions in all third-party services. The cost savings for consumers of the GFE are estimated to be from 7.5 to 10 percent of current fees, which translates to a loss of \$326 million-\$438 million for appraisers. Because it is not expected that small business will bear a disproportionate burden of the reform than large business (see argument above), one can apply the small business revenue percentage of 83.1 percent can be used to estimate the impact of the rule on small business: the estimates of the economic impact of the GFE will be from \$273 million to \$364 million.

### **VIII.D.3 Other Third-Party Settlement Services**

The issues facing surveyors and pest inspectors are similar to those of the appraisal industry. These services are not required as frequently as are appraisals; still, as noted, surveys represent 2.9 percent of all third-party settlement costs and pest inspections, 1.3 percent. Surveys are vital in ensuring that property line disputes do not threaten the collateral value of the property. Pest inspections are needed to reassure lenders that termites have not infested a property before extending a mortgage loan. Similar to traditional appraisals, both of these services are locally provided and the majority of industry revenue is earned by small businesses. In 2004, small businesses accounted for 81.3 percent of the revenue earned by all firms (nonemployer and employer) in the surveying and mapping services industry and for 53.9 percent of the revenue of the exterminating and pest control industry.<sup>132</sup> A more in-depth description of these industries can be found in Sections V.B (surveyors) and V.C (pest inspectors) of Chapter 5, which also report the estimated revenue impacts on these two industries. For the surveying industry, the cost savings for consumers of the GFE are estimated to range from \$54 million to \$73 million. Because it is not expected that small business will bear a disproportionate burden of the reform than large business (for the same reasons that apply to appraisers), the economic impact of the GFE will be \$44 million-\$59 million on small surveyors. For pest inspectors, the revenue impact of the GFE translates to a loss of \$24 million - \$33 million. The economic impact of the GFE on small businesses in the pest control industry will be \$13 million - \$18 million.

One trend of some concern to surveyors is that lenders appear to be substituting survey coverage in their title insurance for an actual survey.<sup>133</sup> If there were to be a dispute over property lines that led to a decrease in the property value, then the homeowner would bear the brunt of that loss. However, if the decrease in property value were to exceed the owner's equity, then the excess loss would be a cost paid by the lender. To avoid such a situation, lenders have traditionally required surveys before closing. An alternative strategy is for lenders to insure themselves against the remote possibility that such a loss would occur. As represented by the

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<sup>132</sup> Note that credit reporting is different because it is characterized by a high-level of concentration and is dominated by three large firms.

<sup>133</sup> Comments from Curtis W. Sumner, President, Executive Director, American Congress on Surveying and Mapping, to Rules Docket Clerk, HUD, regarding "Docket No. FR-4627-P-01, Real Estate Settlement Procedures Act (RESPA); Simplifying and Improving the Process of Obtaining Mortgage Settlement Costs to Consumers," October 28, 2002, page 1.

American Congress on Surveying and Mapping, surveyors worry that this trend could be hastened by the RESPA rule to the disservice of the consumers.<sup>134</sup> However, it is important to note that this practice has already become widespread and is not likely to be affected by RESPA reform.

Again, it is important to emphasize that the impacts of the rule on these two industries must be considered in the context of their local nature. As discussed above for appraisals:

- The transportation cost of making on-site visits adds substantially to the cost of providing these third-party services if the firm were not local. Transportation costs and the value of local expertise could outweigh any advantages that a larger firm would have.
- It is not expected that there will be a significant change in the local provision of these third-part settlement services because of this rule. Since large lenders will have to work with many smaller firms in order to ensure complete geographic coverage, there is no reason to believe that small firms will be excluded from business under this rule.
- The local orientation of these industries could change over time with the introduction of various technologies; however, it is not likely that RESPA reform will initiate such a trend.

#### **VIII.D.4 The Real Estate Industry**

Beyond bringing the buyer and seller together, real estate agents generally do not provide settlement services *per se*, but they can be involved in the settlement process in number of ways. Real estate agents provide information about the settlement process and may accompany their clients to the settlement table. Frequently real estate agents refer potential buyers to lenders and title and settlement companies. While some homebuyers may limit their relationship with their real estate agent, many homebuyers depend on the real estate agent for wide-ranging advice and referrals throughout the entire purchasing process. Homebuyers usually develop a business relationship with a real estate agent prior to establishing such relationships with lenders, settlement agents, or other professionals involved in the settlement process. Consequently, homebuyers tend to view real estate agents as a trusted source of information about the home-buying process. Moreover, real estate agents and builders increasingly encourage homebuyers to use affiliated or in-house mortgage and settlement service providers.<sup>135 136</sup>

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<sup>134</sup> Ibid.

<sup>135</sup> Individual real estate agents are generally not directly affiliated with mortgage and settlement service providers. Rather, the affiliation is generally indirect; the agent is affiliated with a real estate broker and the broker is affiliated with a mortgage or settlement service provider.

<sup>136</sup> The real estate agency Coldwell Banker Residential Brokerage provides an example of the trend towards using affiliates and in-house mortgage and settlement service providers. The firm launched a new joint venture to offer its

Census data from the year 2004 indicate that the Real Estate Agents Brokers industry employed 323,045 people at 86,258 firms. These firms had estimated annual revenue of \$91.7 billion. Thus, the industry averaged 3.7 employees per firm and had estimated annual revenue per firm of \$1,062,995. Most of those employed within the industry are employed by relatively small firms: 70.3 percent of the employees worked at firms employing fewer than 100, and 53.9 percent worked at firms employing fewer than 20. In addition to the 86,258 firms in the Real Estate Agents Brokers Industry offices that had employees in 2004, the Census reports there were 702,898 nonemployer firms in the Real Estate Agents Brokers industry. (See Section VI of Chapter 5 for further details on the characteristics of the real estate industry, including a definition of nonemployer firms.)

Most real estate agents and their brokers are represented by National Association of Realtors (NAR). NAR primarily commented on aspects of the RESPA rule having no direct impact on their members such as the YSP disclosure requirements on the GFE. NAR also commissioned a study on the compliance costs of the proposed rule which is reviewed in Chapter 6 of this analysis.

## **IX. Summary of Transfers, Benefits, Efficiency Gains, and Costs**

This section pulls together estimates about the benefits, costs, transfers, and efficiency gains associated with the rule that have either been discussed in this chapter or are discussed in Chapter 6. Specific quantitative estimates are provided below. As discussed throughout this chapter and in Chapter 6, it is difficult to estimate these effects, given available data. The reader is referred to the relevant sections for the specific assumptions and the range of possible estimates around those reported below. Still, the estimates provide a sense of the substantial benefits of the rule to consumers.

### **IX.A. Transfers**

It is estimated that borrowers would save \$8.35 billion in origination and settlement charges. This \$8.35 billion represents transfers to borrowers from high priced producers, and constitutes 12.5 percent of total charges.

- The assumption that consumers will benefit by a reduction of settlement costs of at least \$668 per loan has not been challenged.

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customers title and escrow services in California. Coldwell implemented an online records-management service whereby property sellers, lenders agents and title and escrow officers have electronic access to the latest documented events in a property's sale, such as an appraisal or an inspection report. Coldwell already offered mortgage financing through its parent Cendant Corporation. Coldwell explained the push towards affiliates and in-house service providers is driven by "customer demand for greater convenience." Sharon Simonson, "Residential Real Estate Brokers Push Customer Convenience," San Jose Business Journal, June 16, 2003.

- Indeed, results from a recent statistical analysis of FHA data imply that the savings to consumers may be as much as \$1,200 per loan.

## IX.B. Efficiencies

While most of the effect of this rule comes in the form of transfers from originators and settlement firms to consumers, many efficiencies have also been discussed in this chapter and elsewhere. They are listed below.

- Mortgage applicants and borrowers realize **\$1,169 million** savings in time spent shopping for loans and third-party services. This amount is derived from a time savings worth \$55 per applicant (75 minutes at \$44 per hour) over 21.25 million applications.
- If half the borrowers' time saved comes from less time spent with originators and third-party settlement service providers, then originators and borrowers will spend 37.5 minutes less answering borrowers' follow-up questions.
- The value of the time savings from dealing with follow-up questions is \$956 million (37.5 minutes at \$72 an hour multiplied by 21.25 applications). Loan originators receive a saving of \$765 million (30 minutes per application) and third-party settlement \$191 million (7.5 minutes per application).
- There will be reductions in compliance costs from average cost pricing. It is estimated that the benefits of average cost pricing will lead to a reduction in originator costs of 0.5 percent, or \$210 million.
- The lower profitability of seeking out vulnerable borrowers for non-competitive and abusive loans should lead to a reduction in this activity. If the decline in this activity represented one percent of current originator effort, this would result in \$420 million in savings to firms.
- Some or all of industry's total of **\$1,586 million** in efficiency gains have the potential to be passed through to borrowers through competition.

## IX.C. Costs of the Rule

Chapter 6 examines the compliance and other costs associated with the new GFE form and its tolerances. Additional costs could arise from the new GFE and changes to the HUD-1. The total one-time compliance costs to the lending and settlement industry of the GFE and HUD-1 are estimated to be **\$571 million**, \$407 million of which is borne by small business. Total recurring costs, in the high-cost scenario, are estimated to be **\$918 million annually** or **\$73.40 per loan**. The share of the recurring costs on small business is \$471 million. For a more detailed discussion of these recurring costs, as well an analysis of one-time adjustment costs, the reader is referred to Chapter 6..

## **Exhibit 1: Items from an Actual Good Faith Estimate**

### **800 Series: Items Payable in Connection With Loan**

- 801. Origination Fee
- 802. Loan Discount (Permanent Buydown)  
Loan Discount (Points)
- 803. Appraisal Fee
- 804. Credit Report Fee
- 808. Tax Service Fee
- 810. VA Funding Fee
- 811. Application Fee
- 812. Underwriting Fee
- 813. Document Preparation Fee
- 815. Flood Hazard Certification Fee
- 821. Processing Fee
- 822. Temporary Buydown Fee
- 828. CCCS Homebuyer/  
Education/Counseling Fee
- 831. Appraisal Recertification Fee
- 833. Satisfactory Completion  
Certificate Fee
- 837. Float Down Fee
- 838. Commitment Fee
- 839. Courier Fee-Bank
- 844. Condo/PUD/Co-Op/ Approval  
Fee
- 845. Condo/PUD/Co-Op/ Waiver  
Fee
- 846. Loan Coordination Fee
- 848. Fire & Police Service Fee
- 856. Escrow Waiver Fee
- 858. Consolidation Extensions  
Modification Fee
- 861. Modification Option Fee
- 862. Construction Underwriting Fee
- 863. Construction Loan Origination  
Fee
- 872. Close EXTN Rate Lock Fee
- 873. Close Rate Xtend Fee
- 874. Accelerator Program Fee

### **1100 Series: Title Charges**

- 1101. Settlement/Closing Fee-  
Refinance
- 1102. Abstract or Title Search
- 1103. Title Examination
- 1104. Title Insurance Binder
- 1105. Document Preparation Fee
- 1106. Notary Fee
- 1107. Attorney's  
Settlement/Abstract/Title Fee
- 1108. Title Insurance Fee
- 1109. Lender's Coverage
- 1110. Owner's Coverage
- 1111. Special Assessment
- 1115. Endorsement Fee
- 1122. Special Assessment Search  
Fee
- 1124. Tax Certification Fee
- 1125. Courier Fee-Settlement Agent

**Exhibit 2: Items Payable in Connection With Loan (800 Series),  
from sample of 3,000 HUD-1 forms across five metropolitan areas**

2nd Application Fee	Broker Origination Fee
2nd Credit Report Fee	Broker points
2nd Document Preparation Fee	Broker Processing Fee
2nd Mortgage Fee	Brokerage Fee
2nd Servicing Fee	Business Credit Report Fee
4506 Fee	Buy-down Deposit
Access Fee	Buy-down Expense
Additional Credit Report	Buy down Fee
Additional Origination Fee	Closing Fee
Additional Appraisal Fee	Closing Redraw Fee
Additional Loan Charges	Commitment Fee
Additional Loan Discount	Commitment Update Fee
Additional Loan Processing Fee	Compliance Inspection Fee
Additional Underwriting Fee	Compliance Review Fee
Amortization Schedule Fee	Credit Review Fee
Application Fee	Desktop Underwriter Fee
Appraisal Conversion Fee	Deposit Verification Fee
Appraisal Fee	Discount Fee
Appraisal Retype Fee	Document Fee
Appraisal Review Fee	Document Processing Fee
Appraiser Re-inspection Fee	Document Review Fee
Assignment Fee	Down Payment Assistance Fee
At Home Service Fee	Energy Efficient Mortgage Fee
Attached Charges	Energy Improvement Fee
Automated Underwriting System Fee	Engineering Report Fee
Authority Fee	Escrow Set Up Fee
Balance of Set-up Fee	Express Fee
Bond Application Fee	Extension Fee
Bond Delivery Fee	Field review Fee
Bond Fee	FHA Commitment Fee
Bond Participation Fee	FHA Compliance Fee
Bond Procurement/Compliance Fee	FHA Funding Fee
Bond Program Fee	FHA Mortgage Insurance Premium
Broker Admin Fee	Final Inspection Fee
Broker Application Fee	Final Appraisal Inspection Fee
Broker Commitment Fee	Final Compliance Review Fee
Broker Courier Fee	Flood Hazard Certification Fee
Broker Credit Report Fee	Flood Hazard Determination Fee
Broker Fee	Flood Inspection Fee
Broker Loan Discount	Funding Delivery Fee
Broker Origination Fee	Home Buyers Counseling Fee

Home Inspection Fee	Rush Fee
Homestretch Participation Fee	Southern California Mortgage Exchange
Inspection Fee	Recording Fee
Insurance Tracking Fee	Second Mortgage Fee
Insurance Fee	Septic Inspection Fee
Interim interest	Servicing Fee
Investor Delivery Fee	Set-up Fee
Leader Fee	Settlement Fee
Lender Processing Fee	Sacramento Home Loan Counseling
Lender's Inspection Fee	Center Fee
Lenders Charge	Storage Fee
Loan Discount fee	Submission Fee
Loan Fee	Tax Administration
Loan Processing Fee	Tax Lien Fee
Loan Set-up Fee	Tax Service Fee
Lock-in Fee	Temporary Buy-down Fee
Management Fee	Termite Inspection Fee
Mortgage Credit Certificate Fee	Title Review Fee
Mortgage Electronic Registration	Underwriting Fee
System Fee	US Fee to Sacramento Housing and
Miscellaneous Fee	Redevelopment Agency
Mortgage Offer Conditions Fee	Virginia Housing Development
Mortgage Service Fee	Authority Bond Loan Fee
Participation Reservation Fee	Verification of Deposit Fee
Preliminary Preparation Fee	Warehouse Fee
Pennsylvania Housing Finance	Wire fee
Authority Bond Fee	Yield Spread Premium
Pennsylvania Housing Finance	
Authority Qualifying Fee	
Post-closing Fee	
Premium Pricing Fee	
Prepaid on 2nd Deed of Trust	
Principal Curtailment	
Processing Fee	
Property Inspection Fee	
Qualifying Fee	
Rate Extension Fee	
Real Estate Tax Service Fee	
Recertification Fee	
Redraw Fee	
Re-inspection Fee	
Repair Certification	
Review Appraisal	
Review Fee	
Roof Certification Fee	
Roof Report	

**Exhibit 3: Title Charges (1100 Series),  
from sample of 3,000 HUD-1 forms across five metropolitan areas**

Abstract Recertification Fee	CPL (Cost per Lead) Fee
Abstract Update Fee	CTS (Commission Tracking System) Fee
Abstract Update Search	D/T Recon/Release Fee
Accommodation Signing & Notary Fee	Data Down Fee
Accommodation Signup Fee	Deed & Mortgage Recording Fee
Additional Attorney Fees	Deed Preparation Fee
Additional Charges	Delay Closing Fee
Additional Closing Fee	Delivery Charges
Additional Pin Search Fee	Disbursing / Closing Service Letter Fee
Additional Policy Fee	Disclaimer Deed Fee
Additional Risk Fee	Document Processing Fee
Additional Work Charge	Domestic Relations Search Fee
Administrative Fee	Drawing Fee
After Hours Closing Fee	Drawing Interspousal Deed Fee
ALTA (American Land Title Association) Inspection Fee	Duplicate Policy Fee
ALTA Loan Policy Fee	Early Hour Closing Fee
Assessment Letter Fee	Electronic Recording Fee
Attorney Fees	Encroachment Endorsement Fee
Binder Step-up Rate	EPA Endorsement Fee
Bond in Lieu of Probate Fee	EPA/Later Date Fee
Broker service Fee	EPA/LOC (Level of Concern) Note Fee
Buyer recording Fees	EPL Endorsement Fee
Buyer Title Insurance	Escrow Fee
Certification and License to Lawyers Title Fee	Escrow Holdback Fee
Cancellation Fee	Estate Search Fee
Case Examination Fee	Estoppel Fee Request
Certification of Abstract Fee	Estoppel/Municipal/Water/Tax Search Exam Fee
City Certification Fee	Extra Policy Fee
City Lien Inquiry Fee	Extra Risk Premium
Closing Fee	Fee for Water Certification and Zoning
Commitment Update Fee	FHA Broker Service Fee
Commitment Fee	FHA Repair Reimbursement
Commitment Later Date Fee	Final Abstract Endorsement Fee
Condo Estoppel Request Fee	Final Abstract Update Search Fee
Construction Title Charges	Final Certification Fee
Conveyance Fee	Final Recertification Fee
Copies of Tax Bills Fee	Final Search Title Recertification Fee
Courier Fee	Final Title Fee
Court Case Exam Fee	Final Update Search Fee
Government Recording and Transfer	Florida form 9 Fee

GAP (Guarantee Asset Protection)	Post-Closing Fee
Coverage Fee	Post Recording Title Search Fee
Government Recording and Transfer	Pre-Computer Title Chain Fee
Charges	Pre-Computer/ Gap Search
Grass Cut Fee	Preparation Fee
Handling Fee	Principal Repayment Fee
Hard Copy Fee	Pro Option Fee
Hazard Insurance Reimbursement	Processing Fee
Homeowners Association (HOA)	PUD (Planned Unit Development)
Estoppel Letter Fee	Endorsement Fee
Homestead Endorsement Fee	R-5 Form Processing Fee
Homestead Waiver Endorsement	Radon Test Fee
HUD Closing Fee	Realty Fee
Impact Fees	Recording Deed Fee
Insured Closing Protection Letter Fee	Recertification Fee
Interspousal Deed	Recertification Update Fee
Joint Protection Policy Fee	Reconveyance Tracking Fee
Judgments	Recording Assignment of Mortgage to
Later Date Fee	Board of County Commissioners Fee
Lender Policy Fee	Recording of Buyers Deed & Mortgage
Lender's ALTA Policy Fee	Fee
Lenders Title Insurance Fee	Recording Power of Attorney Fee
Lien Search Fee	Recording Fees
Loan Tie-in Fee	Recording of Release Fee
Location Endorsement Fee	Recording Post Plg/Admin Fee
Locksmith Fee	Recording Release Fee
Misc. Income/ Service Fees	Recording Service Fee
Misc/Telephone Tolls/ Faxes	Release Processing Fee
MLS (Multiple Listing Service) Fee	Reimburse Tax Printouts Fee
MLS/Conveyance Fee	Reimburse Domestic Relations
Mortgage Release Tracking Fee	Repairs Termite Fee
MPA (Mortgage Purchase Agreement)	Restriction Endorsement Fee
Charge	Revised Commitment Fee
Municipal Lien Search Fee	Risk Premium
Municipal/Water/Tax Search Fee	Roof Certification Fee
Origination Fee	Roofing Fee
Out-claim Deed Fee	Runner Fee
Overnight Courier Fee	Rush Fee
Overnight Mortgage Package Fee	S&H (Shipping & Handling) Fee
Overnight Payoff Fee	Search Fee
Overnight Processing Fee	Second Recording Fee
Owners Policy Fee	Service Closed Letter Fee
Payoff Processing Fee	Service Fee
Payoff/PKG Processing fee	Signing Fee
Plumbing Fee	Simultaneous Issue Fee
Post-Closing Certification Fee	Special Services Fee

Spousal Deed Fee  
Standard Lenders Fee  
Standard policy Fee  
Survey Escrow Fee  
Tax and City Lien Searches Fee  
Tax and Water Search Fee  
Tax Certificate Fee  
Tax Printout Fee  
Tax Search Fee  
Technology Service Fee  
Termite Certification Fee  
Title Insurance Fee  
Title Indemnity Set-up Fee  
Title Recertification Fee  
Title Review Fee  
Title Search Fee  
Title Update Recertification Fee  
Tracking Fee  
Transaction Processing Fee  
Transfer Fee  
Title Recon Tracking (TRT) Fees  
Trust Deed Fee  
Trustee Fees  
Title Recertification Fee  
Use and Occupancy (U&O) Fee  
Update Fee  
Update Search Fee  
Update Title Recertification Fee  
UPS fee  
UPS Payoff Fee  
Waiver Exam Fee  
Water & Zoning Cert Fee  
Water Accommodation Service Fee  
Water Certification & Messenger Fee  
Water Processing Fee  
Water Revenue Bureau Fee  
Water Sewer Rents  
Wire Fee  
Zoning Certification Fee  
Zoning Ordinance Fee

## CHAPTER 4

### ALTERNATIVES TO THE FINAL RULE

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#### I. Introduction

In this chapter, we discuss alternatives to the final rule. We also discuss the arguments pro and con for each alternative and why the alternatives were not adopted. First, we discuss the status quo as an alternative to the final rule (Section II). Second, we present alternative means of implementing the final GFE such as whether or not the YSP should be presented and different versions of the GFE form (Section III). We also explain why (or why not) HUD made changes in response to comments on the 2008 proposed rule.

#### II. Status Quo

The most basic alternative, of course, was to maintain the status quo, that is, make no change to the current GFE and HUD-1. This alternative was rejected for reasons given in Section II of Chapter 1, entitled “Need for Final Rule.”<sup>1</sup> As explained there, the current GFE does little to help consumers overcome the many problems they face when shopping for a mortgage – there is convincing evidence that many borrowers pay non-competitive prices in today’s markets for both loan originator and third-party services. Today’s GFE is not an effective tool for facilitating borrower shopping nor for controlling third-party settlement costs. The current GFE format contains a long list of charges that often overwhelms consumers, rather than succinctly informing them of the major costs that they need to know for effective comparison shopping. The proliferation of charges that has evolved under the current GFE makes consumer shopping and the mortgage settlement process difficult, even for the most informed shoppers. Long lists of charges certainly do not highlight the bottom-line costs so consumers can shop and compare mortgage offers among different originators.

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<sup>1</sup> For a detailed discussion of problems with the current system, and thus the need for this proposed rule, see Sections V, VI, and VII of Chapter 2 and Sections I and VII of Chapter 3.

In addition, under today's rules, the estimated costs on GFEs may be unreliable or incomplete, or both, and final charges at settlement may include significant increases in items that were estimated on the GFE, as well as additional unexpected fees, which can add substantially to the consumer's ultimate closing costs. The process of shopping for a mortgage can also involve complicated financial trade-offs, which are not always clearly explained to borrowers. Today's GFE is neither an effective tool for facilitating borrower shopping nor for controlling origination and third-party settlement costs.

Thus, not to change the GFE would continue the current system of consumers paying non-competitive prices for mortgage services. The enormous potential for cost reductions in today's market is indicated by studies showing that yield spread premiums do not always offset consumers' origination costs and by studies showing relatively high and highly variable charges for third-party services, particularly for title and closing services that account for the major portion of third-party fees. This situation is particularly onerous on those cash-constrained families who are seeking a home for the first time. Changes to the GFE are needed to make the settlement process more transparent, to get rid of junk fees, to increase comparison-shopping, and to reduce costs for consumers.

For the above reasons, HUD rejected this alternative. As discussed in Chapter 3, the current GFE can be improved to make it an effective shopping document, which will lead to substantial savings for consumers (see estimates in Section I.A of Chapter 3). The new GFE format simplifies the process of originating mortgages by consolidating costs into a few major cost categories. The GFE of the final rule ensures that in brokered transactions, borrowers receive the full benefit of the higher price paid by wholesale lenders for a loan with a high interest rate; that is, so-called yield spread premiums. On both the GFE and HUD-1, the portion of any wholesale lender payments that arise because a loan has an above-par interest rate is passed through to borrowers as a credit against other costs. Thus, there is assurance that borrowers who take on an above-par loan receive funds to offset their settlement costs. The GFE also includes a trade-off table that will assist consumers in understanding the relationship between higher interest rates and lower settlement costs. The GFE includes a set of tolerances on originator and third-party costs: originators must adhere to their own origination fees and estimates of transfer taxes, and give estimates of many third-party charges and government recording charges subject to an overall maximum 10% increase. Finally, HUD conducted consumer tests to develop the GFE form. During the tests, consumers said that the new GFE was user-friendly and written at the right level, and that they liked the summary sheet and trade-off table, among other things. Consumers could also identify the cheaper loan using the new GFE. (See Section II.F of Chapter 3 for discussion of the consumer tests.)

### **III. Alternative Manners of Implementing the New GFE**

In this section we discuss major, as well as minor, variations on the new GFE. In Section III.A, the issue as to whether or not the yield spread premium calculation should be included in the new GFE is discussed. In Section III.B, we discuss changes to the trade-off table between loan charges and the interest rate. In Section III.C, changes to the tolerances on the new GFE are described. In Section III.D., we discuss how allowing average-cost pricing will yield many of the advantages of the Settlement Service Package, which was a major alternative. In Section

III.F, a host of minor variations to the new GFE are discussed. Section III.H discusses alternative GFE forms that were considered. In Section III.I, different ways of implementing the GFE to HUD-1 crosswalk are described.

### **III.A. Do Not Include the Yield Spread Premium Calculation in the New GFE**

HUD considered and rejected the alternative of not including the yield spread premium calculation in the GFE.<sup>2</sup> The main issue raised by the brokers concerned the treatment in the 2008 proposed rule of yield spread premiums on the 2008 proposed Good Faith Estimate (GFE). This was also the main small business issue with the 2008 proposed GFE since practically all brokers qualify as small businesses. Mortgage brokers and their trade groups expressed vigorous opposition to HUD's singling out indirect compensation to the broker and disclosing the yield spread premium as a lender credit to the borrower. They maintained that such a characterization is misleading, unfair and anti-small business.<sup>3</sup> Mostly, mortgage brokers and their representatives generally felt that yield spread premiums being disclosed as credits to borrowers would place mortgage brokers at a competitive disadvantage. They said that the broker fee disclosure in the 2008 proposed GFE would severely disadvantage mortgage brokers as compared to lenders (i.e., mortgage bankers and conventional lenders) because mortgage brokers would not be able to advertise certain mortgage loans and remain competitive. Section III of Chapter 3 dealt with this issue in some detail; a summary of this issue and HUD's response is provided below.

Under the March 2008 proposed rule, the first page of the GFE presented the net origination charge as "your adjusted origination charges." The second page of the proposed GFE informed the consumer how the adjusted origination charge was computed. Block 1 disclosed as "Our service charge" the originator's total charge to the borrower for the loan. The rule proposed that in the case of loans originated by mortgage brokers, the amount in Block 1 would have to include all charges received by the broker and any other originator for, or as a result of, the mortgage loan origination, including any payments from the lender to the broker for the origination. In the case of loans originated by originators other than mortgage brokers, the amount in Block 1 would have to include all charges to be paid by the borrower that are to be received by the originator for, or as a result of, the loan origination to the borrower, except any amounts denominated by the lender as discount in Block 2.

In loans originated by mortgage brokers, Block 2 of the second page of the proposed GFE would have disclosed whether there is any charge or credit to the borrower for the specific interest rate chosen for the GFE. The second check box would have indicated whether there was a payment for a higher interest rate loan, described as the "credit of \$ \_\_\_\_ for this interest rate

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<sup>2</sup> There were at least three methods considered: 1) a separate mortgage broker disclosure of the yield spread premium; 2) a separate mortgage broker contract; 3) disclosure of the yield spread premium on the GFE but not integrated at the top of page 2.

<sup>3</sup> A variety of reasons for opposition were provided including that HUD's proposal: 1) creates confusion for the borrower; 2) will unnecessarily increase HOEPA transactions; 3) will stifle FHA and low/mod lending; 4) unfairly targets brokers; 5) creates an uneven playing field with retail lenders; and 6) may adversely affect tax treatment of borrowers. See Section III of this chapter for a detailed discussion of YSP issues and industry concerns.

of \_\_\_\_%. This credit reduces your upfront charges.” The third check box would have indicated a “charge of \$\_\_\_\_ for the interest rate of \_\_\_\_%. This payment (discount points) increases your upfront charges.” Any lender payment would have been subtracted and any points would have been added to arrive at “your adjusted origination charge” that would have also been disclosed on the first page of the form. The proposed rule provided that for mortgage brokers, the amounts of any charge or credit in Block 2 would have to equal the difference between the price the wholesale lender pays the broker for the loan and the initial loan amount.

Only mortgage brokers would have been required to disclose their total origination fees received: direct fees plus the yield spread premium. Lenders can also receive yield spread premiums when they sell mortgages into the secondary market but were not required to disclose yield spread premiums to consumers as a result of the secondary market exemption under HUD’s rules. But, more practically, the pricing information for calculating yield-spread premiums is often simply not available at closing in lender transactions.<sup>4</sup> Thus, unlike brokers, lenders did not have to report their total origination fees received on the 2008 proposed GFE.

HUD has determined to retain the mortgage broker disclosure. HUD’s testing of the form demonstrated that consumers understood the relationship between the interest rate and the settlement charges and no bias against brokers resulted from the form. While the substance of the broker disclosure remains the same in the final rule as it was in the proposed rule, some minor stylistic changes have been made to draw the borrower’s attention to specific terminology in the disclosure. HUD maintained the disclosure on the top of page 2 of the revised GFE, while making some stylistic changes to this portion of the form in the interest of borrower comprehension.

- The top of page two refers to “Your Adjusted Origination Charges” instead of “Your Loan Details” on the proposed form because this is the section of the disclosure that sets forth the origination charges.
- The box on the top of page two informs the borrower how the adjusted origination charge is computed. Block 1 discloses as “Our origination charge” the originator’s total charge to the borrower for the loan.
- The revised rule requires that in the case of loans originated by mortgage brokers, the amount in Block 1 must include all charges to be paid by the borrower that are to be received by the broker and any other originator for, or as a result of, the mortgage loan origination, including any payments from the lender to the broker for the origination. In the case of loans originated by originators other than mortgage brokers, the amount in Block 1 must include all charges to be paid by the borrower that are to be received by the originator for, or as a result of, the loan origination to the borrower, except any amounts denominated by the lender as discount which are disclosed in Block 2.

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<sup>4</sup> Whereas the market price of the loan is always available at closing in brokered transactions (i.e., the price the wholesale lender is paying for the loan at closing), such a price is not necessarily available in lender transactions (e.g., the lender may be holding the loan in portfolio rather than selling the loan to a wholesale lender).

- Block 2 discloses for loans originated by mortgage brokers whether there is any charge or a credit to the borrower for the specific interest rate chosen for its GFE. The heading for block 2 of the proposed form included the term “points” at the end of the sentence. In the interest of borrower comprehension, on the revised form this sentence now states “Your credit or charge (points) for the specific interest rate chosen.”
- The second check box indicates whether there is a payment for a higher interest rate loan described as the “credit of \_\_\_\_\_ for this interest rate of \_\_\_\_\_. This credit reduces your settlement charges.” In the interest of borrower comprehension, the word “settlement” has replaced the word “upfront” from the proposed form. The third check box indicates any “charge of \_\_\_\_\_ for this interest rate of \_\_\_\_\_. This payment (discount points) increases your settlement charges.” In the interest of borrower comprehension the word “settlement” has replaced the word “upfront” from the proposed form. Any lender payment is then subtracted and any points are added to arrive at “your adjusted origination charge.”
- At page two, while lenders are not required to check the second or third boxes of Block 2, in loans where they do not make such disclosures, they are required to check box 1 that indicates that “The credit or charge for the interest rate of \_\_\_\_ is included in ‘Our origination charge.’” If lenders denominate any amounts due from the borrower as “discount points,” they must check the third box indicating that there are charges for the interest rate and enter the appropriate amount for points as a positive number. If lenders denominate any amounts as a credit to the borrower for the particular interest rate covered by the GFE, they must check the second box and enter the appropriate amount as a negative number. Lenders must also add any such positive amounts or deduct any negative amounts to arrive at “Your Adjusted Origination Charge,” listed on Line A of page two of the form.

In reaching its determination, HUD considered providing only the adjusted origination charge without the calculation and disclosing yield spread premium and discount points elsewhere on the form. HUD concluded, however, that a complete disclosure of the payments to the broker as presented on page 2 of the revised form, read in conjunction with the trade-off table on page 3, is essential to borrower understanding of: 1) the broker’s total compensation; 2) how rate based payments from lenders can help reduce borrowers’ up-front origination charges and settlement costs in brokered loans; and 3) how payments to reduce the interest rate and monthly charges increase up-front charges.

HUD believes that the disclosure of yield spread premiums as offsetting other closing costs within the disclosure of the array of fees rather than as a separate disclosure elsewhere on the form is the best method for making the borrower aware of the existence of yield spread premiums. In addition, using it as an offset makes it more likely that yield spread premiums will be used to reduce settlement costs rather than increase broker compensation – in other words, using it as an offset seeks to change the behavior in today’s market where statistical studies indicate that yield spread premiums are too often used to increase broker compensation rather than to reduce consumer settlement costs. The disclosure was retained because HUD believes that it is important to improve borrower understanding of the basis for yield spread premiums and discount points, making it more likely that interest rate variations are used to the consumer’s

advantage rather than by the originator to enhance profit at the consumer's expense, which is what often happens in today's market, according to recent statistical studies of yield spread premiums. These statistical studies are reviewed in Section IV.D and E. of Chapter 2.

In response to the concern that this treatment may lead to consumer errors that impede comparison shopping that disadvantage brokers, HUD has taken several steps to reduce the likelihood that borrowers will make systematic errors in evaluating loan offers from brokers. (See Section III of Chapter 3.) Specifically, HUD has dealt with the potential for bias with six key features of the GFE. Once the improvements suggested by the results of the earlier rounds of testing were incorporated into the forms, borrowers generally identified the cheaper loan 90 percent of the time or more. In response to FTC findings based on an abbreviated and previous version of the GFE, HUD engaged in two more rounds of testing and improvement involving 600 subjects per round. The end result on the forms adopted was that borrowers consistently identified the cheapest loan 90 percent of the time or more regardless of whether the broker or the lender was cheaper. The pattern of the results was quite similar regardless of whether the broker or the lender was cheaper. The Department believes that the forms adopted in the final rule perform well resulting with borrowers having little difficulty identifying the cheapest loan offered in the market whether from a broker or a lender.

### **III.B. Trade-off Table**

It is important that consumers fully understand the various options that are available to them, when considering trade-offs between interest rates and loan charges. Because these financial concepts are complicated, some consumers may not fully understand them, placing them in a vulnerable position when negotiating terms with originators. Brokers and lenders may not always inform consumers that there are alternative products with different combinations of interest rates, discount points, and settlement charges. While most comments supported the idea of a chart showing settlement cost and interest rate trade-offs, some wanted a generic chart in the Settlement Cost Booklet rather than a customized chart that compares alternatives to the shopper's own loan. The final rule GFE continues to include the customized chart that compares the borrower's selected option with higher- and lower-interest rate options (assuming the originator offers such options). Originators have the option to fill out the chart, but it will be included in all GFE forms. Borrowers are encouraged to ask for additional information if the chart is not completed. The presentation has been improved so that the effect of the interest rate chosen on upfront charges ties in better with the explanation of how yield spread premiums affect the upfront charges. As noted in Chapter 3 (see Sections I.A.2 and II.D), the trade-off table will make borrowers aware of different interest-rate options available to them, which should improve their understanding of, and ability to shop for, mortgages with and without yield spread premiums.

### **III.C. Tolerances**

Several comments expressed concerns about their ability to control costs and meet the specified tolerances in the 2008 proposed rule. The final rule makes clear that "zero tolerance" does not pertain in "changed circumstances" beyond the originator's control; the new definition

of changed circumstances in the final rule expands on and clarifies the definition of “unforeseeable circumstances” in the proposed rule; and the tolerance for fees for government recording charges was increased to 10 percent. The rule’s new definition of “changed circumstances” includes circumstances that could not be reasonably foreseen at the time of GFE application; situations where the borrower changes the loan terms; bona fide business emergencies outside of a lender’s control; and changes in material information that was relied on in providing the original GFE. Where a lender (or broker) cannot perform because of changed circumstances, the lender (or broker) must document the costs occasioned by the changed circumstances.

### **III.D. Opportunity to Cure**

The final rule provides loan originators with an opportunity to cure any potential violation of the tolerance by reimbursing the borrower within 30 days of closing any amount by which the tolerances were exceeded. The opportunity to cure will permit loan originators to give an estimate of expected settlement charges in good faith, without subjecting them to harsh penalties if the estimate turns out to be lower than the actual charges at settlement.

### **III.E. Definition of Application**

Commenters objected to the bifurcated application process (a preliminary “GFE application” followed by the final “mortgage application”), which was designed to promote shopping. There was a fear of commitment by lenders to loan terms based on a preliminary underwriting, as well as fear that that the preliminary underwriting would be based on information that was too limited (borrower’s name, Social Security number, property address, gross monthly income, borrower’s information on the house price or best estimate of the value of the property, and the amount of the mortgage loan sought). In response, HUD has adopted a streamlined application process for the final rule and expanded the amount of information an originator may collect before issuing a GFE beyond the six pieces specified in the proposed rule. When the borrower provides the minimum information required by the originator for a GFE, the GFE will be triggered within 3 days.

### **III.F. Other Changes to the GFE**

HUD made several changes that address a number of practical and implementation problems raised by lenders and others about the GFE and tolerances. For example, many industry groups complained that the four-page proposed GFE was too long. HUD reduced the form in the final rule to three pages by consolidating the third and fourth pages but still retaining the essential trade-off table and shopping chart.

### **III.G. Alternative Methods of Implementing the GFE**

The below represent the main alternatives considered to the GFE in the 2008 final rule as well as major alternatives raised during the comment period.

### III.G.1. Itemization of Costs

Some commenters were concerned that lumping costs together into large categories would confuse consumers during shopping and later when they compare data on the GFE with data on the HUD-1. Based on consumer tests and for numerous other reasons discussed in this chapter, HUD decided that a standardized GFE with consolidated cost categories would serve as an effective cost disclosure that will facilitate borrower shopping. In addition, the use of the new GFE form does not preclude lenders from providing more detail or itemization of their charges. (See Section II.C of Chapter 3.)

### III.G.2. Volume Discounts

**Comment.** One of the primary concerns of small firms was the potential adverse effect of HUD's clarification that volume discounting is legal as long as the savings are passed along to the consumer. ALTA, ICBA, NAMB, and NAR contend that volume discounts will favor large settlement service providers and loan originators/lenders at the expense of small businesses and place them at a disadvantage. The Office of Advocacy formally endorsed this position in their comment letter on the 2008 proposed rule and predicted that HUD's proposed clarification "may cause small businesses to leave the market and result in higher prices for consumers in the long term." Rep. Donald A. Manzullo expressed concern over volume based discounts, which he described as a "thinly veiled attempt to reintroduce the concept of 'bundling' services." He reiterated his previously stated concerns that the long term impact of volume discounts will eliminate competition and destroy small businesses.

Consumer groups, the National Consumer Law Center (NCLC) and the Center for Responsible Lending (CRL), supported volume based discounts as long as the discount is passed along to the consumer. However, CRL expressed concern that discounts may lead originators to steer consumers to certain settlement service providers, limiting consumers' choice of servicers and therefore would support additional safeguards to ensure that volume based discounts in fact benefit the consumer.

**Response.** HUD remains committed to a RESPA regulatory scheme that fosters mortgage settlement pricing mechanisms, that, as stated in the preamble to the March 2008 proposed rule "result in greater competition and lower costs to consumers" (73 FR at 14050). Nevertheless, given the comments received on the proposed change to HUD's current regulatory definition of "thing of value" and the significant operational and other questions raised by the proposed change, by both industry and consumer groups alike, HUD has decided to give further consideration beyond this rulemaking to a regulatory change that explicitly allows negotiated discounts, including volume-based discounts, between loan originators and other settlement service providers. HUD wants to ensure that any change will adequately protect consumers, while at the same time provide adequate market flexibility, and due consideration to small business concerns.

The purpose of HUD's clarification was to set a clearer standard for compliance in the context of the new GFE. Firms that were profitable before the clarification should not be negatively impacted as the change would be superficial for those that understand the law.

However, there is a great deal of confusion in the industry concerning the legality of volume discounts and different courts have different interpretations of the law. Thus, the proposed rule could have had a considerable material impact on business practices.

HUD did not expect the practice of volume discounting to have the adverse effects advanced by the Office of Advocacy and many industry groups. The importance of local orientation is a fundamental aspect of the real estate industry and one that ensures the continued success of small firms. Nevertheless, if there were to be adverse effects from volume discounting, they will occur without HUD clarifying that the practice is legal.

HUD will not address volume discounts in the rule. However, the absence of any mention volume discounting in the rule does not change the department's long-held belief that volume discounts are not a violation of RESPA when the discount is ultimately passed on to the borrower. As long as the price charged to the borrower on the HUD-1 is no greater than the discounted price paid to the third party, the discounted price poses no problem. Thus, in addition to further rulemaking, HUD will consider other avenues for providing guidance on negotiated discounts, including through the issuance of statements of policy.

### **III.G.3. Interest-rate guarantee**

Only settlement and origination charges independent of the interest rate are required to be guaranteed. An alternative would be to require that all loan terms on the GFE be guaranteed for 10 shopping days.

**Comment.** In response to the March 2008 proposed rule, CRL also noted that the 10-day period does not apply to the interest rate, which can come with no guarantee at all. NCLC and CRL stated that an interest rate lock must be required in order for the GFE to be effective. According to CRL, not including a requirement for an interest rate lock will force consumers to shop on settlement costs alone, which are a relatively small component of the total home settlement cost. CLR stated that, in addition, not requiring a rate lock makes it too easy for loan originators to engage in baiting and switching, that is, they offer low settlement costs, only to recoup those costs by increasing the interest rate when the consumer comes back three days later. NCLC stated that, because interest is the largest component of the price of a mortgage, if interest rates are allowed to float, while settlement costs are fixed, consumers will be encouraged to shop on the smallest portion of mortgage costs, the settlement costs, and lenders are encouraged to play bait and switch games with the offered interest rate. Thus, according to NCLC, in order for the GFE to be an effective shopping tool, all costs, including the interest rate, must be fixed at the time the GFE is delivered.

**Response.** Ann Schnare analyzed such an alternative in her 2008 report for the National Association of Realtors. If the GFE required that loan originators guarantee an interest rate, then this would impose hedging expenses. Issuers of GFEs would want to insure against interest rate movements to keep GFE offers open for the required 10 business days. According to the NAR report, the hedging costs could range from \$136 to \$272 per loan (see Exhibit 1 of the NAR report). HUD's 2008 proposed rules did not require originators to guarantee an interest rate quoted on a GFE for a period of 10 days for precisely that reason. Interest-dependent items on

the GFE (interest rate, monthly payment, YSP/discount points, adjusted origination fees, and daily interest charges) can have a separate availability period that can be as short as the time until a new rate sheet is issued. Only the prices on non-interest-dependent items on the GFE (total origination fees, appraisal fees, title fees, etc.) must remain available for 10 business days. These interest-rate-dependent items only become fixed, for purposes of comparison to the HUD-1 at closing, when the borrower locks the interest rate. HUD let these dates differ because HUD is aware that the hedging costs of an interest guarantee for a period as long as ten business days would be very costly.

#### **III.G.4. Ban the YSP**

The Urban Institute (2008) report shows that consumers do not get value for their money when implicitly paying a YSP to a mortgage broker. In one test, consumers lose 93 cents on the dollar and in another they lose \$1.16 for every dollar. The concern over this issue has generated many policy proposals, one of which is to ban the YSP.

**Comment.** The FDIC recommended that HUD ban YSPs to ensure that broker compensation will not be based on steering the consumer to a loan that is more expensive than one for which the borrower otherwise would qualify. FDIC recommended that HUD ban any mortgage broker compensation that is not a flat or point-based fee.

**Response.** HUD believes that the YSP disclosure on the GFE form will go a long way in lowering excess fees pay to mortgage broker brokers (and lenders). Rigorous testing of the final GFE form across 1,200 subjects resulted in an average 95 percent success rate in identifying the cheapest loan with very little or no anti-broker bias. HUD maintains that while rate-based payments to mortgage brokers must be clearly disclosed to borrowers, at the same time, mortgage brokers also must not be disadvantaged in the marketplace since such disadvantage will only result in decreased competition and higher costs to consumers. Many mortgage brokers offer products that are competitive with and frequently lower priced than the products of retail lenders, and HUD wishes to preserve continued competition and lower prices for consumers. The most important determinant of a loan's value on the wholesale market is its interest rate. Mortgage brokers would be greatly disadvantaged if restricted from earning income from originating high-interest loans if, at the same, lenders were allowed to be compensated by selling higher interest rate loans for a higher price. It is true that the Urban Institute (2008) found that consumers do not appear to gain much, if any, benefit by paying a YSP to a mortgage broker but the same study found that consumers do not benefit much more from (estimated) implicit YSPs to lenders.

The principal problem with YSPs, both explicit and implicit, is that so many borrowers fail to understand that there ought to be a trade-off between interest rates and upfront charges, and both mortgage brokers and direct lenders exploit this ignorance to their gain. Consumer testing shows that the final GFE, with its YSP disclosure and trade-off table, is a highly effective tool for informing consumers about the existence of the interest rate/upfront cost tradeoff. In addition, once the total fees to be received by originators are established with the "Our origination charge" disclosure, the incentive to steer borrowers into higher interest rate loans disappears. Because of zero tolerance on "Our origination charge" the GFE, and the requirement

that any amount paid to the broker by the lender in excess of the face value of the loan must be deducted from this total and credited to the borrower, the GFE serves as a fixed fee agreement for brokers. In the context of an agreement that the mortgage broker make a fixed fee on a loan, the mortgage broker no longer has an incentive to steer a borrower into a higher interest rate loan unless he is willing to commit fraud by violating the agreement. Within the constraint of a fixed fee agreement, the mortgage broker's incentive is to find the borrower the loan with the combination of features (fixed rate or adjustable, monthly payment, closing fees, etc.) that makes the borrower happiest (so the broker can close the deal and collect the fixed fee) as quickly as possible (so the broker can move on to the next customer and collect more fixed fees).

### **III.H. Other Proposed Forms**

HUD held RESPA Reform Roundtable discussions with representatives of the industry and consumers in 2005. As part of the roundtable process, HUD asked interested parties to submit proposals for revised GFE forms. In addition, other groups submitted redesigned GFE and HUD-1 forms as part of their comments on the 2008 proposed rule, or in meetings with OMB and HUD officials about the RESPA rule. While HUD considered ideas presented in these forms for potential improvements in the GFE and HUD-1, these forms presented to HUD did not meet the policy goals of HUD.<sup>5</sup> Secondly, none of the forms presented to HUD was accompanied by evidence of extensive consumer testing that showed they could achieve all of HUD's objectives for the redesign of the GFE and HUD-1 as well as, or better than, the forms in the rule.

### **III.I. Comparing the GFE with the HUD-1**

One of the purposes of RESPA is to reduce unnecessarily high settlement costs. The final GFE promotes that goal in several ways. Through consolidation and of loan and title fees, the presentation of GFE settlement cost figures is greatly simplified by eliminating fee proliferation that often serves little purpose and that can easily overwhelm the borrower. Comparison shopping by borrowers that promotes competition is made easier through standardization and clear presentation of fees on the GFE. The need to adhere to the tolerances means that there GFE cost estimates can be more reliable compared to today, providing the borrower with more incentive to comparison shop. Since the GFE figures will be more reliable, it is more likely that the borrower who shops will wind up getting the lower price they found by comparison shopping.

In order for the borrower to become an enforcer of the figures presented on the GFE from the loan source selected, the borrower has to be able to compare the figures on the HUD-1 to the figures on the GFE and determine that the HUD-1 figures are within the tolerances placed on the figures from the GFE.

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<sup>5</sup> Please see pp. 4-20 of Chapter 4 of the Regulatory Impact Analysis of the Proposed Rule for a discussion of the alternative forms considered for the proposed rule,

In order to enhance comparability of the GFE to the HUD-1, HUD is modifying the HUD-1 so that, for each settlement cost item on the GFE, there is a line on the HUD-1 with exactly the same label as on the GFE. These matching categories on the HUD-1 also identify the location on the GFE where the corresponding entry is located. The borrower could simply hold the HUD-1 next to the GFE and compare the lines with the same labels. To facilitate comparison, there will be a third page added to the HUD-1. This new page shows the settlement charges as they appear on the GFE, the HUD-1, and whether tolerances on applicable figures from the GFE have been violated. An additional feature of this page is a summary, which mirrors the first page of the GFE, of the loan and the borrower's obligations.

Other methods have been suggested and considered for facilitating the comparison of the HUD-1 and GFE: a separate crosswalk, a GFE inserted into the HUD-1 form, and a read-aloud closing script including a crosswalk. The GFE insert was not chosen because it is a more significant change to the HUD-1 than the alternative of changing the labels on some of the lines. The read-aloud script was proposed in the 2008 proposed rule, but ultimately rejected because of cost and operational issues. In the final rule the format of the crosswalk from the proposed script was adopted as part of a new page 3 in the HUD-1, which also includes summary information on loan terms as on the GFE so the borrower can confirm at closing that he is getting the same loan as indicated on the GFE.

### **III.I.1. Separate Crosswalk**

The intermediary document between the GFE and the HUD-1 is referred to as the separate crosswalk. The left side of the separate crosswalk would contain spaces for most of the items from page 2 of the new GFE. The right side would have corresponding spaces for entries from the HUD-1. They are grouped according to the different tolerances that apply.

The first group includes (1) our service charge, (2) your credit or charge for the specific interest rate chosen, (A) your adjusted origination charges, and (6) Government recording and transfer charges. The service charge plus the charge or minus the credit for the specific interest rate chosen equals the adjusted origination charge. On the right side of the separate crosswalk are spaces for the same entries from the HUD-1. They are listed by the line number on the HUD-1 where the charge is located. Line 801 has our service charge, line 802 has your credit or charge for the specific interest rate chosen, and line 803 has your adjusted origination charge. Since the combination of the first two entries equals the third entry, there would be double counting if all three appeared as charges to the borrower or seller. The department decided to put the first two numbers to the left of the borrower's column to show the numbers that lead to the adjusted origination charge and allow for their verification.

As with any charge showing up on the HUD-1, the correct number to show on the separate crosswalk is the sum of any dollar values appearing as "paid outside of closing" (POC), in the borrower's column, and in the seller's column since any charge could be paid any of these three ways or in any combination of the three. So, all three potential sources of these dollar values must be checked: POC, buyer, and seller: in order to catch the full size of the charge. This is true for all items coming from the HUD-1. When we refer to the "HUD-1 figure," we will always be referring to the sum of these three numbers.

There is zero tolerance on this first set of items which means that the HUD-1 figure for our origination charge may not exceed the GFE figure for that same charge and that the HUD-1 figure for your adjusted origination charge may not exceed the GFE figure for that charge either. The same applies to section eight, transfer taxes. So long as these HUD-1 figures are less than or equal to their respective GFE figures, the tolerance has not been violated.

The second set of figures on the left side of the separate crosswalk comes from sections three, four, five, six and seven on the GFE. Section three is required services that we select and all of its components can be listed: appraisal, credit report, tax service, Flood certification, and spaces for other charges. Next comes section four, title services and required title insurance, which is recorded as one figure. Section five is owners title insurance. Section six is required services that you can shop for and all of its components can be listed: survey, pest inspection, and spaces for other charges. Section seven is government recording charges. Finally, there is a space for the sum of all section three, four, five, six and seven charges. A ten percent tolerance applies to the sum of all of these charges where either the lender selected the service providers or the borrower used ones referred to him by the lender.

On the right side are the corresponding entries from the HUD-1 along with the HUD-1 line where these figures are located. The appraisal, credit report, tax service, flood certification, and spaces for other charges are listed as coming from lines 804 through 809. Title services and required title insurance comes from line 1101. Owner's title insurance is from line 1102. The section six figures, required services that you can shop for: survey, pest inspection, and spaces for other charges are listed as coming from lines in the 1300 series of the HUD-1. Finally, there is a space for the sum of all the charges from these three areas. The sum of these HUD-1 figures should not exceed the sum of the GFE figures by more than ten percent for the services where either the lender selected the service providers or the borrower used ones referred to him by the lender.

The last five items on the left side of the separate crosswalk are from section nine, reserves and escrow: section ten, daily interest charges; and section eleven, homeowner's insurance. The corresponding entries come from lines 1001, 901, and 903 of the HUD-1. There is no tolerance constraint on any of these figures.

The fees mentioned above from the HUD-1 should exhaust all of the required settlement service provider fees. If there are any other HUD-1 fees for loan origination, title work, or any other settlement service required to get the loan, they should be closely examined to see if they should have been included in the first section of the separate crosswalk and subject to the zero tolerance, or if they should have been included in the second section charges and subject to the 10 percent tolerance. Real estate commissions, charges for roof repairs or termite extermination, charges for homeowner's warranties, or escrowed amounts to satisfy some contingency are examples of figures that probably do not belong on the separate crosswalk since these are not likely to be fees that should be included in those to which tolerances apply.

The changes that were made to the HUD-1 to enhance the ease of use and comprehension of the separate crosswalk are the relabeling of some of the HUD-1 lines mentioned above so that there are lines that exactly match the individual entries from the new GFE that are entered on the separate crosswalk.

The separate crosswalk approach was not chosen. Instead, the related option of a crosswalk table as part of a new page 3 of the HUD-1 form was selected for the final rule. While this increases the length of the HUD-1 form, it increases the likelihood that the crosswalk will be reviewed.

### **III.I.2. The HUD-1 with the GFE Insert**

The second alternative crosswalk would have modified the HUD-1 differently. It would have inserted the GFE information in between the “700” and “800” series. The figures from the GFE would have been reproduced exactly in the inserted GFE.

“Our origination charge” and “Your charge or credit for the specific interest rate chosen” would be combined to get “A. Your Adjusted Origination Charge” just as on the GFE. Including all three would lead to a double counting error. The adjusted origination charges would be broken down the parts that were paid from the seller’s funds at settlement, the borrower’s funds at settlement, or paid outside of closing. The sum of these three components would be compared to the figure from the GFE the borrower had received. Items three through eleven on the GFE would likewise be broken out into the seller, buyer, and POC components and the sum of these components would be compared to the respective figure on the GFE. The breakdowns of items three, “Required services that we select,” and six, “Required services that you can shop for” would be shown on the inserted GFE but not put in the any of the three HUD-1 categories to avoid double counting.

If itemization of any combined GFE figure were desired, the details could be shown below in the appropriate category, but could not be shown in the seller column, borrower column, or as POC since that would result in double counting. So the escrow deposits could be broken out in the “1000” series, title charges could be broken out in the “1100 series, and government fees would go in the “1200” series.” Again, these dollar values would not be listed in the seller’s column, buyer’s column, or as POC since that would lead to double counting.

Other legitimate charges that belong on the HUD-1 could be shown as they have before. For example, real estate commissions, roof repairs, or homeowner’s warranty could appear as they always have. The real estate commission would go in the “700” series just as before and the roof repair or homeowner’s warranty would go in the “1300 series just as before. These figures for items not necessary to get a loan should not be on the GFE. But they are a closing cost and should appear in the seller’s column, buyer’s column, or as POC.

As with the previous rearrangement of the HUD-1, the intent was to leave places for all entries required to close the loan. In this case, the items that appear on the GFE are rearranged on the HUD-1 so that they appear just as they do on the GFE. But no lines required for a closing are eliminated.

### **III.I.3. The Closing Script**

The 2008 proposed rule required an addendum to the HUD-1, which was a script to be completed and read aloud at closing. The closing script would: (1) compare the GFE to the

HUD-1 and advise borrowers whether tolerances have been met or exceeded; (2) verify that the loan terms summarized on the GFE match those in the loan documents, including the mortgage note; and (3) provide additional information on the terms and conditions of the mortgage.

Many comments were opposed to the proposed HUD-1 Addendum or “script.” The primary objection to the script was the time costs. HUD estimated that, in a worst-case scenario, the total cost of the script would be 45 minutes or \$54 per loan. In a normal year (12.5 million originations), this would amount to \$676 million. Settlement industry groups were concerned about these potential costs of preparing and reading the script. A second objection was that the script could place a settlement agent in the position of committing the unauthorized practice of law. This would occur if they were required to answer questions concerning issues such as the loan terms for which they had no responsibility.

Given the concern expressed concerning the implications of the potential cost and legal implications of the script, HUD will not require a script in its final rule. To replace the script, HUD has added a page to the HUD-1 form. This will contain much of the same information but will be much easier to fill out and will not have to be read the settlement agent. The top half will contain a table that compares settlement charges with those on the GFE and shows the amount and percentage by which the charges have changed (in order to check whether the change is within the tolerance). The bottom half of the page consists of a summary of the loan terms, very similar to the first page of the GFE.

# Chapter 5

## Industry Sector Data Analysis

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## **I. Introduction**

This chapter has three main purposes. First, the chapter provides a description of the industries involved in mortgage origination, lending, and real estate settlement, including background information on recent trends in the industry. Census Bureau data and mortgage market data are used to describe the characteristics (number of firms, revenue, payroll, size, etc.) of the various industries involved in the mortgage origination and settlement process. The goal of this analysis is to deepen the understanding of the potential impacts of the RESPA rule on industry, especially small business as defined by the Small Business Administration (SBA). The discussion of industry trends (such as the growth of the broker industry) and special industry issues (such as concerns about excessive broker fees on loans with yield spread premiums) is often brief, as these topics have already been detailed in Chapters 2-4.

Second, this chapter produces the parameters for estimating the economic impact of this rule on small business. The following Table 5-1 illustrates the type of results found in this chapter. The first column shows the proportion of firms that are considered a small business, while the second column shows the proportion of industry revenue that was earned by small business. The information in Table 5-1 is obtained by applying SBA definitions of a small business to industry data reported by the Census Bureau. It serves as the starting point for this chapter's analysis of the small business share of mortgage origination revenue and settlement revenue. In some cases, this chapter relies solely on the Census Bureau data, but in other instances, it also relies on HMDA and industry data to produce a range of small business estimates. A range of estimates, rather than precise point estimates, reflects the uncertainty due to lack of complete information on the small business share of industry revenue, as well as other complications. For example, the relative importance of each sub-industry (e.g., thrift institutions in the case of the overall lending industry) in originating and processing single-family mortgages is necessary for estimating a small business share for the overall industry. Information is not always readily available on these weights, as the analysis in this chapter will show. Another complication concerns the fact that mortgage activity may be only a small part of the overall activity of an industry. Lawyers, for example, provide many services unrelated to real estate settlement, whereas title abstract and settlement offices work almost exclusively on residential real estate settlements. In such cases, the Census-Bureau-based small business percentage for an entire industry is replaced by an estimate developed in this chapter that is specific to mortgage activity.

Third, this chapter examines the revenue impacts of the new GFE on each industry affected by the RESPA rule. The more disaggregated analyses in this chapter (e.g., lenders are divided into banks, thrifts, mortgage banks, and credit unions) complements the more aggregated analyses of revenue impacts presented in Chapters 3 and 4. In some cases, several sensitivity analyses are provided to account for different projections about the relative share (importance) of a specific industry, or to account for different approaches for estimating the small business share of a specific industry. Where possible, the transfers are also reported on a per firm basis and as a share of industry revenue.

**Table 5-1. 2002 Estimates of Proportion of Industry that is Small Business**

<b>Industry</b>	<b>Percentage of firms that are small</b>	<b>Share of revenue earned by firms that are small</b>	<b>Section of Chapter 5</b>
<b>ORIGINATION</b>			
1. Mortgage and non-mortgage loan brokers	99.1%	67.2%	II
2. Commercial banking	67.0%	4.9%	III
3. Savings institutions	48.0%	3.7%	III
4. Real estate credit	92.9%	6.7%	III
5. Credit unions	92.6%	32.2%	III
<b>THIRD PARTY SERVICES</b>			
6. Direct title insurance carriers	95.2%	4.8%	IV
7. Title abstract and settlement offices	98.5%	49.8%	IV
8. Offices of lawyers	99.1%	47.8%	IV
9. Other activities related to real estate	99.9%	86.9%	IV
10. Offices of real estate appraisers	99.8%	83.1%	V.A
11. Surveying and mapping (except geophysical) services	99.6%	81.3%	V.B
12. Exterminating and pest control services	99.5%	53.9%	V.C
13. Credit bureaus	96.0%	10.5%	V.D
14. Offices of real estate agents and brokers	99.5%	54.1%	VI
<b>MISCELLANEOUS SERVICES</b>			
15. New Single-Family General Contractors	99.1%	53.1%	VII.A
16. New Housing Operative Builders	97.4%	31.9%	VII.B

**Note:** See text for alternative estimates of the small business revenue share for 2-5 and 7-8. As discussed in Section IV.B, the Census Bureau-reported small business data for Direct Title Insurance carriers is likely inaccurate due to misreporting; All firms in this industry are likely large businesses.

The industries analyzed in this chapter are as follows: mortgage brokers, mortgage lenders (commercial banks, thrifts, mortgage banks, and credit unions), title and settlement agents (title insurance, title abstract and settlement services, lawyers, and escrow), other third-party settlement services (appraisers, surveyors, pest inspectors, and credit bureaus), real estate agents and brokers, and residential construction (new single-family general contractors and new housing operative builders). For every industry, a similar set of tables is presented in the Appendix and discussed in the industry section. The four tables are: 1) characteristics of employer firms in 2004; 2) a summary of all employer firms in the industry in 2004; 3) characteristics of employer firms in 2002; and 4) a summary of all firms in the industry in 2002. The data for the industry characteristics tables are taken from the 2002 Economic Census and the 2004 Statistics of U.S. Businesses – both publications of the Census Bureau. These two data sets provide information on the number of firms, establishments, employees, the annual payroll, and size distribution of firms within an industry. The primary difference between the two series is that revenue data are available for 2002, but not for 2004. For this reason, revenue data for 2004 are estimated based on payroll data.

The industry characteristics tables are only for employer firms, that is, firms that pay payroll taxes. However, there are many small firms that are sole proprietorships or limited

partnerships, or hire workers from an administrative support service. Most nonemployer businesses are very small, and many are not the primary source of income for their owners. There are many such firms in the settlement services industry. It should be noted that, although they are plentiful, they account for only a small portion of total revenue. For example, in all U.S. industries, nonemployers account for nearly 3/4 of all businesses but only 3% of business revenue. The Bureau of the Census releases an annual series of tabulations of nonemployers. These data are used to create the tables that describe total industry activity in 2002 and 2004 (see the Data Appendix at the end of this chapter).

Frequently, other data are presented, as noted above. For industries where the competitive environment is a concern, data on industry concentration from the 2002 Economic Census are included in the industry description. Whenever industry data are available from other reliable sources, they are used to complement and verify Census data. Because the revenue of most of the industries analyzed is very sensitive to the mortgage origination activity, the revenue figures are adjusted when making some inter-year comparisons.

To summarize, this chapter presents an overview of the industries involved in the origination and settlement of mortgage loans: mortgage brokers, mortgages lenders, settlement and title services, as well as other third-party settlement services. Industry trends are briefly summarized and special issues related to RESPA are noted. There is also a description of the economic statistics for each industry, with an emphasis on each industry's share of small business activity. Both the estimation of the revenue share for various industry sub-sectors (e.g., large title insurers share of total revenue in the title and settlement industry) and the estimation of the small business share of mortgage-related revenue within the industry, often involve several technical analyses that pull together data from a variety of sources, in addition to the Census Bureau data. This leads to several sensitivity analyses to show the effects of alternative estimation methods and assumptions. This chapter also reports the revenue transfers from the RESPA rule for the specific industry sectors; these transfers are reported in dollar terms and, where possible, as a percentage of industry revenue. Finally, a number of technical issues and special topics, such as techniques for estimating the number of commercial bank employees engaged in mortgage origination activities, are discussed.

**Organization of Chapter.** The chapter is organized as follows: brokers (Section II); lenders, including commercial banks, thrift institutions, mortgage banks, and credit unions (Section III), title and settlement industry, including large insurers, title and settlement agents, lawyers, and escrow firms (Section IV), appraisers (Section V.A), surveyors (Section V.B), pest inspectors (Section V.C), credit bureaus (Section V.D), real estate agents (Section VI), and background data for the private mortgage insurance industry is provided in Section VII. A technical appendix provides relevant definitions and explains the methodology associated with the economic data obtained from the Census Bureau. A data appendix includes tables with the economic data (number of firms, employment, revenue, etc.) for each industry sector.

## **II. Mortgage Brokers**

It has been estimated that brokers originate 60% or more of all mortgages, and that practically all brokers are small businesses. It is therefore important to carefully consider the

impact of the new GFE on brokers, as has been emphasized in Chapters 2-4. This section contributes to the analysis mainly by presenting Census Bureau data that characterize the broker industry and its small business components, and by pulling together into one place various findings from earlier chapters concerning the revenue impacts of the final rule on brokers. Section A provides an overview of the broker industry and issues that have been raised about this industry (also see Sections III and IV of Chapter 2). Section B.1 reports Census Bureau data for 2002 and 2004 on the number and characteristics (payroll, revenue, etc.) of brokers. The Census Bureau data are important because they report the percentage of brokers who are small businesses and the percentage of industry revenue accounted for by small brokers. Following presentation of the Census Bureau data, Section B.2 examines industry data on broker characteristics, compares industry-based revenue estimates with Census-Bureau-based revenue estimates, estimates the revenue impacts of the new GFE on small brokers, and presents various estimates of the number of employees in the broker industry.

## **II.A. Overview of Industry**

The mortgage brokerage industry includes establishments primarily engaged in arranging loans by bringing borrowers and lenders together on a commission or fee basis. Chapter 2 includes a detailed analysis of brokers, explaining how they handle the front end of the mortgage application process, documenting their recent growth and their large share of the mortgage market,<sup>1</sup> discussing their efficiency in originating mortgages, and summarizing concerns about their overcharging consumers, particularly on loans that involve yield spread premiums.<sup>2</sup> This section will provide some of the main highlights of that discussion. Readers are referred to Sections III.E and IV of Chapter 2 for a more detailed discussion. Readers are also referred to Section VIII.A of Chapter 3 and Section VII.A of Chapter 4 for discussions of the competitive impacts of the new GFE on small brokers.

During the 1980s and 1990s, mortgage lending evolved from the traditional portfolio lender model where single companies (bank and thrift depositories) performed all steps in the mortgage process -- making, closing, funding, servicing, and holding the loan - to a more specialized industry of originators, funding lenders, warehouse lenders, separate secondary market buyers of loans, and servicers.<sup>3</sup> Mortgage brokers, which hardly existed before 1980, were an important part of this development. Originations by mortgage brokers have greatly increased, from 20% of all originations in 1987 to over 60% for the years after 1996. Similarly, the number of brokers has risen from about 7,000 in 1987 to over 30,000 for the years after 1996. According to Wholesale Access (2005), there were approximately 37,000 brokers operating in

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<sup>1</sup> As noted in Chapter 2, the description of the role of brokers and wholesale lenders in the mortgage market has benefited from survey work conducted by Wholesale Access (2005) and [LaMalfa \(2006\)](#).

<sup>2</sup> The discussion of recent concerns about brokers' overcharging consumers has benefited from recent work by Jackson and Berry (2001), Jackson (2002), Guttentag (2002), and Woodward (2002, 2003a). This work is reported in Sections IV.B and IV.D of Chapter 2 and is summarized in Section VII.E.1 of Chapter 3 and Section VI.E.1 of Chapter 4.

<sup>3</sup> Michael G. Jacobides, "Mortgage Banking Unbundling: Structure, Automation, and Profit," *Mortgage Banking*, January 2001, pages 28-40.

the mortgage market in 2001 (also see Section B below), although that number has fluctuated recently, rising from 31,000 in 1997 to 36,000 in 1998 (a heavy refinance year) before dropping to 30,000 in 2000 (a low volume year) and then rising to 37,000 in 2001, 44,000 in 2002 and 50,000 in 2003 (all heavy refinance years). Based on his most recent survey, Wholesale Access concluded that there were 53,000 brokers during the heavy refinance year of 2004; the same survey placed the broker share of the mortgage market at 68 percent.

A major driving force behind the unbundling of the mortgage functions, as well as the rise of mortgage brokers, has been the rise and eventual dominance of mortgage securitization, which separated the provision of capital from loan origination and servicing. Increasing technical sophistication and information technology were also important factors in the restructuring of the mortgage finance system and the rise of mortgage securitization. Jacobides (2001) also notes that the traditional mortgage banking function (defined by independent mortgage bankers that sell their originations in the secondary market but retain servicing) has recently been disintegrating, highlighted by birth of the mortgage brokerage function and the corresponding development of the wholesale segment of the market.

As explained in Section III of Chapter 2, brokers originate loans mainly for wholesale lenders. Recently, there has arisen a group of “mega” wholesale lenders -- such as Countrywide, Wells Fargo, Chase Manhattan, and Washington Mutual – that have been a byproduct of the recent consolidation process in the banking and thrift industries. According to Inside Mortgage Finance (January 24, 2003), the mortgage market share of the top 25 wholesale lenders had increased to almost 80% by 2002. These wholesale lenders purchase loans from brokers and correspondents (such as a mortgage bank) as well as operate their own retail business. Brokers and correspondents allow these large wholesalers to expand their sales force in a low-cost way and to enter markets that they otherwise would not find profitable.

Chapter 2 reviewed several studies that have examined the competitive nature of the mortgage market and the characteristics of mortgage brokers. In general, these studies paint a picture of a highly competitive market, with thousands of brokers and lenders originating loans for consumers, and with many of these loans being sold to large wholesale lenders who compete vigorously for mortgage market share (LaMalfa 2002, Woodward 2003a).

Morgan Stanley (2002) concludes that the prime mortgage market is highly competitive and efficient, and that brokers are an important reason for this. The report notes that "tens of thousands of independent brokers" have competed away business from traditional (small and medium-sized) banks and thrifts; Morgan Stanley does not foresee any reversal in this trend. According to Morgan Stanley, brokers are not hampered by high fixed costs and are flexible enough to respond to the extreme cyclicity of the mortgage origination function. Morgan Stanley says there is little evidence of economies of scale in mortgage origination and cites evidence that brokers are more efficient originators than mid-size and large lenders.

Olson (2002) also reports that his surveys find no economies of scale in mortgage production - a one-person firm produced as many loans per employee as a larger firm. Olson sees brokers as low-cost, highly-competitive firms, vigorously competing with one another and with little opportunity to earn above-normal profits.

An examination of revenue statistics for 2002 provides further evidence of the competitive nature of the industry. The smallest firms, with less than five employees, generate \$166,273 of revenue per employee. The largest firms, those with five hundred or more employees, generate considerably less revenue per employee (\$87,266). A general decline in revenue per employee occurs from the smallest firm to those with 100 to 499 employees.

**Table 5-2. Revenue per Employee for Mortgage Brokers (NAICS 522310) (employer firms, 2002)**

Firm Size (number of employees)	1-4	5-9	10-19	20-99	100-499	500+
Revenue per employee	\$166,273	\$134,273	\$124,351	\$121,288	\$136,346	\$87,266

Data on industry concentration are available from the 2002 Economic Census. The four largest firms earn 4.2% of the total revenue, and employ 1.6% of all employees, who earn 2.5% of the annual payroll.

**Table 5-3. Concentration by Largest Firms 2002: Mortgage Brokers**

Concentration Ratios of Firms	Share of Establishments	Share of Sales, etc of largest firms	Share of Annual payroll (\$1,000)	Share of Employees
All firms	100.0%	100.0%	100.0%	100.0%
4 largest firms	0.2%	4.2%	2.5%	1.6%
8 largest firms	0.3%	6.1%	4.4%	2.6%
20 largest firms	1.1%	10.1%	8.7%	5.9%
50 largest firms	2.3%	15.6%	13.8%	9.7%

With respect to overall competition in the prime mortgage market, Morgan Stanley (2002) echoed the comments of Jacobides (2001), who argued that intense competition has reduced mortgage fees by almost 40% in recent years. Morgan Stanley sees advances in technology continuing the trend toward lower origination costs. The Morgan Stanley report emphasizes that technology and automated underwriting systems are making big changes in the mortgage industry in areas such as servicing, pricing, connectivity, and unit costs. Brokers are increasingly using this technology supplied by lenders and the GSEs (Fannie Mae and Freddie Mac) when submitting loans for electronic approval. Morgan Stanley also concludes that the spread of automated underwriting and "open architecture" systems (allowing brokers to quickly qualify applicants and obtain prices from several lenders) should further improve brokers' price sensitivity and competitive position.

The Joint Center for Housing Studies<sup>4</sup> echoed the same theme when they stated:

...these trends have also supported the growth of mortgage brokers, who working on a fee-for-service basis, handle the front end of the mortgage application process, a function that often still requires a presence in a local market area, and some face-to-face communication with a loan applicant. Here, scale economies are decidedly less

<sup>4</sup> Joint Center for Housing Studies, *The 25<sup>th</sup> Anniversary of the Community Reinvestment Act: Access to Capital in an Evolving Financial Services System*, March 2002.

significant, and relatively small organizations continue to thrive as mortgage brokers.  
(p. 15)

Despite the competitive structure of the industry, there is concern that brokers are overcharging consumers. Section IV of Chapter 2 presents this evidence and readers are referred there for the details. Much of the controversy has centered around brokers' use of yield spread premiums (YSPs). Cash-constrained borrowers can avoid paying settlement costs (partially or even fully as in a "no-cost" loan) by choosing above-market-rate loans that generate YSPs that reimburse the originator (broker or lender) for settlement costs. In other words, consumers agree to an above-market-rate loan in exchange for not having to pay for settlement costs. As explained in Chapter 2, studies have found that consumers do not reap the full benefits of YSPs but, rather, brokers retain a portion of the YSP in excess of any payments for settlement services.<sup>5</sup> That is, yield spread premiums are not always used to offset closing costs. These studies present a picture of a market characterized by excessive fees, price dispersion, and price discrimination -- with some borrowers getting market-rate deals but others getting bad deals.

As discussed in Chapter 2, it seems surprising to see such anti-competitive behavior in what appears to be a highly competitive market (see Section IV.D.4 of Chapter 2 for discussion of this issue). Search costs and asymmetry of information may be introducing noncompetitive elements into the market. Mortgage brokers may be able to price discriminate because of the significant costs of shopping around for better deals. A large part of the search costs would be developing an understanding of the origination process itself. When customers fail to become informed, then mortgage brokers would be able to charge higher prices. Jack Guttentag has stated that comparison-shopping for mortgages is difficult and that improved disclosure could reduce brokers' fees by half.<sup>6</sup> Howell Jackson, according to whom brokers often charge twice what would be a fair fee, confirms this view.<sup>7</sup> According to Woodward (2003a), her data confirmed that shopping for a mortgage is not easy, particularly for borrowers attempting more difficult shopping strategies involving a tradeoff of interest rates and points. Borrowers choosing the more difficult strategy pay higher broker fees on average than borrowers who roll closing costs into the interest rate and thus can shop on the basis of rate alone.<sup>8</sup> Woodward notes that "the discovery of just how ill-prepared some borrowers are to deal with the mortgage market and how much it costs them is disheartening" (p. 39). She says it is "shocking" that less well-educated borrowers pay nearly \$1,500 more in broker fees than well-educated borrowers. Also according to Woodward, the race of the borrower matters – on average, African-Americans pay their brokers an additional \$500 and Hispanic borrowers, \$275, compared to other borrowers, after accounting for education and other characteristics.

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<sup>5</sup> See Jackson and Berry, 2001; Jackson, 2002, Woodward, 2002 and 2003a; and Urban Institute, 2007b.

<sup>6</sup> Wall Street Journal, "Huge Fees Draw the Scrutiny of Regulators and Spawn Lucrative Small Companies," February 24, 2003. Guttentag's statements appear to be based on his observations of the market, as he offers no specific data.

<sup>7</sup> WSJ, February 24, 2003.

<sup>8</sup> Borrowers who roll at least the broker's fee (plus possibly some or all other closing costs) into the interest rate pay broker fees that are \$900 lower on average than other borrowers. Borrowers who roll all closing costs into the interest rate pay fees that are \$1,500 lower than those paid by other borrowers.

David Olson, on the other hand, has pointed out that information is readily available and that a shopper can easily obtain information from the Internet, television, or newspaper.<sup>9</sup> But Olson also points out that shoppers prefer local brokers to Internet firms, because a local broker “can walk them through the complex process of originating a mortgage.” Given the complexity of the process, it is possible that some consumers, especially first-time homebuyers, are not sufficiently sophisticated to avoid paying interest rates that are higher than normal.

But, as noted above, recent studies by Jackson and Berry (2001), Jackson (2002), Guttentag (2002), Woodward (2002, 2003a), and Urban Institute (2007b) present evidence that brokers overcharge consumers and that yield spread premiums are not always used to offset closing costs. These studies present a picture of a market characterized by excessive fees, price dispersion, and price discrimination. Readers are referred to Section IV of Chapter 2 for a complete discussion of the YSP issue, concerns about excess fees, and the empirical findings from the various studies.

## **II.B. Description of Economic Data**

Section B.1 reports Census Bureau data on the mortgage brokerage industry for the years 2002 and 2004. These data are important for determining the small business characteristics of the mortgage broker industry. Section B.2: (a) compares the Census Bureau revenue data with industry revenue estimates and attempts to reconcile some of the differences in data; (b) presents estimates of revenue transfers from brokers due to the consumer savings from the new GFE; and (c) provides estimates of the number of employees in the broker industry

### **II.B.1. Census Bureau Data on Broker Industry**

The Census Bureau reports employment, payroll, and revenue<sup>10</sup> for the Mortgage and Non-mortgage Broker industry, which includes: loan agencies, loan brokerages, mortgage brokerages, loan brokers' offices, mortgage brokers' offices, and independent loan brokers' or agents' offices. This industry comprises establishments primarily engaged in arranging loans by bringing borrowers and lenders together on a commission or fee basis.

Census Bureau data from the year 2004 indicate that the Mortgage and Non-mortgage Loan Broker industry employed 138,328 people at 19,138 firms. These data are for “employer” firms, that is, a firm that has a payroll. The employer firms had an estimated annual revenue of eighteen billion dollars. Thus, in 2004, Mortgage and Non-mortgage Loan Brokers averaged 7.2

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<sup>9</sup> David Olson, Prepared Statement at Hearing on "Predatory Mortgage Lending Practices: Abusive Uses of Yield Spread Premiums," January 8, 2002 [http://www.senate.gov/~banking/02\\_01hr/010802/olson.htm](http://www.senate.gov/~banking/02_01hr/010802/olson.htm).

<sup>10</sup> The 2002 data are from the 2002 Economic Census and the 2004 data are from Statistics of U.S. Businesses, an annual series. The primary difference between the two series is that revenue data are available for 2002, but not for 2004.

employees per firm and had estimated<sup>11</sup> annual revenue per firm of \$962,634. The majority, 73.1%, of Mortgage and Non-mortgage Loan Broker employees worked at firms employing fewer than 100; 44.4% worked at firms employing fewer than 20. For the industry as a whole, the average annual salary for an employee was \$50,982 in 2004. For firms with less than 20 employees, the average annual salary was slightly less.

In addition to the 19,138 broker offices that had employees in 2004, there were an estimated 31,014 nonemployer firms, which yields a total of 50,152. A nonemployer firm is one with no employees on its payroll for the entire year. Sole proprietorships and limited partnerships are examples. A firm could lease or contract workers and still retain the status of a nonemployer firm. While the data do not provide many details about these non-employer firms, Census methodology ensures that nonemployers meet a reasonable definition of small.

The characterization of the mortgage broker industry by Wholesale Access is similar<sup>12</sup>. According to estimates based on an industry survey by Wholesale Access, there were 53,000 independent brokerages in 2004. These are typically small firms -- the median firm has one office and four workers including the owner. The median firm is only five and a half years old. The median firm originated 200 loans in 1998, 125 loans in 2000, and 90 in 2004. It is estimated that mortgage brokers employed 240,000 workers in 2000, 297,000 in 2001 and 418,700 in 2004. This figure is at odds with the Census employee figure of 138,328 mortgage and non-mortgage loan brokers in 2004. A large part of this difference may be in how employees are defined. In the Census, an employee is defined as a worker on the payroll, whereas the estimates of Wholesale Access may define an employee as anyone who works for a firm (partners, sole proprietors, or employees of a temp agency).

Census Bureau data from 2002 provide somewhat more detailed information about loan brokers. According to the Census, the employer firms in this sector employed 105,147 people at 15,590 firms in 2002 (compared with 138,328 people at 19,138 firms in 2004). These firms had annual revenue of fourteen billion dollars. In contrast with the revenue estimate of eighteen billion dollars for 2004, the 2002 revenue figure is taken directly from Census publications. The average number of employees of a firm in 2002 was 6.7. Average revenue per firm was \$906 thousand, which is \$943 thousand in 2004 dollars, slightly less than the 2004 estimate of \$963 thousand.<sup>13</sup> In addition to the 15,590 brokerage firms that had employees in 2002, there were an estimated 25,105 non-employer firms.<sup>14</sup> This yields a total of 40,695 firms, similar to other

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<sup>11</sup> Revenue statistics for employer firms are available from the Economic Census of 2002, but are not available for more recent years. To estimate revenue for 2004, payroll statistics for 2004 are multiplied by a revenue-payroll ratio for the relevant firm size calculated from 2002 data.

<sup>12</sup> "Mortgage Brokers 2004", Wholesale Access, July 2005.

<sup>13</sup> In order to convert 2002 dollars to 2004 dollars, multiply by 179.9/172.2, or 1.0447. The deflator is based on the U.S. Consumer Price Index for all items (Not Seasonally Adjusted). The base period is from 1982-84.

<sup>14</sup> The primary reason that the 2002 estimate of the number of nonemployer loan brokers is much less than the 2004 estimate is that, according to the Census Bureau, the base from which the number of loan brokers was estimated (Activities Related to Credit Intermediation, NAICS 5223) increased dramatically. The Census reported that there were 28,100 nonemployers in 2002; 43,773 in 2003; and 45,392 in 2004. Thus, according to the Census Bureau, there was a 62 percent increase from 2002 to 2004. This continues a long-term trend from 14,477 in 1997; 20,321 in 1998; 24,239 in 1999 and 24,723 in 2000.

estimates for 2002. Wholesale Access provides an estimate of 44,000 broker firms for 2002. The differences in these estimates may be explained by the differences in their collection methods. The Census Bureau figures are calculated using IRS data so there is no sampling error. However, there is the possibility of non-sampling error, that is, of firms classifying themselves incorrectly. Whereas the results of Wholesale Access are based on surveys where there is the potential of sampling error, their estimates are even more consistent with the previously discussed 2004 estimate (50,152) based on Census Bureau numbers. For this reason, the analysis uses the 2004 estimate as the preferred Census Bureau estimate of firm totals in the loan broker industry.

If this estimate is correct, then there were 50,152 firms in the loan broker industry. This represents a difference of just over 5% from the 53,000 firm estimate of Wholesale Access for 2004. One reason for the difference between the estimates is that many loan correspondents, which are defined as belonging to Real Estate Credit industry by the Census, may have been defined by Olson as mortgage brokers because Olson's more expansive definition includes brokers with warehouse lines of credit that also operate through correspondent arrangements with larger wholesale loan purchasers. As explained in Chapter 2, Olson defines a broker as any independent firm (i.e., not connected with a bank, thrift, or credit union) that table funds more than half its production, doesn't service loans, and doesn't buy whole loans from other firms. Thus, his broker definition includes brokers that use lines of credit to finance up to half their production.

#### **II.B.1.a. Census Bureau Data for Small Businesses: Loan Brokers**

The greater financial detail provided in the 2002 data makes the 2002 data better suited for the task of determining how many firms meet the SBA's definition of small. The 2002 size standard for Mortgage and Nonmortgage Loan Brokers is \$6 million in revenue. Census Bureau data, however, reports data on firms with annual revenue of less than \$5 million and between \$5 million and \$10 million. Of the 15,590 employer firms in this sector, it is estimated that 97.3% had annual revenues less than \$6 million and would have been considered small by the SBA. Considering both employer and nonemployer firms, it is estimated that 99.1% of all broker firms are small according to the SBA's definition.<sup>15</sup> Data on the revenue of employer firms indicate that at least 96.9% of employer firms would be considered small in 2002 according to Census data.<sup>16</sup> These small employer firms earned 64.2% of the industry's revenue, employed 73.9% of its employees, and paid 66.0% of the payroll. Applying these ratios to employer firm totals and counting nonemployer firms as small businesses provides an estimate of the prevalence of small businesses in 2002: 99.1% of all firms in 2002 are estimated to be small and 67.2% of the industry revenue is earned by these small firms. The share of revenue earned by small businesses

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<sup>15</sup> The 99.1 percent is derived by adding the estimated 25,105 nonemployer firms to the 12,029 employer firms operating the entire year earning less than \$6 million and dividing by the sum of all 12,365 employer firms operating the entire year and the number of nonemployer firms; in other words, 37,134 divided by 37,470. As explained in the text, it appears that the 37,470 figure underestimates the number of loan brokerages.

<sup>16</sup> The 2002 Economic Census data are the percentage of firms operating for the entire year earning less than \$5 million. Although this omits firms earning between \$5 million and \$6 million, Census data indicates that the number of omitted firms is small, approximately 50.

increases by only two percentage points when adding nonemployers because the average revenue of a nonemployer broker is estimated to be fairly low (\$48,871) in 2002.

**“Very Small” Brokers.** As described above, estimating the proportion of broker firms that are “small” involves some estimation. However, data are available in 2004 to describe the characteristics of those firms that are “very small” as defined by the number of employees (less than twenty employees). Employer firms, employing less than twenty employees, accounted for 93.0% of all employer firms in the Mortgage and Non-Mortgage Loan Broker industry, employed 44.4% of its employees, and received 47.5% of its (estimated) revenue. Including the (estimated) data on nonemployer firms would yield that “very small” firms constitute 97.3% of all firms and earn 51.4% of the revenue received by loan brokers in 2004.

## **II.B.2. Brokers: Revenue Estimates, Small Business Transfers, and Other Data Considerations**

As discussed above, the Census-Bureau-based estimate of 50,152 firms in mortgage loan broker industry in 2004 was only 2% less than the 53,000 estimate of David Olson of Wholesale Access.<sup>17</sup> The characterization of the broker industry provided by the Census Bureau data was also similar to that provided by Olson. This section continues this analysis by combining the Census and industry data on brokers. Section II.B.2.a compares industry-based revenue estimates with Census-Bureau-based revenue estimates, Section II.B.2.b estimates the revenue impacts of the new GFE on small brokers, and Section II.b.2.c presents various estimates of the number of employees in the broker industry.

The Census Bureau data suggest that at least 99.0% of all brokers are small businesses, or 37,470 firms based on the Census-Bureau-based estimate of 40,695 provided above. If there were 53,000 broker firms in 2004, as Olson suggested, then there were 52,470 small brokers; or 49,500 small brokers based on Olson’s estimate of 50,000 brokers in 2003 and 43,560 small brokers based on Olson’s recent estimate of 44,000 brokers in 2002. The recent increases in the number of brokers are due to the large volume of refinancing activity associated with record low mortgage rates.

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<sup>17</sup> As noted in the text, Wholesale Access defined a broker as any independent firm (i.e., not connected with a bank, thrift, or credit union) that table funds more than half its production, doesn’t service loans, and doesn’t buy whole loans from other firms. This broker definition includes brokers that use lines of credit to finance up to half their production; it is therefore broader than the definition used by HUD and LaMalfa (2006). As discussed in Chapter 2, LaMalfa estimates that approximately one-third of mortgage production has come through the brokerage channel (defined as table funding and concurrent funding) while another quarter has come through the correspondent channel. Wholesale Access’ larger estimate that brokers account for 68 percent or more of market originations is due to his more expansive definition that covers brokers with warehouse lines of credit that also operate through correspondent arrangements with larger wholesale loan purchasers (rather than simply table funding loans). See Section III.B.5.d of this chapter for additional analysis related to Wholesale Access’ estimates of the broker share of the market.

## II.B.2.a. 2004 Broker Revenue

The Census Bureau data also suggest that small brokers account for 67.2% of all revenue in the broker industry. Thus, it is interesting to compare various estimates of industry revenue for brokers. Above it was estimated that broker revenue totaled \$19.920 billion during 2004, a year when mortgage originations totaled \$2,589 billion (MBA estimate). Of course, this \$19.920 billion estimate applies only to 50,152 brokers; an adjustment is needed if one assumes there were 53,000 brokers, instead of 50,152. The following represent revenue estimates based on different treatment of the remaining 2,848 brokers and different per-firm revenue estimates:

(1) \$20.058 billion for 53,000 brokers, assuming the additional 2,848 firms were non-employer firms and their average firm revenue was \$48,285. The \$48,285 figure is the estimated revenue per firm for non-employer firms. In this case, the 2,848 non-employer firms add just \$138 million in revenue. Because the \$48,285 appears to be such a small figure for the revenue of a broker (not net income, but total revenue), additional sensitivity analyses were conducted.

(2) \$20.394 billion for 53,000 brokers, assuming the additional 2,848 firms were non-employer firms and their average firm revenue was \$378,478. The \$378,478 figure is the average per-employee revenue for small (<5 employees) broker firms. In this case, the 3,199 non-employer firms add \$1,077 million in revenue. Notice that the \$378,478 is almost eight times the revenue estimate of \$44,369 in (1) above.

(3) \$23.580 billion for 50,152 brokers, assuming the \$166,273 (which is the average per-employee revenue for broker firms with less than 5 employees) could be applied to the estimate of 31,014 non-employer firms in the initial estimate of 50,152 brokers.

(4) \$24.053 billion for 53,000 brokers, assuming the additional 2,848 firms were non-employer firms and that all 33,862 (31,014 of the initial 50,152 plus the additional 2,848) non-employer firms had average firm revenue of \$166,273 (instead of \$48,285 as in (1) above).

(5) \$21.051 billion for 53,000 brokers, assuming the additional 2,848 firms were split between 1,087 employer and 1,761 non-employer firms and the average firm revenue was \$962,634 for employer firms and \$48,285 for non-employer firms (see Table 5-23 in the Data Appendix for the average revenue).

(6) \$21.259 billion for 53,000 brokers, assuming the additional 2,848 firms were split between 1,087 employer and 1,761 non-employer firms and the average firm revenue was \$962,634 for employer firms and \$166,273 for non-employer firms.

Thus, there are a range of possible revenue estimates for 2004 based on the Census Bureau revenue data applied to either 50,152 broker firms or 53,000 broker firms. One can also make rough revenue estimates based solely on industry data. In 2004, the broker share of mortgage originations was 68%, or \$1,761 billion (of total originations of \$2,589 billion<sup>18</sup>).

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<sup>18</sup> This estimate coincides with estimates released by the Mortgage Bankers Association (MBA). Alternatively, Freddie Mac estimates total single-family originations were \$2,906 billion in 2004, and Fannie Mae estimates the total was \$2,790 billion.

Based on Wholesale Access (2005), brokers earn about 1.7 percent in origination fees, or \$29.937 billion (multiplying 0.017 times \$1,761 billion).<sup>19</sup> As noted in Chapters 3 and 4, there have been anecdotal reports of lower origination fees. If fees were 1.50%, then broker revenues were \$26.41 billion. This estimate, based on simple industry calculations, is slightly higher than the range reported in (1)-(6) above for the Census-Bureau-based estimates. While the various industry-based revenue estimates for 2004 vary somewhat depending on fee assumptions, the fact that they are in the same range as the Census-Bureau-based estimates offers some comfort, particularly since the industry-based estimates are used to estimate the revenue impact on small businesses.

### **II.B.2.b. Consumer Savings and Revenue Transfers: Brokers**

As explained in Chapter 3, consumer savings and transfers associated with the new GFE assume \$2.4 trillion in mortgage originations, with brokers accounting for 60% of this total.<sup>20</sup> While the base case assumed brokers earn a 1.75% fee, sensitivity analyses were conducted using 1.5% and 2.0% fees. In this case, broker revenues are projected to be: (a) \$21.6 billion if fees are 1.5%, (b) \$25.2 billion if fees are 1.75%, and (c) \$28.80 billion if fees are 2.0%. As discussed above, revenue estimates generated in this manner for the year 2004 were similar to revenue estimates for brokers based on Census data.

As noted above, 99.1% of broker firms are small businesses and this analysis assumes they account for 70% of all broker revenues.<sup>21</sup> Thus, small broker revenues would be: (a) \$15.1 billion if fees are 1.5%, (b) \$17.6 billion if fees are 1.75%, and (c) \$20.2 billion if fees are 2.0%.

**GFE Consumer Savings and Transfer Estimates.** Section VII.E of Chapter 3 conducted several analyses with respect to projected transfers from brokers due to the new GFE. The estimates ranged from 11.0% to 14.0%. In the case of a 1.75% origination fee, the dollar range was from \$2.77-\$3.53 billion. Small businesses would account for 70% of these transfers, or \$1.94-\$2.47 billion. If there are 40,000 (44,000) (46,000) (50,000) brokers, then these transfers would come from 39,640 (43,604) (45,586) (49,550) small brokers.<sup>22</sup> Because the industry-based revenue estimates are similar to the Census-Bureau-based revenue estimates (see above demonstration of this for the year 2004), then the percentage change in broker revenues is

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<sup>19</sup> Origination fees include both direct origination fees and indirect origination fees (or yield spread premiums).

<sup>20</sup> According to Olson, the broker share was 65 percent during the heavy refinance years of 2001 and 2002 and 68 percent in 2004. While 60 percent is used here, Chapter 3 includes sensitivity analyses of higher broker shares. The results for 65 percent are easily calculated by multiplying the projected revenues in the text by 1.083, or 65/60. Also see Section III.B.5.d of this chapter for a discussion of some issues related to the broker share of the market.

<sup>21</sup> The 2002 Census of Business estimates a revenue share of 67.2% for small brokers; however, as discussed above, that survey may not have included all brokers. Therefore, to ensure that the small broker revenue share is not underestimated, this analysis rounds it up slightly to 70%.

<sup>22</sup> However, it is recognized that in the latter cases (46,000 and 50,000 brokers), the mortgage origination volume could be higher than \$2,400 billion, which is a projection for a more normal home purchase environment.

given by the 11.0%-14.0% reported above. This percentage loss in revenues refers to both small and large brokers.<sup>23</sup>

If broker fees are 2.0% instead of 1.75%, then broker revenues and the above revenue transfers are increased by the ratio of 2.00/1.75, or 1.14. Revenue transfers for all brokers would be \$3.17-\$4.03 billion, and revenue transfers for small brokers would be \$2.22-\$2.82 billion – again, these revenue transfers for both groups would represent 11.0%-14.0% of their total revenues. If broker fees were 1.5% of the value of originated loans, then revenue transfers for all brokers would be \$2.38-\$3.02 billion, and revenue transfers for small brokers would be \$1.67-\$2.12 billion.

For estimates of the allocation of consumer savings of the GFE by size of firm, see Table A.1. In addition, Table A.1 shows estimates of the allocation of consumer savings per firm for the GFE.

For a discussion of the competitive impacts of the RESPA reform on brokers, see Section VIII.A of Chapter 3. See Chapter 6 for a description of the compliance costs and regulatory burden of the rule.

### **II.B.2.c. Number of Employees in Broker Industry**

This section examines the number of employees in the broker industry and the number of loans per worker – as explained below, these topics are relevant to the estimation of compliance and regulatory costs in Chapter 6. Again, the source of information is Wholesale Access. While Wholesale Access has provided numerous estimates over the past few years, the analysis below focuses on their two most recent surveys implemented in 2002 and 2004.

**2002 and 2004 Estimates.** In 2002, Wholesale Access estimated that the 44,000 brokers that originated 65 percent of all mortgages employed 448,800 workers, or 10.2 employees per firm. In 2004, Wholesale Access estimated that the 53,000 brokers that originated 68 percent of all mortgages employed 418,700 workers, or 7.9 employees per firm. Wholesale Access also provides production numbers – the average number of loans per worker in 2002 was 22.7 while the average in 2004 was 20.0. The average number of loans per broker firm was 232 in 2002 and 158.3 in 2004.

Wholesale Access' estimates of loan production per employee and the number of employees in the broker industry come from his survey of brokers. It should be noted that a higher figure for number of industry employees is obtained if one applies Wholesale Access' estimate of 20 loans per employee to available estimates of the number of mortgages originated in 2004. For example, the Office of Federal Housing Enterprise Oversight (OFHEO) estimates

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<sup>23</sup> One could also project the revenue transfers for 2004, rather than for the projection year, and compare the projected revenue transfers to the Census-Bureau-based estimates of actual revenues. This could be done by multiplying the range of loss rates (11.0 percent-14.0 percent) by the revenue estimates given in (1)-(6). For example, consider revenue estimate of \$21.259 billion in step (6); in this case, revenue transfers could range from \$2.338 billion to \$2.976 billion. The revenue of small brokers would total \$14.881 billion and the small broker revenue transfers could range from \$1.637 billion to \$2.083 billion.

that there were \$2,920 billion in mortgages originated during 2004, which translates into 16,783,573 mortgages assuming an average loan amount of \$173,980 (obtained from HMDA). Using Wholesale Access' broker share of 68% means that brokers originated 11,412,830 mortgages in 2004, which translates into 570,641 employees using Wholesale Access' estimate of 20 loans per employee. If Wholesale Access' 2002 estimate of 22.7 loans per employee were used, the number of broker employees would be 502,767. Using a lower estimate (\$2.762 billion) of mortgages originated during 2004 (obtained by averaging estimates from Freddie Mac, Fannie Mae, and the Mortgage Bankers Association) produces an estimate of 539,699 broker employees assuming 20 loans per employee, and 475,506 broker employees assuming 22.7 loans per employee. All these numbers are higher than Wholesale Access' estimate of 418,700 employees in 2004.

In its 2004 study, Wholesale Access assumes \$2,589 billion (from the Mortgage Bankers Association) in mortgage originations; using his estimate of 20 loans per employee combined with the other assumptions (68% broker share and \$173,980 average loan amount) yields 505,955 employees in the broker industry. If his 2002 estimate of 22.7 loans per employee were used, then the estimate of 2004 employees would drop to 445,775, which is close to his reported 2004 figure of 418,700.

**Projection Year.** Wholesale Access' data can be used to estimate the number of workers in the broker industry during the projection year. First, assume their most recent 2004 estimate of 20 loans per worker. As discussed earlier, mortgage originations are projected to be \$2.4 trillion, which translates into 12,500,000 mortgages. If the broker share is 60% (65%), brokers would employ 375,000 (406,250) workers to produce 7,500,000 (8,125,000) loans. The 375,000 is 43,700 less than the 418,700 employed in 2004, reflecting the lower volume of mortgages originated. If it is assumed each employee produces 23 loans (similar to Wholesale Access' 2002 estimate of 22.7 employees per loans), then the number of broker employees in the projection year would be 326,087 (352,261) assuming a 60% (65%) broker share of mortgage originations.

According to the Census data reported in Section II.B.1, small broker firms account for 67.2% of the revenue of all broker firms (including employer and non-employer). Given that the Census data do not report quite as many broker firms as Wholesale Access and a desire to fully reflect the impact of RESPA reform on small firms, a slightly higher figure of 70% is used in Chapter 3 and in Section II.B.2.b of this chapter to calculate the small broker share of the revenue transfers under the new GFE. Section II.B.2 reported information that the small broker share of employees is higher than the small broker share of revenue. Considering only firms with employees, data from the 2002 Economic Census indicate that small employer firms earned 64.2 of the industry's revenue but employed 73.9 of its employees – a differential of 9.7 percentage points. This suggests that the small broker share of all workers is probably closer to 77.0 percent.<sup>24</sup> Thus, in the case of the projection year, workers in small broker firms are

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<sup>24</sup> A figure of 76.9% (which is rounded in the text to 77%) is obtained by simply adding the incremental revenue share (3.0%) for non-employer firms to the 73.9% employee share for small employer firms – or stated differently, by adding the differential 9.7 percentage points (see text) to the small business revenue estimate (67.2%) for both employer and non-employer firms. While crude, this probably serves as a good proxy for the share of broker workers accounted for by small businesses (assuming, of course, that the underlying Census Bureau data are correct).

estimated to be 288,750 (312,813) if total workers are 375,000 (406,250). Workers in small broker firms during 2004 are estimated to have been 322,399 using Wholesale Access' figure of 418,700 for all broker employees and 342,246-439,394 depending on the various industry employee figures given above for all broker employees.

### **III. Mortgage Lending**

Mortgage originators include brokers and lenders. Section II discussed brokers; this section examines the lender group, which consists of commercial banks, savings and loan institutions, and mortgage banks. Credit unions, which originate a small but growing percentage of mortgage loans, are also included with the lender group. Section A provides a broad overview of the lender group; readers are referred to Chapter 2 for a discussion of trends in mortgage lending over the past twenty years. Sections B.1 to B.4 report Census Bureau data for 2002 and 2004 on the number and characteristics (payroll, revenue, etc.) of banks, thrifts, mortgage banks, and credit unions. The Census Bureau data are important because they report the proportion of each lender group that is small business, although alternative estimates will be developed in Section B.5.

Section B.5 includes several technical analyses related to estimating the share of mortgage originations among the separate lender groups and the small business share of mortgage originations for each lender group. That section compares Census and industry data for lenders, derives the mortgage origination share for each small lender group, describes the revenue transfers under the new GFE for each lender group (including aggregate and per firm transfers from small lenders), expenses the bank and thrift transfers as a percentage of industry revenue, and estimates the number of lender employees engaged in mortgage origination activity. The latter is important for the analysis of compliance costs and regulatory burden in Chapter 6.

#### **III.A. Overview of Industry**

According to the Federal Deposit Insurance Corporation (FDIC), there were 7,402 commercial banks and 1,279 savings institutions (thrifts) at the end of 2006, for a total of 8,681 depositories. Banks had total assets of \$10.1 trillion and outstanding loans (both mortgage and non-mortgage) of \$6.0 trillion. The average return on equity for banks was 12.3 percent and approximately 88.6 percent were profitable, according to the FDIC. Thrifts had total assets of \$1.8 trillion and outstanding loans (both mortgage and non-mortgage) of \$1.3 trillion. The average return on equity for thrifts was 7.8 percent and approximately 85 percent were profitable. In terms of single-family mortgage debt, the Federal Reserve reports that banks held \$2,053 billion at the end of 2006, representing 20.1 percent of outstanding mortgage debt, while thrifts held \$869.6 billion or 8.5 percent of outstanding mortgage debt. Together, depositories held 28.6 percent of all outstanding mortgages.

The annual volume of mortgages originated by depositories can be estimated from Home Mortgage Disclosure Act (HMDA) data.<sup>25</sup> For 2005, the most recent year for which HMDA data are available, mortgage originations were distributed as follows:

	<u>2005 Originations (bill. \$)</u>		<u>Number of Loans</u>	
		<u>%</u>		<u>%</u>
Comm. Banks	1,201.5	44.2%	6,501,145	44.9%
Thrifts	494.0	18.2	2,302,568	15.9
Mortgage Banks <sup>26</sup>	965.4	35.6	5,268,746	36.4
Credit Unions	54.6	2.0	411,202	2.8
Total	2,715.5	100.0	14,483,661	100.0

### **III.A.1. Depositories: Commercial Banks and Thrifts**

In terms of dollars of originations, depositories originated 62.4% of all mortgages, with commercial banks originating 44.2% of all mortgages and thrifts, 18.2%. As shown in Table 5-4, the above origination data for depositories (banks and thrifts) include both the data for the parent firms and the data for their mortgage banking subsidiaries. In 2005, there were 466 mortgage-banking subsidiaries of banks that originated \$495.0 billion, or 41.2% of the total originations of commercial banks. These subsidiaries include such mega lenders as Citicorp Mortgage, Chase Manhattan Mortgage Corporation, and Wells Fargo Home Mortgage. Similarly, there were 34 mortgage-banking subsidiaries of savings institutions that originated \$78.5 billion, or 15.9% of all thrift originations. The “Mortgage Bank” data reported above include only those mortgages originated by independent (non-subsidiary) mortgage banks. In 2005, there were 1,287 independent mortgage banks that reported originations under HMDA; most of these are small, but giants such as Argent Mortgage Company, GMAC Mortgage, and American Home Mortgage are also in this group.

Loans originated by brokers are typically reported in HMDA by the broker's wholesale lender (i.e., the bank, thrift, or mortgage banker that the broker is working with). Mega lenders such as those listed above purchase the bulk of loans originated by brokers. The reporting entity

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<sup>25</sup> Observers estimate that HMDA covers approximately 85 percent of mortgage originations (see Scheessele, 1998). The data in the text represent all single-family home purchase and refinance mortgages reported by HMDA.

<sup>26</sup> Mortgage banks only include independent mortgage banks. Mortgage banking subsidiaries of commercial banks, savings institutions, and credit unions are included with their parents.

under HMDA regulations is the entity responsible making the credit decision.<sup>27</sup> Thus, brokers' loans are typically reported under HMDA by the wholesale lender.<sup>28</sup>

There were 4,831 depositories (4,228 banks and 603 thrifts, ignoring subsidiaries) reporting to HMDA in 2005, which is substantially fewer than the 8,833 depositories reported by the FDIC for the same year.<sup>29</sup>

**Table 5-4. HMDA Reported Mortgage Originations by Lender Type, 2005**

	Number of Lenders	Number of Mortgages	Percent	Mortgage Originations	
				(\$1,000,000)	Percent
<b>Commercial Banks</b>					
Banks	4,228	3,910,396	27.0%	706,463	26.0%
Subsidiaries	466	2,590,749	17.9%	495,036	18.2%
Total: Banks	4,694	6,501,145	45.9%	1,201,499	44.2%
<b>Savings Institutions (Thrifts)</b>					
Thrifts	603	1,898,328	13.1%	415,431	15.3%
Subsidiaries	34	404,240	2.8%	78,544	2.9%
Total: Thrifts	637	2,302,568	15.9%	493,975	18.2%
<b>Credit Unions</b>					
Credit Unions	1,977	392,249	2.7%	51,384	1.9%
Subsidiaries	25	18,953	0.1%	3,213	0.1%
Total: Credit Unions	2,002	411,202	2.8%	54,597	2.0%
Independent Mortgage Banks	1,287	5,268,746	36.4%	965,397	35.6%
<b>Total Market</b>	<b>8,620</b>	<b>14,483,661</b>	<b>100.0%</b>	<b>2,715,468</b>	<b>100.0%</b>

Note: See text for discussion of the mortgage company subsidiaries.

In 2005, banks and thrifts that operated in non-metropolitan areas, or had no more than \$34 million in assets,<sup>30</sup> or made no mortgage loans in the preceding year were not required to report to HMDA. (Section III.B.5 below examines banks and thrifts that do not report to HMDA.)

<sup>27</sup> Specifically, "an institution that makes a credit decision on an application prior to closing reports that decision under HMDA regardless of whose name the loan closes in." See *A Guide to HMDA Reporting: Getting It Right!* Federal Financial Institutions Examination Council. January 1, 1998.

<sup>28</sup> However, loan correspondents who fund loans through warehouse lines of credit are also required to report under HMDA those loans in which they make the credit decision.

<sup>29</sup> For the remainder of this section, we report 2005 data from the FDIC since it corresponds with 2005 HMDA data. As noted above, there were also 466 subsidiaries of commercial banks and 34 subsidiaries of savings institutions that reported to HMDA in 2005.

<sup>30</sup> Prior to 1997, the threshold was \$10 million dollars. Since 1997, the threshold has been adjusted for inflation.

Chapter 2 discussed basic trends in the mortgage market over the past twenty years including the decline in the traditional portfolio lender, the rise of the secondary market, and the rise of the mortgage banking and broker methods of originating mortgages. The recent growth of "mega" lenders and their wholesale purchase activity were also discussed in Chapter 2. Depositories include those large banking and saving institutions (such as Bank of America and Wells Fargo) that purchase mortgages from brokers and mortgage bankers (the so-called broker and loan correspondent channels of mortgage origination) as well as originate mortgages through their own offices and branches (the so-called retail channel of mortgage origination). The consolidation of the mortgage origination market was also discussed in Chapter 2. Analysis of HMDA data show that the share of single-family originations accounted for by the top five (25) originators increased from 31.5 to 36.9 percent (from 60.8 to 68.5 percent) between 2001 and 2005. An analysis of the Community Reinvestment Act by the Joint Center for Housing Studies (2002) noted the trend toward consolidation of banks and thrifts during the 1990s. In 2000, there were 10 large banks and thrifts (defined as originating over 50,000 loans) that originated 47 percent (1.1 million of 2.5 million) of all conventional home purchase loans in metropolitan areas. Between 1993 and 2000, the largest depositories were responsible for 78 percent of the increase in home purchase originations by all depositories.<sup>31</sup> At the other end of the spectrum, the Joint Center for Housing Studies notes that the number of depositories originating less than 100 loans shrank by 10 percent between 1993 and 2000, and this group made fewer loans in 2000 than they did in 1993.

### **III.A.2. Mortgage Banks**

According to HMDA data, 1,287 independent mortgage banks originated \$965.4 billion during 2005, or 35.6 percent of all dollar originations that year. The share of originations due to all mortgage banks is higher, as these figures do not include loans originated by the mortgage banking affiliates of depositories (see Table 5.4). As noted above, most mortgage banks are small, but there are some large ones, such as Argent Mortgage Company, GMAC Mortgage, and American Home Mortgage. The 25 largest independent mortgage banks accounted for half of loans originated by independent mortgage banks during 2005.<sup>32</sup>

### **III.A.3. Credit Unions**

The credit union industry comprises institutions primarily engaged in accepting members' deposits in cooperatives that are organized to offer consumer loans to their members. Credit

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<sup>31</sup> One factor fueling these numbers was the acquisition or merger of large independent mortgage bankers with large banks. For example, North American Mortgage was acquired by Dime Savings Bank and Norwest Mortgage merged with Wells Fargo and Company

<sup>32</sup> At the other end of the spectrum, the Joint Center for Housing Studies (2002) reports that smaller independent mortgage bankers, as well as credit unions, were on the rise during the 1990's. Between 1993 and 2000, the number of independent mortgage companies and credit unions making less than 100 conventional home purchase loans rose 28 percent (from 1,163 to 1,483) and the number of home loans originated by these firms rose 42 percent. However, these small firms accounted for only 2.8 percent of the home loans originated by all independent mortgage banks and credit unions during 2000.

unions are also member-owned institutions, with each member having an equal vote regardless of the amount within their accounts. Over recent years, credit unions have increased in capacity and services. More than half of credit unions accept loan requests via the Internet and 10 percent of credit unions provide mutual fund and stock brokerage services.<sup>33</sup> According to the National Credit Union Administration (NCUA), there were 8,695 credit unions in 2005 – 5,393 Federal credit unions and 3,302 Federal-insured, state-chartered credit unions. According to HMDA data (see above), 1,977 credit unions (with 25 subsidiaries) originated 411,202 mortgages during 2005, which represented 2.8 percent of single-family originations that year. A credit union, like a depository, was exempt from reporting under HMDA in 2005 if it had assets that did not exceed \$34 million, or originated no mortgage loans in the preceding year, or if it operated only in a non-metropolitan area. The majority of credit unions have assets at or below the \$34 million asset threshold for reporting. Also, as discussed in Section III.B.5 below, a substantial number of credit unions do not originate a significant number of mortgage loans.

The next section reports Census Bureau data for 2002 and 2004 on the number and characteristics (payroll, revenue, etc.) of banks, thrifts, mortgage banks, and credit unions. The Census Bureau data are important because they report the proportion of each lender group that is small business. As will be seen, the Census Bureau data are generally consistent with the data reported above. For example, the above analysis shows there are many small lenders, but that large lenders account for most mortgage originations; similarly, the Census Bureau data will show there are many small lenders but they account for only a small portion of total industry revenue. Those instances where the Census Bureau data differs from data reported in this section will be noted throughout this analysis, it is important to keep in mind that mortgage originations provide only a portion of the total revenue earned by banks, thrifts and credit unions.

### **III.B. Description of Economic Data**

Section B.1 reports Census Bureau data for 2002 and 2004 on the number and characteristics (payroll, revenue, etc.) of commercial banks. Following this, similar data are presented for thrift institutions (B.2), mortgage banks (B.3), and credit unions (B.4). Section III.B.5 will then derive estimates of the small business share of mortgage originations for banks, thrifts, mortgage banks and credit unions, and examine the small business impacts of the new GFE on these four lender groups.

#### **III.B.1. Commercial Banking - Data Description**

According to the Census Bureau, the Commercial Banking category comprises establishments primarily engaged in accepting demand and other deposits and making commercial, industrial, and consumer loans. Commercial banks and branches of foreign banks are included. Census Bureau data from the year 2004 indicate that Commercial Banking employed 1.6 million people at 6,978 firms. These firms had estimated annual revenue of \$497

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<sup>33</sup> For more details, see United States Department of Treasury, *Comparing Credit Unions with Other Depository Institutions*, January 2001.

billion. Thus, in 2004 Commercial Banking averaged 234 employees per firm and had an estimated annual revenue of \$71 million. A low proportion, 11.1%, of Commercial Banking employees worked at firms employing fewer than 100; 1.3% worked at firms employing fewer than 20. In addition to the 7,594 employer firms from Commercial Banking in 2004, there were an estimated 285 non-employer firms in Commercial Banking.<sup>34</sup> While the data do not provide many details about these non-employer firms, Census methodology ensures that nonemployers meet a reasonable definition of small. The existence of nonemployer Commercial Banks may seem implausible. However, according to the Census, as many as 172 firms with less than five employees (1-4) classified themselves as Commercial Banks in 2004. A similarly small business that leased or contracted all of its employees would be considered a nonemployer because the payroll for the business would be zero. Thus, since very small banks appear to exist, then it is possible that nonemployer ones would as well. However, whether these small banks participate in the mortgage market is questionable. In addition, they do not account for much revenue; the Economic Census of 2002, the last year for which revenue data are available, reports that commercial banks with less than five employees accounted for three-hundredths of one percent of revenue. Thus, the inclusion or exclusion of these firms would not have a noticeable effect on estimates of the economic impact of the rule.

Census Bureau data from 2002 provide somewhat more detailed information about Commercial Banking. In 2002 the sector employed approximately 1.7 million people at 7,285 firms with 81,357 establishments compared to 6,978 firms with 83,030 establishments in 2004. These firms had aggregate annual revenue of \$489 billion. In contrast with the revenue estimate for 2004, the 2002 revenue figure is taken directly from Census publications. The average number of employees per firm was 238, similar to 234 in 2004. Average revenue per firm was \$67 million in 2002.

### **III.B.1.a. Census Bureau Data for Small Businesses: Commercial Banking**

The size standard defined by the Small Business Administration (SBA) for Commercial Banking is in terms of assets (\$150 million effective October 1, 2002), not revenue<sup>35</sup>. According to FDIC Statistics on Banking, 5,278 out of 7,883 (or 67.0%) of FDIC-insured banks had \$150 million in assets or less in 2002 and were considered small by SBA standards. In 2004, 4,765 out of 7,629 (or 62.5%) of banks had less than \$150 million in assets. Firms with less than \$150 million in assets owned 4.9% of all assets in 2002. In 2004, firms considered small by SBA standards owned 3.7% of all assets. The Economic Census does not provide data on assets but it does provide data on revenue.

Since the size standard of many sectors is based on revenue, rather than assets, it is interesting to apply the common revenue-based size standard of \$6 million to the Commercial

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<sup>34</sup> See the Technical Appendix for a definition of nonemployer firms as well as a description of the methodology of estimating nonemployer firms for Commercial Banking.

<sup>35</sup> The current size standard for Commercial Banking, which became effective January 6, 2006, is \$165 million in assets. However, to remain consistent with other industries for which more recent data is not available, 2002 data is used to calculate the percent of small businesses.

Banking industry. According to Census Bureau data, it is estimated that 48.8% of employer firms had annual revenues less than \$6 million. These small firms accounted for 2.0% of the revenue of all employer firms. Adding the estimated 237 firms with no employees to the calculations, 50.4% meet this definition of small. These firms accounted for 2.0% of the industry's total 2002 revenue.

**“Very Small” Banks.** An alternative method of characterizing a small business is by the number of employees. Although this is not the Small Business Administration's method of defining a small business, Census data on firms with less than twenty employees reveals the characteristics of those firms that are “very small.” In 2004, employer firms, employing less than twenty employees, accounted for 28.1% of all employer firms in the Commercial Banking industry, employed 1.3% of its employees, and received 1.2% of its (estimated) revenue. Including nonemployer firms would yield that “very small” firms constitute 31% of all Commercial Banks in 2004 and earn 1.2% of the industry's (estimated) revenue.

### **III.B.2. Savings Institutions – Data Description**

According to the Census Bureau, Savings Institutions are defined as establishments primarily engaged in accepting time deposits, making mortgage and real estate loans, and investing in high-grade securities. Savings and loan associations and savings banks are included in this industry. Census Bureau data from the year 2004 indicate that Savings Institutions employed 248,962 people at 1,390 firms. These firms had estimated annual revenue of \$92.5 billion. Thus, in 2004 Savings Institutions averaged 179.1 employees per firm and had an estimated annual revenue of \$67 million. A minority (13.3%) of Savings Institution employees worked at firms employing fewer than 100, and only 1.3% worked at firms employing fewer than 20. In addition to the 1,642 employer firms in the Savings Institutions sector, the Census Bureau reports there were 111 Savings Institutions nonemployer firms. While the data do not provide many details about these nonemployer firms, Census methodology ensures that nonemployers meet any reasonable definition of small. As with commercial banking, the existence of nonemployer savings institutions may seem implausible. However, according to the Census, 48 firms with less than five employees (1-4) classified themselves as Savings Institutions in 2004. A similarly small business that leased or contracted all of its employees would be considered a nonemployer because the payroll for the business would be zero. Thus, since very small savings institutions appear to exist, then it is possible that nonemployer ones would as well. However, whether these small savings institutions participate in the mortgage market is questionable. The overall results of this analysis are not materially changed whether or not these nonemployers are included.

Census Bureau data from 2002 provide somewhat more detailed information about Savings Institutions. In 2002 the sector employed 246,426 people at 1,480 firms. These firms had annual revenue of \$77.5 billion, which, after adjusting for inflation is \$80.9 billion, considerably less than the 2004 estimate of \$92.5 billion. In contrast with the revenue estimate for 2004, the 2002 revenue figure is taken directly from Census publications. Savings Institutions averaged slightly fewer employees in 2002 compared to 2004, 166.5 versus 179.1 yet had considerably lower average inflation adjusted revenues. In addition to the 1,480 Savings

Institutions that had employees in 2002, there were an estimated 93 firms in the industry that were nonemployers.

### **III.B.2.a. Census Bureau Data for Small Businesses: Savings Institutions**

Effective October 1, 2002, the size standard for savings institutions was \$150 million in assets. The current size standard for Savings Institutions, which became effective January 6, 2006, is \$165 million in assets. According to Thrift Financial Reports provided by the FDIC, 711 out of 1,481 savings institutions had assets of \$150 million or less in 2002 and were considered small by SBA standards. These thrifts accounted for 3.7% of the total assets of all regulated thrifts. Since the size standard of many sectors is based on revenue, rather than assets, it is interesting to apply the common revenue-based size standard of \$6 million to the savings institutions sector. According to the Census Bureau, approximately 39.0% of savings institutions had 2002 revenue of \$6 million or less. It is estimated that these firms accounted for 1.9% of industry revenue.

**“Very Small” Thrifts.** An alternative method of characterizing a small business is by the number of employees. Although this is not the Small Business Administration’s method of defining a small business, Census data on firms with less than twenty employees reveals the characteristics of those firms that are “very small.” In 2004, employer firms, employing less than twenty employees, accounted for 23.5% of all employer firms in the Savings Institutions industry, employed 1.3% of its employees, and received 1.0% of its (estimated) revenue. Including nonemployer firms would yield that “very small” firms constitute 29.2% of all Savings Institutions in 2004 and earn 1.0% of the industry’s (estimated) revenue.

### **III.B.3. Real Estate Credit - Data Description**

Mortgage bankers are included in the Real Estate Credit category which, according to the Census Bureau, comprises establishments primarily engaged in lending funds with real estate as collateral. This includes: Construction lending, Farm mortgage lending, Federal Land Banks, Home equity credit lending, Loan correspondents (i.e., lending funds with real estate as collateral), Mortgage banking (i.e., nondepository mortgage lending), and Mortgage companies. Real Estate Credit does not include brokers, banks, thrifts and credit unions. Real Estate Credit also does not include firms primarily engaged in secondary market financing (the buying, pooling, and repackaging of loans for sale to others on the secondary market).

As can be seen by the above definition, the Real Estate Credit industry includes firms in addition to mortgage banks. Census Bureau data from the year 2004 indicate that the Real Estate Credit industry employed 360,951 people at 9,502 firms, while the discussion in Section A above suggested there were approximately 1,300 mortgage banking firms. Firms in the Real Estate Credit category had estimated annual revenue of \$105.7 billion. Thus, in 2004 Real Estate Credit averaged 38 employees per firm and had estimated annual revenue of \$11.1 million. Although 94.0% of firms had less than one hundred employees, only 17.4% of employees worked for firms with less one hundred employees. Most Real Estate Credit firms (84.6%) had less than twenty employees; these smaller firms employed 7.5% of all employees and paid 5.9% of the payroll for the Real Estate Credit industry.

Census Bureau data from 2002 provide somewhat more detailed information about Real Estate Credit. In 2002 the sector employed 274,356 people at 7,175 firms. These firms had aggregate annual revenue of \$75.5 billion. In contrast with the \$105.7 billion revenue estimate for 2004, the 2002 revenue figure is taken directly from Census publications. The average number of employees per firm was 38.2 and average revenue per firm was \$10.5 million. After adjusting for inflation, the 2002 revenue per firm is \$11.0 million, which is approximately equal to the 2004 estimate of \$11.1 million.

### III.B.3.a. Census Bureau Data for Small Businesses: Real Estate Credit

The greater financial detail provided in the 2002 data makes the 2002 data better suited for the task of determining how many firms meet the SBA's definition of a small business. The 2002 size standard for Real Estate Credit is \$6 million in revenue. Census data, however, is reported for firms earning less than \$5 million and \$5 million to \$10 million. Of the firms in the Real Estate Credit sector that had employees, it is estimated that 85.2% had annual revenues less than \$6 million and are considered small by the SBA; these small employer firms accounted for 6.1% of the revenue, 13.4% of the employees, and 9.9% of the payroll of all employer firms in the Real Estate Credit group. Including both employer and non-employer firms, it is estimated that small businesses accounted for 6.7% of total revenue in the Real Estate Credit sector.

An insight into size standards can be gained by estimating the number of employees of a firm at the size standard limit. Dividing the most recent size standard (\$6 million in revenue, effective October 1, 2002) by the estimated revenue per employee for 2004 yields an approximate size standard of 20.

Data from the Economic Census indicate that although the Real Estate Credit industry shows some signs of concentration, it is by no means excessive. The four largest firms own 11.2% of the establishments, earn 25.2% of revenue, pay 17.6% of the payroll, and employ 15.1% of all employees.

Since the size standard of many sectors is based on revenue, rather than assets, it is interesting to apply the common revenue-based size standard of \$6 million to the Real Estate Credit industry. According to Census Bureau data, it is estimated that 83.9% of employer firms had annual revenues less than \$6 million. These small firms accounted for 5.6% of the revenue of all employer firms. Adding the estimated 5,516 firms with no employees to the calculations, 92.9% meet the SBA's definition of small. These firms accounted for 6.7% of the industry's total 2002 revenue.

**Table 5-5. Real Estate Credit: 2002 Concentration Ratios**

<b>Firms</b>	<b>Number of establishments</b>	<b>Percent establishments</b>	<b>Percent Revenue</b>	<b>Percent Annual payroll (\$1,000)</b>	<b>Percent employees</b>
<b>All Firms</b>	19,234	100.0%	100.0%	100.0%	100.0%
<b>4 largest firms</b>	2,161	11.2%	25.2%	17.6%	15.1%
<b>8 largest firms</b>	4,044	21.0%	38.5%	30.4%	28.1%
<b>20 largest firms</b>	5,720	29.7%	54.1%	41.8%	37.7%
<b>50 largest firms</b>	8,171	42.5%	68.4%	56.1%	55.3%

**“Very Small” Real Estate Credit Industry.** A final method of characterizing a small business is by the number of employees. Although this is not the Small Business Administration’s method of defining a small business, Census data on firms with less than twenty employees reveals the characteristics of those firms that are “very small.” In 2004, employer firms, employing less than twenty employees, accounted for 84.6% of all employer firms in the Real Estate Credit industry, employed 7.5% of its employees, and received 5.4% of its (estimated) revenue. Including nonemployer firms would yield that “very small” firms constitute 91.1% of all Real Estate Credit firms in 2004 and earn 5.9% of the industry’s (estimated) revenue.

### **III.B.4. Credit Unions – Data Description**

Credit unions are cooperative establishments primarily engaged in accepting member deposits and offering them consumer loans. Census Bureau data from the year 2004 indicate that the Credit Union Industry employed 229,213 people at 8,358 firms. These employer firms had estimated annual revenue of \$44.6 billion. The large percent of employees, 46.1%, in the Credit Union Industry worked at firms employing fewer than 100; and 15.5% worked at firms employing fewer than 20. Also, in 2004, employer firms in the credit union industry averaged 27.4 employees per firm and had estimated annual revenue per firm of \$5,340,573. In addition to the 8,358 firms from the Credit Union Industry offices that had employees in 2004, the Census reports there were 7,226 Credit Union Industry offices with no employees.<sup>36</sup> While the data do not provide many details about these non-employer firms, Census methodology ensures that nonemployers meet a reasonable definition of small.

Census Bureau data from 2002 provide somewhat more detailed information about the Credit Union Industry. In 2002 the sector employed 208,038 people at 8,836 firms versus 229,213 employees and 8,358 firms in 2004. These firms had annual revenue of over \$37 billion. In contrast with the \$44.6 billion revenue estimate for 2004, the 2002 revenue figure is taken directly from Census publications. In 2002, the Credit Union Industry averaged 23.5 employees versus 27.4 employees in 2004. Average revenue per firm was \$4.2 million, which is \$4.4 million in 2004 dollars after adjusting for inflation,<sup>37</sup> and which is somewhat less than the 2004 estimate of \$5.3 million.

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<sup>36</sup> The existence of a nonemployer financial institution may seem implausible. However, according to the Census, as many as 3,576 credit unions with less than five employees (1-4) classified themselves as credit unions in 2004. A similarly small business that leased or contracted all of its employees would be considered a nonemployer because the payroll for the business would be zero. Thus, since very small credit unions are numerous, then it is possible that there are nonemployer ones as well. However, these 7,226 nonemployer credit unions increase the total number of credit unions reported by the Census Bureau to 15,584 (combining the employer figure of 8,358 and the nonemployer figure of 7,226). As noted earlier, the National Credit Union Administration reported 9,687 credit unions in 2002, a figure that is close to the employer number (8,358) reported by the Census Bureau but significantly less than the overall total (15,584) reported by the Census Bureau.

<sup>37</sup> See the technical appendix for information on the price deflator used to convert 2002 to 2004 dollars.

### III.B.4.a. Census Bureau Data for Small Businesses: Credit Union Industry

The small business size standard for the credit union industry is in terms of assets, not revenue. The current size standard for Credit Unions, which became effective January 6, 2006, is \$165 million in assets. Effective October 1, 2002, the size standard for Credit Unions was \$150 million in assets. According to National Credit Union Administration (NCUA) statistics, 8,644 out of 9,687 credit unions had less than \$150 million in assets. Thus, by SBA standards 92.6% of all credit unions were small in 2002. Those firms with less than \$150 million in assets owned 32% of all assets in 2002. Assuming that revenues are distributed similarly to assets, then small credit unions accounted for 32% of total industry revenues. Section III.B.5.a below uses information from Call Report data from the NCUA to estimate the number of small credit unions that are actually making mortgages (see Table 5-7 below).

Since the size standard of many sectors is based on revenue, rather than assets, it is interesting to apply the common revenue-based size standard of \$6 million to the credit union industry. According to Census Bureau data, it is estimated that 86.5% of employer firms had annual revenues less than \$6 million. These small firms accounted for 21.4% of the revenue of all employer firms. Adding the Census reported 6,017 firms with no employees to the calculations, 92.1% meet this definition of small. These firms accounted for 21.8% of the industry's total 2002 revenue.<sup>38</sup>

**“Very Small” Credit Unions.** An alternative method of characterizing a small business is by the number of employees. Although this is not the Small Business Administration's method of defining a small business, Census data on firms with less than twenty employees reveals the characteristics of those firms that are “very small.” In 2004, employer firms, employing less than twenty employees, accounted for 74.4% of all employer firms in the Credit Union industry, employed 15.5% of its employees, and received 10.9% of its (estimated) revenue. Including nonemployer firms would yield that “very small” firms constitute 86.3% of all Credit Unions in 2000 and earn 11.3% of the industry's (estimated) revenue.

The next section will continue this discussion of the characteristics of lenders, providing updated estimates of the number of small lenders, the small lender share of mortgage originations, and the revenue impacts of the new GFE on small lenders. The next section uses data from the mortgage market, rather than the general business data discussed in this section. Several technical and data issues necessary for estimating the small business share for each lender group are explored.

For a discussion of the competitive impacts of the RESPA reform on lenders, see Section VIII.B of Chapter 3 and Section VII.B of Chapter 4. See Chapter 6 for a description of the compliance costs and regulatory burden of the rule.

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<sup>38</sup> Adding the 6,017 nonemployer firms to the 8,836 employer firms gives a total of 14,853 credit unions, as reported by the Census Bureau. As noted in the earlier footnote, this combined number of the Census Bureau is substantially above the number reported by the NCUA; the NCUA number for 2002 is similar to the number of credit unions with employees reported by the Census Bureau.

### **III.B.5. Lenders: Revenue Estimates, Small Business Transfers, and Additional Data Considerations**

This section examines numerous technical issues that are important for determining the small lender share of mortgage originations and reports the revenue impact of the RESPA rule on small lenders. Compared with the previous section, which provides general business data for each lender group, this section incorporates data on mortgage originations in order to derive the small business estimates used in Chapters 3 and 4 – as will be seen below, the small business estimates based on mortgage data are not the same as those reported above based on general revenue data for lenders. Unlike Chapters 3 and 4, which conducted the small business analysis for lenders as a group, this section also conducts the revenue transfer analysis on a disaggregated basis, that is, for each separate lender group. Specifically, this section:

- provides updated estimates of the number of small lenders and small credit unions likely to be impacted by the RESPA rule (Subsection III.B.5.a);
- estimates the dollar volumes of mortgage originations by small banks, small thrifts, small mortgage banks, and small credit unions, which are then combined to estimate an the overall small business share of total lender originations (23%, with a range from 20%-26%) (Subsection III.B.5.b);
- reports revenue impacts of the new GFE on small lenders as a group (Subsection III.B.5.c);
- estimates the share of mortgage originations accounted for by the separate lender groups (banks, thrifts, mortgage banks, and credit unions). (Subsection III.B.5.d for all lenders and III.B.5.e for small lenders);
- reports the revenue transfers under the new GFE for each separate lender group and for small lenders within each group, and as a share of industry revenue for banks and thrifts (Subsection III.B.5.f); and
- provides estimates of employees for all lenders and for small lenders (Subsection III.B.5.g).

When estimating the various market shares for the different lender groups, this section pulls together mortgage activity data from several sources, which introduces some degree of uncertainty into the various estimates. In most cases, the discussion below shows the effects on key parameters (such as the small business percentage) of a number of alternative approaches. This provides the basis for sensitivity analyses when examining the revenue impacts of the new GFE on small lenders.

#### **III.B.5.a. Number of Small Lenders**

A first issue concerns the number of lenders (thrifts, banks, and mortgage banks) likely to be impacted by the RESPA rule. The following numbers of lenders are suggested as starting points:

	<u>HMDA-Reporters</u> <sup>39</sup>	<u>Industry Data</u> <sup>40</sup>	
	<u>2005</u>	<u>2006</u>	<u>2005</u>
Commercial Banks:	4,694	7,402	7,526
Savings Institutions	637	1,279	1,307
Depository Total	5,331	8,681	8,833
Mortgage Banks	1,287	1,287	1,287
All Lenders	6,618	9,968	10,120

The “Industry” figures for depositories are taken from statistics published on FDIC’s web site, while the number of mortgage banks is based on HUD analysis of HMDA data.

As shown in Table 5-6, there are many small banks and thrifts operating in non-metropolitan areas that do not have to report their mortgage originations to HMDA. In 2005 3,243 of the 3,249 depositories with their main office in a non-metropolitan area did not report any loans to HMDA.<sup>41</sup> In all, 4,187 of the 9,518 banks and thrifts<sup>42</sup> did not report any loans to HMDA. Thus, the 6,618 depositories and mortgage banks (see above) that report HMDA data is too small. Many of the non-HMDA reporters probably do little or no mortgage originations; so 10,120 lenders (see above) may be too large. However, practically all the non-HMDA reporting banks and thrifts hold at least some mortgage loans as assets, which suggests that most of them may be originating mortgages. As shown in Table 5-6, 3,996 of the 4,187 non-HMDA-reporting depositories indicated on their call reports that they held mortgages on their balance sheets. Thus, it appears that most of these non-HMDA reporters may be originating mortgages, although it could be in very small amounts. Based on Olson (2004), there were 8,200 lenders in 2003, so it seems reasonable to conclude that there will be at least 8,200 lenders affected by the rule and possibly as many as the 2006 industry number of 9,968 (see above).<sup>43</sup>

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<sup>39</sup> The bank and thrift (depository) data also include their mortgage banking subsidiaries.

<sup>40</sup> The “industry” estimates for banks and thrifts are from the FDIC while those for mortgage banks are from HMDA data. As discussed in Sections III.B.1 and III.B.2 above, the Census-Bureau-reported numbers for banks (6,978 with employees and 285 without employees) and thrifts (1,642 with employees and 182 without employees) are similar to the numbers reported by the FDIC for banks (7,836) and thrifts (1,467). As discussed in Section III.B.3, the Census category (Real Estate Credit) that includes mortgage banks reports 8,794 firms with employees (plus thousands of estimated non-employer firms), which means that it includes firms in addition to independent mortgage banks.

<sup>41</sup> The bank or thrift was designated as “non-metropolitan” or “metropolitan” based on the physical address of the headquarters of the parent bank. In Table 5-6, “small” is defined as having assets of less than \$150 million

<sup>42</sup> The 9,518 banks and thrifts include mortgage company subsidiaries of depositories that report under HMDA.

<sup>43</sup> Also see the brief summary of “The 1999 Lender Study” by Olson’s firm, Wholesale Access, at [www.wholesaleaccess.com/lenders.shtrr](http://www.wholesaleaccess.com/lenders.shtrr). This study reports there are 1,500 independent mortgage originators (who

According to the Census Bureau, the small business percentages for lenders are as follows: (a) 67.0% for banks; (b) 48.0% for thrifts; and (c) 92.9% for mortgage bankers. Applying these percentages to the “2006 Industry Data” yields (a) 4959 small banks, (b) 614 small thrifts, and (c) 1,196 small mortgage banks. Thus, the total number of small lenders is 6,769, or 67.9% of all 9,968 lenders. However, as explained in Section III.B.3, the 92.9% small business figure for mortgage bankers includes the effect of thousands of non-employer firms; focusing only on employer firms, the small business percentage reported by the Census Bureau falls to 85.2%. Using the 85.2% figure (instead of the 92.9%) in the above lender calculation, the number of small lenders would be 6,670 (instead of 6,769), or 66.9% of all lenders. The following sections further examine these small business estimates, by incorporating data on actual mortgage originations. In addition, small business estimates for credit unions are provided.

**Commercial Banks and Thrifts.** The small business percentages from the Census Bureau for depositories (banks and thrifts) are based on 2002 data, with a definition of less than \$150 million in assets. As explained above, applying the Census Bureau's percentages shows that 5,573 or 64.2%, of the 8,681 depositories operating at the end of 2006 qualified as small businesses. HUD examined asset data from the 2004 year-end call report for banks and thrifts<sup>44</sup> to determine the number of banks and thrifts having less than \$150 million in assets, which remained the current definition of a small bank or thrift through 2005. That analysis found that 58.9% of all depositories had assets less than \$150 million, a figure slightly lower than the Census-Bureau-based small business percentage of 64.2%. As shown in Table 5-6, 5,137 (or 59.8%) of the 8,586 commercial banks were small, as were 467 (or 50.1%) of the 932 savings institutions. On this basis, the total number of small depositories is 5,604, or 58.9% of all 9,518 depositories in 2005.

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close with a warehouse line of credit more than half the time, buy loans from others, or do servicing) as well as 2,000 thrifts and 5,000 banks who routinely originate mortgages for sale. Olson also reports there are about 1,500 credit unions who routinely originate mortgage loans for sale.

<sup>44</sup> Note that the assets reported in the 2004 year-end call report correspond to assets reported in the 2005 HMDA data reported by lenders in March.

**Table 5-6. Number of Commercial Banks and Savings Institutions with Mortgage Activity**

	Commercial Banks			Savings Institutions			Depositories		
	All	Small	Percent	All	Small	Percent	All	Small	Percent
<u>A. Metropolitan Areas</u>									
1. HMDA Reporters	4,689	2,030	43.3%	636	236	37.1%	5,325	2,266	42.6%
2. Did Not Report Under HMDA	837	572	68.3%	107	79	73.8%	944	651	69.0%
a. Number with Outstanding Mortgages	711	503	70.8%	65	48	73.9%	776	551	71.0%
3. Total Number of Lenders (1+2)	5,526	2,602	47.1%	743	315	42.4%	6,269	2,917	46.5%
a. Total Number with Mortgages (1+2a)	5,400	2,533	46.9%	701	284	40.5%	6,101	2,817	46.2%
<u>B. Non-Metropolitan Areas</u>									
4. HMDA Reporters	5	2	40%	1	1	100%	6	3	50.0%
5. Did Not Report Under HMDA	3,055	2,533	82.9%	188	151	80.3%	3,243	2,684	82.8%
a. Number with Outstanding Mortgages	3,033	2,512	82.8%	187	150	80.2%	3,220	2,662	82.7%
6. Total Number of Lenders (4+5)	3,060	2,535	82.8%	189	152	80.4%	3,249	2,687	82.7%
a. Total Number with Mortgages (4+5a)	3,038	2,514	82.8%	188	151	80.3%	3,226	2,665	82.8%
<u>C. Total (A+B)</u>									
7. HMDA Reporters	4,694	2,032	43.3%	637	237	37.2%	5,331	2,269	42.6%
8. Did Not Report Under HMDA	3,892	3,105	79.8%	295	230	78.0%	4,187	3,335	79.7%
a. Number with Outstanding Mortgages	3,744	3,015	80.5%	252	198	78.6%	3,996	3,213	80.4%
9. Total Number of Lenders	8,586	5,137	59.8%	932	467	50.1%	9,518	5,604	58.9%
a. Total Number with Mortgages	8,438	5,047	59.8%	889	435	48.9%	9,327	5,482	58.8%

Note: HMDA data are for 2005. Lenders that report HMDA data but no Call Report data were included with metropolitan lenders.

**Mortgage Banks.** Two estimates of the small business percentage for mortgage banks were noted above -- a high estimate of 92.9%, which was driven by the inclusion of non-employer firms in the analysis (see Section III.B.3), and a lower but similar estimate (85.2%), which was based on employer firms only. But as discussed in Section III.B.3, the Census data included over 9,502 employer firms -- or over seven times the actual number (about 1,300) of independent mortgage banking firms.<sup>45</sup> Even this lower figure is somewhat suspect since the industry of interest accounts for only one seventh of the available data.

The small business threshold for mortgage banks is \$6 million in revenues per year. While HUD has asset data for depositories that it can link with the HMDA origination data, HUD does not have revenue data for mortgage banks. For this reason, HUD simulated a revenue estimate for mortgage bankers that could be used in combination with HMDA origination data to provide some insights into the share of mortgages originated by small mortgage banks (recognizing that this was only a starting point). For mortgage banks that report to HMDA, HUD simulated annual revenue as follows: [0.02 (i.e., an assumed 2% origination fee) times all originations (i.e., single family, multifamily, and home improvement loans)] plus [0.0025 (or 25 basis points) times all purchased mortgages].<sup>46</sup> While obviously rough, this may be a conservative revenue estimate since mortgage banks have other sources of revenue than the fees (mainly origination fees) captured in this equation; one example being servicing fees on an outstanding stock of previously-originated or purchased mortgages, although it is recognized that small mortgage banks do not service their own originations to the same extent as large mortgage banks such as Argent Mortgage Company. There were 1,287 independent mortgage-banking firms that reported single-family mortgage originations to HMDA during 2005. Of these 1,287 mortgage banks, 919 (or 71.4%) had estimated revenues below \$6 million. These small mortgage banks originated \$80.3 billion (or 8.3%) of the \$965.4 billion reported as mortgage bank originations in HMDA. Thus, in this case, the estimated small business percentage is 71.4%, which is smaller than the percentage (85.2%) estimated based on employer data from the Census Bureau.<sup>47</sup> Other groups of mortgage banks were examined. Originations of the smallest 78.2% (83.7%) of mortgage banks totaled \$110.6 (\$146.8) billion, or 11.5% (15.2%) of all

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<sup>45</sup> In fact, it could be that many of the loan correspondents that reported under the "Mortgage Banking and Correspondents" and "Real Estate" categories were brokers (in terms of David Olson's broad definition that is used in this analysis). Recall that the Census-Bureau-reported estimate of brokers was lower than Olson's estimates of the number of brokers; see Section II.B.1.

<sup>46</sup> In other words, it is assumed that mortgage banks earn a two-percentage-point origination fee on new mortgage originations and 25 basis points on acquired loans; the two-percentage-point origination fee includes the revenue effects of any servicing release premium. As explained in the text, this estimate is rough but probably underestimates the annual revenues of mortgage banks.

<sup>47</sup> The 92.9% small business percentage estimate based on employer and non-employer data of the Census Bureau is most likely wrong for mortgage banks. The Census Bureau data suggest that these small businesses account for 6.7% of industry revenue; however, a small business percentage of 92.9% would have represented 1,196 of the 1,287 independent mortgage banks reporting to HMDA in 2005. In 2005, the 1,196 mortgage bankers with revenues below the remaining 91 accounted for 27.1% of all mortgage originations -- or four times the small business revenue share of 6.7% suggested by the Census Bureau data. Thus, the 92.9% figure is not a good estimate of the percentage of mortgage banks that are small.

originations by mortgage banks during 2005. The smallest 85.2% of mortgage banks originated \$160.3 billion in 2005, or 16.6% of all originations. Thus, HUD's analysis of 2005 HMDA data for mortgage banks suggests that the small business share of revenue (approximated by the share of origination volume) increases from 8.3% to 15.2% as the small business percentage of mortgage banks increases from 71.4% to 83.7%, and increases further to 16.6% if the bottom 85.2% of mortgage banks are considered. Based on the 2002 Census Bureau data, the 85.2% of employer firms in the "Real Estate Credit" industry accounted for 6.1% of industry revenue.<sup>48</sup>

Based on the above analysis of HMDA data, small businesses probably account for 71.4%-85.2% (or more generally 71%-85%) of the number of mortgage banks and for 8.3%-16.6% (or more generally 8%-17%) of industry revenue. Many of the analyses below will use this range for small mortgage banks. The bottom 83.7% of mortgage banks, which accounted for 15.2 percent of originations by all mortgage banks during 2005, will be used as a baseline.

**Small Lenders—Recomputed.** Based on the above analysis, there are two basic ways to compute the share of lenders that are small businesses. First, the data from the Census Bureau suggest the following small business percentages for lenders: (a) 67.0% for banks; (b) 48.0% for thrifts; and (c) 85.2%<sup>49</sup> for mortgage banks. Applying these percentages to the "2006 Industry Data" (see above) yields (a) 4959 small banks, (b) 614 small thrifts, and (c) 1,097 small mortgage banks. In this case, the number of small lenders based on Census-Bureau-reported small business percentages is 6,670, or 66.9% of all 9,968 lenders. Second, HUD's analysis suggests the following small business percentages for lenders: (a) 59.8% for banks; (b) 50.1% for thrifts; and (c) 83.7% for mortgage banks. Applying these percentages to the "2006 Industry Data" (see above) yields (a) 4,426 small banks, (b) 641 small thrifts, and (c) 1,077 small mortgage banks. In this case, the total number of small lenders is 6,144, or 61.6% of all 9,968 lenders. If the wider range (71.4%--85.2%) of mortgage bank percentages is used in (c), then the total number of small lenders is 5,986-6,164, or 60.1%-61.8% of all lenders. This range of 60.1%-61.8% is somewhat lower than the Census-Bureau-based percentage of 66.9% for small lenders in 2006. While the percentage range for small mortgage banks has little effect on the estimate of the number of small lenders, it will have a more significant impact on the estimate of the mortgage originations accounted for by small lenders (discussed later).

As noted earlier, Olson (2004) estimated there were 8,200 lenders, which could be a reasonable estimate of the number of lenders that were active in the mortgage market. If one assumes that all 1,287 mortgage banks that reported to HMDA in 2005 are included in the 8,200, this leaves 6,913 to be split between banks and thrifts. The split between banks and thrifts is based on their share of the total number (9,327) of depositories with mortgages from row 9.a of Table 5-6. On this basis, there would be: (a) 6,254 banks, of which 3,740 are small; (b) 659

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<sup>48</sup> The above comparisons suggest that HUD's analysis of mortgage bankers based on 2005 HMDA yields somewhat similar results to the employer data from the Census Bureau. However, under HUD's analysis, the fixed revenue (\$6 million) definition for small business means that there would be a larger number of mortgage banks labeled as "small" in years with smaller overall levels of originations -- a problem with the technique

<sup>49</sup> The 85.2% figure is used for "Mortgage Banking and Loan Correspondents" rather than the 92.9% figure for reasons discussed earlier.

thrifts, of which 330 are small;<sup>50</sup> and (c) 1287 mortgage banks, of which 1,097 are small. If there are in fact 8,200 active lenders making mortgages, then 5,167, or 63.0%, are small. These calculations assume the 85.2% small business share for mortgage banks; if the 71.4% share is used, the number of small mortgage banks changes to 919 and the number of small lenders changes to 4,989 or 60.8% of the 8,200 lenders.

The information in the above two paragraphs suggests that the number of small lenders likely to be impacted by the rule could range from 4,989 to 6,164; the high end of this range probably includes many small banks that originate only a few mortgages.

**Credit Unions.** As explained earlier, HMDA reports that 2,002 credit unions (including their 25 subsidiaries) originated \$54.6 billion in mortgages during 2005, representing 2.0% of the total dollar volume of single-family mortgages originated that year (see Table 5-4). According to industry estimates, there were 8,801 credit unions in 2005 (National Credit Union Administration Call Reports); the Census reported a similar number (8,358) of credit unions with employees in 2004.<sup>51</sup> The Census Bureau estimated that 92.6% of credit unions were small, based on 2002 data and a definition of \$150 million in assets. Using the industry (Census Bureau) estimate of 9,814 (8,358), this means there were 8,348 (7,740) small credit unions.

All of the approximately 8,000 to 9,000 credit unions reported above are unlikely to be affected by the RESPA rule, as only 2,002 of them reported mortgage loans to HMDA in 2005. To examine this issue, HUD obtained data on the total assets of credit unions and on their mortgage originations for the year 2005. This information was derived from Call Report data from the National Credit Union Administration (NCUA). The key results are reported in Table 5-7. As shown there, 3,969 of the 8,801 credit unions reported mortgages of \$60.4 billion during 2005. The remaining 4,832 credit unions reported no mortgage originations during 2005. Notice that the 2,002 credit unions that reported to HMDA accounted for \$54.6 billion, or 90.4% of the total originations reported by the 3,969 credit unions. The 1,967 credit unions that originated mortgages but did not report to HMDA originated \$5.8 billion (\$60.4 billion minus \$54.6 billion) in mortgages, or \$2.968 million on average. This translates into 30 (60) mortgages per year if the average loan amount is \$100,000 (\$50,000), not a very large number.

Table 5-7 also reports information on the asset size of credit unions. Based on HUD's analysis, 89.8% (or 7,900) of the 8,801 credit unions are small (i.e., had assets less than \$150 million).<sup>52</sup> This is practically the same small business percentage (92.6%) as reported by the

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<sup>50</sup> When the analysis shifts to the smaller number of 8,200 lenders, the small business percentages are probably too high; however, there are no other estimates available.

<sup>51</sup> There were an estimated 7,226 credit unions without employees in 2004, which places the Census number at 15,584 (8,358 plus 7,226). However, one would think the agency (NCUA) number (8,180) would be correct; the Census-reported number (8,358) of credit unions with employees is also similar to the agency number. So it is not clear that the 15,584 estimate based on the Census Bureau data is correct. The credit unions without employees had practically no revenue so they don't affect the revenue estimates produced by the Census Bureau.

<sup>52</sup> The \$150 million small business threshold became effective on October 1, 2002, and remained so through the end of 2005. HUD applied the \$150 million threshold to 2005 call report data on assets to classify credit unions as small.

Census Bureau (see Section III.B.4). The share for small credit unions drops to 78.0% when only the 3,969 credit unions that originated mortgages are considered. The share for small credit unions drops even further to 60.7% when only the 2,002 credit unions that reported mortgages to HMDA are considered.

**Table 5-7. Mortgage Originations by Credit Unions, 2005**

	Small Credit Unions	Total Credit Unions
1. HMDA Data		
Number of Credit Unions	1,215	2,002
Number of Loans	63,416	411,202
Originations (\$1,000)	6,637,000	54,598,000
2. Call Report Data <sup>1</sup>		
a. Mortgages Reported		
Number of Credit Unions	3,097	3,969
Number of Loans	89,246	407,509
Originations (\$1,000)	8,387,172	60,436,870
b. No Mortgages Reported		
Number of Credit Unions	4,803	4,832
c. All Credit Unions	7,900	8,801

<sup>1</sup>The number of credit unions includes mortgage company subsidiaries.

Table 5-7 also reports the share of industry mortgage originations accounted for by small credit unions. In 2005, the 3,097 small credit unions originated \$8.387 billion in mortgages, or 13.9% of the \$60.437 billion originated by all 3,969 credit unions. Based on analysis of data from the Census Bureau, it was estimated that small credit unions account for 22%-32% of industry revenue (see Section III.B.4). Thus, small credit unions account for a smaller share of mortgage originations than they do of industry revenue.

### III.B.5.b. Small Lender Share of Industry Revenue and Mortgage Originations

To calculate the small business share of transfers from lenders (due to the new GFE), requires two pieces of information: (1) the share of total mortgage originations for each of the four lender groups (banks, thrifts, independent mortgage bankers, and credit unions)<sup>53</sup>; and (2) the small business share of mortgages for each group.<sup>54</sup> With respect to (1), HMDA data for 2005 indicates the following shares of total (home purchase and refinance) single-family mortgage originations, expressed in dollars: (a) commercial banks (44.2%); (b) thrifts (18.2%); (c) independent mortgage bankers (35.6%); and (d) credit unions (2.0%). (See Table 5-4 in Section III.A.) With respect to (2), the Census Bureau reports the following small business

<sup>53</sup> For completeness, credit unions are included in the lender group.

<sup>54</sup> The distribution of mortgages (expressed in dollars) is a proxy for the distribution of revenues from mortgage operations because origination fees are expressed as a percentage of the loan amount.

shares of revenue for banks and thrifts (as explained in Sections III.B.1 and III.B.2) and the above sections discussed the following small business shares of mortgages for mortgage banks and credit unions: (e) 4.9% for commercial banks; (f) 3.7% for thrifts; (g) 15.2% for independent mortgage bankers; and (h) 13.9% for credit unions.<sup>55</sup> Ideally, to obtain the share of lender transfers accounted for by small lenders, one would simply multiply (1) a-d by (2) e-h and sum the results; doing this produces 8.5% as one estimate of the small business share of lender transfers. Unfortunately, this estimate may not be accurate, for two reasons. First, HMDA data do not identify loans originated by brokers. In HMDA, broker loans, which account for about 60% of all originations, are reported mainly as originations of large wholesale lenders. Second, the Census-Bureau-based small business shares for banks and thrifts in (2) pertain to each industry's total revenues, which may not be the appropriate percentages for estimating the small business share of mortgage revenues. The remainder of this section discusses these issues in more detail and provides a range of estimates for the small business share of lender transfers.

Mortgage originations (in dollar terms) are the key variable for measuring industry revenues because origination fees are expressed as a percentage (1.5%-2.0% in this analysis) of the mortgage amount. HUD projects \$2.4 trillion in originations, divided between brokers (60%) and lenders (40%). Thus, the lender share of the projected \$2.4 trillion mortgage market is \$960 billion, not the entire \$2.4 trillion (as was suggested by the HMDA analysis in the above sections). Deducting the projected credit union volume (\$48 billion, which is 0.020<sup>56</sup> times \$2.4 trillion) from the \$960 billion yields \$912 billion for projected originations of banks, thrifts, and mortgage banks. The question is how to determine the small business share of this \$912 billion.<sup>57</sup>

One might start by using HMDA data to allocate the \$912 billion as follows: (i) commercial banks (45.1%); (j) thrifts (18.6%); and (k) independent mortgage banks (36.3%).<sup>58</sup> But using HMDA data on total mortgage originations to allocate the non-broker share (i.e., \$912 billion) of mortgage originations is subject to some uncertainty. Banks (e.g., Bank of America), thrifts (e.g., Indymac Bank, F.S.B.), and mortgage banks (e.g. Argent Mortgage Company) are also the wholesale lenders that purchase the loans originated by brokers. In other words, these entities not only originate their own loans on a retail basis (the \$912 billion) but they also purchase the brokered loans (the \$1,440 billion). But in their reports to HMDA, banks, thrifts,

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<sup>55</sup> It is recognized that mixing small business shares of "revenues" with small business shares of "mortgage originations" may not be appropriate; however, there are no data on the small business shares of "mortgage originations" for banks and thrifts, which is the basic problem addressed in this section. The discussion in the text is simply illustrating the two-step method for calculating an overall small business share so little harm is done by mixing these concepts at this stage. Also, as discussed earlier, the small business share of industry revenue for mortgage banks could range from 8.3% to 16.6%.

<sup>56</sup> This 2.0% is based on the credit union share of mortgages reported to HMDA (see Table 5.4 in Section III.A). Credit unions are separated from banks, thrifts, and mortgage banks because their HMDA data probably do not include brokered loans to nearly the same extent as the HMDA data for the other lenders.

<sup>57</sup> The small business share of the \$1,020 billion was determined in Section III.B.1 of this chapter; it was estimated that small brokers account for 70% of broker revenues. See Section VII.E.4 of Chapter 3 and Section VI.E.4 of Chapter 4 for sensitivity analysis of the 70% figure.

<sup>58</sup> See Table 5.4 and compute the lender shares as a percentage of originations without credit unions.

and mortgage banks report as originations their wholesale loans as well as the loans they originate on their own through their retail channel -- there is no indicator in HMDA distinguishing loans originated through the retail channel. Therefore, using HMDA-based lender percentages (i, j, and k above) for the distribution of total originations to allocate the \$912 billion in non-broker (or lender retail) originations among banks, thrifts, and mortgage banks assumes that the wholesale purchases of banks, thrifts, and mortgage banks, are similarly distributed (as i, j, and k). This may not be the case.

This problem of HMDA not separately identifying originations purchased on a wholesale basis also affects the small business percentage for each of the three lender groups. Consider the top portion of Table 5.8, which reports loans originated by small banks and which expresses them as a percentage of originations reported by all banks.<sup>59</sup> According to HMDA data, 2,032 small banks originated \$46.5 billion<sup>60</sup> during 2005, representing 3.9% of the \$1,201 billion in mortgages reported by all banks (and their subsidiaries). This 3.9% figure is not a good measure of the small bank share of bank originations. According to HMDA data, large banks originated the remaining 96.1%, or \$1,155 billion. The problem is that the \$1,155 billion figure includes not only loans that large lenders originated on a retail basis but also loans they purchased on a wholesale basis. If bank retail loans could be separately identified, the small bank volume of \$46.5 billion<sup>61</sup> would represent a much higher share of bank originations. For the same reason, the small business share (2.1% in Table 5-8) of HMDA-reported loans originated by savings institutions is an underestimate.

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<sup>59</sup> HUD merged lender asset data from the FDIC with HMDA data. See <http://www3.fdic.gov/sdi/> for further information. Small lenders in Table 5.8 are those with less than \$150 million in assets.

<sup>60</sup> Because **about half CHECK?** of small banks are not required to report their originations to HMDA, the \$46.5 billion underestimates originations of small banks. This issue is discussed below.

<sup>61</sup> This assumes that the \$46.5 billion for small banks consists of mortgages originated on a retail basis, which is a reasonable assumption.

**Table 5-8. Distribution of HMDA Mortgages for Small Lenders and Small Credit Unions, 2005**

	Small Lenders			All Lenders			Percent Small	
	Number of Lenders	Number of Loans	Loans (\$million)	Number of Lenders	Number of Loans	Loans (\$million)	Number of Loans	Loans (\$)
Commercial Banks	2,031	265,701	46,521	4,694	6,501,145	1,201,499	4.1%	3.9%
Savings Institutions	237	71,533	10,616	637	2,302,568	493,975	3.1%	2.1%
Depositories	2,269	337,234	57,139	5,331	8,803,713	1,695,474	3.8%	3.4%
Credit Unions	1,215	63,416	6,637	2,002	411,202	54,598	15.4%	12.2%

Source: 2005 HMDA Data

Note: Includes data for mortgage company subsidiaries.

The number of commercial banks and savings institutions includes 22 lenders with missing mortgage assets.

To summarize, loans originated by brokers are reported in HMDA data as originations of wholesale lenders, rather than being separately identified as brokered loans.<sup>62</sup> This means that the non-brokered loans of wholesale lenders cannot be identified with HMDA data. Thus, HMDA data are of limited use for allocating the non-broker portion of originations (i.e. the \$912 billion) and for estimating the small business share of each lender group's non-brokered originations.<sup>63</sup> Still, as explained in the remainder of this section, HUD uses HMDA as one source in estimating the small business share of lender originations.

**Estimation Approach.** The basic approach for estimating the small business share of lender originations consisted of estimating the dollar volume of originations by small banks, small thrifts, and small mortgage bankers, summing these three figures, and then expressing that sum as a percentage of total lender (i.e., non-broker) originations. The main steps are outlined below.

(1) According to HMDA, 2,031 small banks and 237 small savings institutions originated \$57.139 billion in 2005. In addition to these 2,269 small depositories, there are an additional 3,212 small depositories (3,015 small banks and 198 small thrifts) that had mortgages on their balance sheets but were not required to report their mortgage originations to HMDA, either because they had less than \$34 million in assets or because they were physically located in a non-metropolitan area. Mortgage origination data are not available for these 3,015 small banks and 198 small thrifts. Step (2) describes the three methods used to estimate mortgage originations for the small banks, while Step (3) does the same for small thrifts.

(2) **Small Commercial Banks.** Using FDIC data from call bank reports, the additional 3,015 small banks were divided into three asset classes: up to \$50 million, \$50-\$100 million, and

<sup>62</sup> As explained in Section II, brokers under Olson's broad definition also originate loans with warehouse lines of credit. It is possible that some of these loans are reported directly to HMDA as originations.

<sup>63</sup> For large lenders, industry sources report originations by the so-called three channels of production -- brokerage, correspondent, and retail. These data are used later to approximate retail originations by large lenders. But first, direct estimates of mortgage originations by small banks and small thrifts are provided.

\$100-\$150 million. The banks were also divided by metropolitan and non-metropolitan location. Three approaches were then used to estimate mortgage originations for these small banks without origination data: (a) average originations per firm approach; (b) share of stock approach; and (c) origination-to-stock ratio approach. These are described below for banks.

**Table 5-9. Mortgage Originations and Outstanding Mortgages for Banks by Asset Size, 2005**

	Asset Size				Total (All Banks)
	Not More than \$50 Million	(\$50-\$100] Million	(\$100-\$150] Million	Less than \$150 Million	
<b>Banks- Metropolitan Areas</b>					
Banks Reporting Originations under HMDA					
Loans Originated	83,233	110,543	71,892	265,668	6,500,657
\$ Originated (\$1,000)	19,565,449	18,433,577	8,519,032	46,521,058	1,201,451,683
Number of Banks	442	908	679	2,029	4,686
Outstanding Loans (\$1,000 )	2,381,011	12,623,902	16,183,079	31,187,992	1,384,060,267
Banks Not Reporting Originations under HMDA					
Outstanding Loans (\$1,000 )	1,528,761	666,695	8,94,146	3,089,602	155,971,031
Number of Banks	362	76	65	710	711
<b>Banks- Non-Metropolitan Areas</b>					
Banks Reporting Originations under HMDA					
Loans Originated	22	0	0	22	398
\$ Originated (\$1,000)	2,898	0	0	2,898	31,407
Number of Banks	2	0	0	2	5
Outstanding Loans (\$1,000 )	0	0	0	0	95,143
Banks Not Reporting Originations					
Outstanding Loans (\$1,000 )	4,655,864	11,785,768	9,834,892	26,278,524	54,977,561
Number of Banks	1,133	949	430	2,512	3,033
<b>All Commercial Banks</b>					
Banks Reporting Originations under HMDA					
Loans Originated	83,255	110,543	71,892	265,690	6,501,055
\$ Originated (\$1,000)	19,568,347	18,433,577	8,519,032	46,523,956	1,201,483,090
Number of Banks	444	908	679	2,031	4,691
Outstanding Loans (\$1,000 )	2,381,011	12,623,902	16,183,079	31,187,992	1,384,155,410
Banks Not Reporting Originations under HMDA					
Outstanding Loans (\$1,000 )	6,184,625	12,454,463	10,729,038	29,368,126	210,948,592
Number of Banks	1,495	1,025	495	3,015	3,744

Note: Includes all commercial banks that reported loans under HMDA whether or not they report outstanding loans on their Call Report.

**(a) Average Originations Per Firm Approach:** This approach simply multiplies the mean level of originations for those small firms with origination data (i.e., those that report HMDA data) by the number of small banks without origination data (i.e., those that do not report to HMDA). More specifically, for each of the three asset classes, the average mortgage origination amount per firm was first calculated for the small banks that reported mortgages to HMDA during 2005. This was done for both metropolitan and non-metropolitan areas, thus producing six averages of per firm originations. These six per firm averages were multiplied by the number of non-HMDA-reporting banks in each of the six categories and the six results were then summed (see Table 5-9). Doing this produces an estimate of \$20.024 billion for the 3,015 small banks without origination data. Adding this figure to the \$46.521 billion for the 2,031 small banks that reported to HMDA yields total estimated originations of \$66.545 billion for all small banks.<sup>64</sup>

**(b) Share of Stock Approach:** This “share of stock” approach estimates a bank's originations based on the bank's share of outstanding mortgages. For the 3,015 small banks without origination data, HUD obtained data from call reports on the dollar volume of outstanding mortgages held as assets. This approach was first implemented in an aggregated manner and then in a disaggregated manner. The outstanding assets (\$29.368 billion) of the 3,015 small banks without origination data represented 2.1% of the total outstanding assets (\$1,384.155 billion) of all 4,691 banks (both large and small) that reported originations to HMDA. This 2.1% was multiplied by the total originations (\$1,201.483 billion) of the 4,691 HMDA reporters to obtain an estimate of \$25.492 billion for the originations of the 3,015 small banks. When added to the \$46.521 for the 2,031 small banks that report originations to HMDA, this yields an overall estimate of \$72.013 billion in originations for small banks. The disaggregated approach followed the same procedure for each of the six separate categories (three asset classes by metro and non-metropolitan status) and then summed the results. This produced an estimate of \$11.357 billion for the 3,015 small banks, which, when added to the \$46.521 for the 2,031 small banks that report originations to HMDA, yields an overall estimate of \$57.878 billion in originations for small banks.

**(c) Origination-to-Stock Ratio Approach.** The share of originations for the 2,031 small banks that reported HMDA data was higher than their share of the outstanding stock of mortgages. If this pattern is also true for the 3,015 small banks that do not report HMDA data, then the “Share of Stock Approach” described above will underestimate the originations of the 3,015 small banks. Approach (c) addresses this by computing the ratio of “mortgage originations” to “outstanding mortgage stock” for the 2,031 HMDA reporters, and then multiplying that ratio by the “outstanding mortgage stock” of the 3,015 non-HMDA-reporters, to obtain an estimate of the “mortgage originations” for the 3,015 small banks. Implementing this

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<sup>64</sup> Of course, it is not clear if the non-HMDA-reporting small banks will have the same average level of originations as the HMDA-reporting small banks in their asset category. Because of the large number of non-HMDA-reporting, non-metropolitan banks 1,133 in the lowest asset category (\$0.0-\$50.0 million), the results depend importantly on the average origination level assigned to that category. If this approach was implemented using the overall average origination level across all three asset categories (but separate averages for metropolitan and non-metropolitan areas), the additional estimated originations for the 3,015 small banks would have been \$15.172 billion, which, combined with the \$46.521 billion for HMDA-reporting small banks, yields an overall estimate for small banks of \$61.693 billion – approximately \$4.9 billion less than the \$66.545 billion reported in the text.

approach in the aggregated manner produced an estimate of \$43.806 billion for the 3,015 small banks, which, when added to the \$46.521 for the 2,031 small banks that report originations to HMDA, yields an overall estimate of \$90.327 billion in originations for small banks.<sup>65</sup>

**(3) Small Thrifts or Small Savings Institutions.** The same procedures were followed for savings institutions. In the case of thrifts, there were 237 small thrifts that reported origination data to HMDA and 198 thrifts that had outstanding mortgages on their balance sheets but did not report any mortgages to HMDA. The estimates for these 198 thrifts are given below for each of the three approaches.

**(a) The Average Originations Per Firm Approach** produced an estimate of \$5.724 billion for the 198 small thrifts without origination data. Adding this figure to the \$10.616 billion of the 237 small thrifts that reported to HMDA<sup>66</sup> yields total estimated originations of \$16.340 billion for all small thrifts.

**(b) The Share of Stock Approach**, when implemented in an aggregated manner (see Step 2b for an explanation), produces an estimate of \$3.913 billion, which, when added to the \$10.616 billion of the 237 small thrifts that reported to HMDA, yields total estimated originations of \$14.530 billion for all small thrifts. Implementing this approach in a disaggregated manner produced an estimate of \$1.792 billion for the 198 small thrifts without origination data, which, when added to the \$10.616 billion of the 237 small thrifts that reported to HMDA, yields total estimated originations of \$12.408 billion for all small thrifts.

**(c) The Origination-to-Stock Ratio Approach** produced an estimate of \$6.910 billion for the 198 small thrifts without origination data, which, when added to the \$10.616 billion of the 237 small thrifts that reported to HMDA,<sup>67</sup> yields total estimated originations of \$17.526 billion for all small thrifts.

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<sup>65</sup> Implementing this approach in a disaggregated manner yields \$74.7 billion as the estimated mortgage originations for the 3,015 small banks, which, when added to the \$46.521 for the 2,031 small banks that reported originations to HMDA, yields an overall estimate of \$121.2 billion in originations for small banks.

<sup>66</sup> However, because thrifts in non-metropolitan areas are no longer required to report under HMDA, originations per firm for firms in the lower asset categories could not be calculated from HMDA data nor could disaggregated estimates of originations for non-reporting, non-metro firms be derived. If this approach were implemented using the overall average origination level across all three asset categories (but separate averages for metropolitan and non-metropolitan areas), the overall estimate for small thrifts would have been \$15.442 billion.

<sup>67</sup> Implementing this approach in a disaggregated manner produced an origination estimate for small thrifts of \$23.1 billion.

**Table 5-10. Mortgage Originations and Outstanding Mortgages for Thrifts by Asset Size, 2005**

	Asset Size				Total (All Thrifts)
	Not More than \$50 Million	(\$50-\$100] Million	(\$100-\$150] Million	Less than \$150 Million	
<b>Thrifts- Metropolitan Areas</b>					
Thrifts Reporting Originations under HMDA					
Loans Originated	37,322	18,331	15,734	71,387	2,302,422
\$ Originated (\$1,000)	5,146,364	3,007,560	2,444,402	10,598,326	493,957,481
Number of Thrifts	41	110	85	236	636
Outstanding Loans (\$1,000 )	720,295	3,507,125	4,109,226	8,336,646	690,227,114
Thrifts Not Reporting Originations					
Outstanding Loans (\$1,000 )	393,492	151,785	152,160	697,437	29,041,150
Number of Thrifts	38	7	3	48	65
<b>Thrifts- Non-Metropolitan Areas</b>					
Thrifts Reporting Originations under HMDA					
Loans Originated	0	0	146	146	146
\$ Originated (\$1,000)	0	0	17,803	17,803	17,803
Number of Thrifts	0	0	1	1	1
Outstanding Loans (\$1,000 )	0	0	65,692	65,692	65,692
Thrifts Not Reporting Originations					
Outstanding Loans (\$1,000 )	941,395	1,622,938	2,207,042	4,771,375	8,940,819
Number of Thrifts	65	47	38	150	187
<b>All Thrifts</b>					
Thrifts Reporting Originations under HMDA					
Loans Originated	37,322	18,331	15,880	71,533	2,302,568
\$ Originated (\$1,000)	5,146,364	3,007,560	2,462,205	10,616,129	493,975,284
Number of Thrifts	41	110	86	237	637
Outstanding Loans (\$1,000 )	720,295	3,507,125	4,174,918	8,402,338	690,292,806
Thrifts Not Reporting Originations under HMDA					
Outstanding Loans (\$1,000 )	1,334,887	1,774,723	2,359,202	5,468,812	37,981,969
Number of Thrifts	103	54	41	198	252

**(4) Small Depositories.** The results from Steps (2) and (3) can now be combined to produce total mortgage origination estimates for all small depositories, which are presented in row 3 of Table 5-11. They are as follows: (a) Average Originations Per Firm Approach: \$82.9

billion; (b) Share of Stock Approach: \$86.5 billion if the approach is implemented in an aggregated manner and \$70.3 billion if the approach is implemented in a disaggregated manner; and (c) Origination-to-Stock Ratio Approach: \$107.9 billion if the approach is implemented in an aggregated manner and \$144.3 billion if the approach is implemented in a disaggregated manner. The estimates range from \$70.3 billion to \$144.3 billion.

Of the three approaches, the "Average Originations Per Firm" approach seems to be the least reasonable in concept and the "Origination-to-Stock Ratio Approach" seems to be the most reasonable, for reasons discussed in Steps (2a) and (2c) above. However, implementation of the ratio approach during 2005 was confounded by a large number of zero values for non-metropolitan firms. Therefore, the "Share of Stock approach" will be used in the analysis below for 2005. In addition, implementing the "Share of Stock Approach" in a disaggregated manner seems more reasonable, from a conceptual point of view.

**Table 5-11. Estimates of Small Lender Originations, 2005 (\$ Billions)**

		Estimation Approaches									
		(a)		(b)				(c)			
		Average Originations		Share of Stock				Origination-to-Stock Ratio			
		Per Firm Approach		Approach				Approach			
		Disaggregated		Aggregated		Disaggregated		Aggregated		Disaggregated	
1. Small Banks		\$66.5	28.0%	\$72.0	29.8%	57.9	25.7%	\$90.3	34.3%	\$121.2	40.5%
2. Small Thrifts		\$16.3	6.9%	\$14.5	6.0%	\$12.4	5.5%	\$17.5	6.7%	\$23.1	7.7%
3. Subtotal: Small Depositories (1+2)		\$82.9		\$86.5		\$70.3		\$107.9		\$144.3	
4. Small Mortgage Banks	(a)	\$146.8	61.7%	\$146.8	65.7%	\$146.8	65.1%	\$146.8	55.8%	\$146.8	49.0%
	(b)	\$80.3		\$80.3		\$80.3		\$80.3		\$80.3	
	(c)	\$160.3		\$160.3		\$160.3		\$160.3		\$160.3	
5. Subtotal: Small Lenders	(a)	\$229.7		\$233.3		\$217.1		\$254.7		\$291.1	
	(3+4)	\$163.2		\$166.8		\$150.6		\$188.2		\$224.6	
	(b)	\$243.2		\$246.8		\$230.6		\$268.2		\$304.6	
	(c)	\$243.2		\$246.8		\$230.6		\$268.2		\$304.6	
6. Small Credit Unions		\$8.4	3.5%	\$8.4	3.5%	\$8.4	3.7%	\$8.4	3.2%	\$8.4	2.80%
7. Total: (5+6)	(a)	\$238.1	100.0%	\$241.7	100.0%	\$225.56	100.0%	\$263.0	100.0%	\$299.4	100.0%
	(b)	\$171.6		\$175.2		\$159.0		\$196.5		\$232.9	
	(c)	\$251.6		\$255.2		\$239.0		\$276.5		\$312.9	
8. % of All Lender											
Originations (\$988.2)	(a)	24.1%		24.5%		22.8%		26.6%		30.3%	
	(b)	17.4%		17.7%		16.1%		19.9%		23.6%	
	(c)	25.5%		25.8%		24.2%		28.0%		31.7%	

Note: In number 8, "All Lender" includes credit unions. See text for definition of "Estimation Approaches" and for an explanation of the three small mortgage bank amounts in number 4. The percentage distribution of originations for small lenders assumes (a) \$146.8 billion for small mortgage banks.

**(5) Small Mortgage Banks.** As discussed earlier, the small business threshold for mortgage banks is \$6 million in annual revenues but revenue data for mortgage banks are not available. HUD's estimation approach for determining small mortgage banks was described earlier. In that analysis, 919 (or 71.4%) of the 1287 mortgage banks that reported to HMDA were considered small; these small mortgage banks originated \$80.3 billion (or 8.3%) of the \$965.4 billion reported as mortgage bank originations in HMDA. But as discussed earlier, HUD's estimation method for determining small mortgage banks could be imprecise. It was noted that originations of the smallest 83.7% (85.2%) of mortgage banks totaled \$146.8 billion (\$186.0 billion), or 15.2% (16.6%) of all originations reported by mortgage banks to HMDA in 2005. Row 4 of Table 5-11 includes the \$146.8 billion estimate as well as the \$80.3 billion and \$160.3 billion estimates.

**(6) Small Lenders.** The estimates of mortgages originated by small lenders (small banks, small thrifts, and small mortgage banks) during 2005 can now be totaled. Consider row 5 in Table 5-11. The estimates range from \$217.1 billion to \$291.1 billion if small mortgage banks originate \$146.8 billion. If the disaggregated "share of stock" and "ratio" approaches are used, the range is from \$217.1 billion to \$291.1 billion if small mortgage banks originate \$146.8 billion. Of course, the estimates depend importantly on the origination amount for small mortgage banks. As shown in Table 5-11, if that amount is \$80.3 (\$160.3), the estimates of small lender originations varies from \$150.6 billion to \$224.6 billion (\$230.6 billion to \$304.6 billion).

**(7) Small Credit Unions.** Table 5-7 reports the share of credit union originations accounted for by small businesses. In 2005, the 3,097 small credit unions originated \$8.387 billion in mortgages, or 13.9% of the \$60.437 billion originated by the 3,969 credit unions that reported mortgages during in 2005. Row 6 in Table 5-11 adds this amount (\$8.387 billion) for small credit unions to each of the various figures for small lenders (banks, thrifts, and mortgage banks) in row 5 to arrive at a range of overall estimates of originations by small lenders (including credit unions) in row 7. If small mortgage banks originate \$146.8 billion, the total for small lenders (including credit unions) is \$299.4 billion, under the disaggregated "ratio approach".

**(8) Small Lender Share of Mortgage Originations.** It is estimated that mortgage originations totaled \$3,088 billion in 2005. Olson (2004) reports that brokers accounted for 68% of these originations, leaving 32%, or \$988.2 billion, for banks, thrifts, mortgage banks, and credit unions. Under the disaggregated "share of stock approach", Steps 5-7 suggest that small lenders (including credit unions) accounted for \$225.5 billion (\$217.1 billion for small depositories and small mortgage banks and \$8.4 billion for small credit unions), or 22.8%, of the \$988.2 billion. In other words, small lenders (including credit unions) account for 22.8% of all lender (non-broker) originations. Other estimates are possible, as indicated in the various rows of Table 5-11. In addition, there is some uncertainty with the share of mortgages accounted for by brokers. If the estimate for the broker share in 2005 were 63%, instead of 68%, then \$1,142.6 billion (instead of \$988.2 billion) would be the estimate of lender (non-broker) originations. In this case, the \$225.4 billion originated by small lenders (including credit unions) would represent 19.7% (instead of 22.8%) of lender originations.

The baseline analysis in Chapter 3 assumes that small businesses account for 22.8% of lender revenue, which is consistent with the disaggregated "share of stock approach" for small depositories and the \$146.8 billion estimate for small mortgage banks. Sensitivity analyses are conducted to show the effects of higher and lower revenue percentages for small lenders (specifically, 20% and 26%). If the baseline percentage of 22.8% or the top end of the range of 26.0% overestimate the revenue share of small lenders, that is preferable to underestimating the small lender share.

### **III.B.5.c. Lender Revenue in Projection Model: Aggregated Analysis**

This section uses the above estimates of the small lender share of mortgage originations, in combination with the estimates of consumer savings and transfers in Chapter 3, to examine revenue impacts on small lenders. As explained in Chapter 3, consumer savings and transfers associated with the new GFE assume \$2.4 trillion in mortgage originations, with 40% (\$960 billion) of this total originated by lenders and 60% (\$1,440 billion) by brokers.<sup>68</sup> While the base case assumed lenders earn a 1.75% fee, sensitivity analysis was conducted using 1.50% and 2.0% fees. In this case, lender revenues are projected to be: (a) \$19.2 billion if fees are 2%, (b) \$16.8 billion if fees are 1.75%, and (c) \$14.4 billion if fees are 1.50%.

As noted above, small lenders are estimated to account for 23% of all lender revenues (or specifically 22.8%). Thus, small lender revenues would be: (a) \$4.38 billion if fees are 2%, (b) \$3.83 billion if fees are 1.75%, and (c) \$3.28 billion if fees are 1.50%. As noted above, sensitivity analyses were conducted in Chapter 3 for small business revenue shares of 20% and 26%. With this range, small lender revenues would be: (a) \$3.84 billion - \$4.99 billion if fees are 2%, (b) \$3.36 billion - \$4.37 billion if fees are 1.75%, and (c) \$2.88 billion - \$3.74 billion if fees are 1.50%.

**GFE Transfer Estimates for Lenders.** Section VII.E.4 of Chapter 3 conducted several analyses with respect to projected consumer savings and transfers from lenders associated with the new GFE. The estimates ranged from 11.0% to 14.0%. In the case of a 1.75% origination fee, the dollar range for consumer savings from lenders was from \$1.85-\$2.35 billion. Small businesses would account for 22.8% of these transfers, or \$422-\$537 million.<sup>69</sup> If there are 8,200 active lenders that originate mortgages, the consumer savings and transfers would come from 5,167 small lenders (3,740 small banks, 330 small thrifts, and 1,097 small mortgage banks). If there are 9,968 active lenders (see earlier discussion), then the consumer savings and transfers would come from 6,670 small lenders (4,959 small banks, 614 small thrifts, and 1,097 small mortgage banks). In both cases, 3,097 small credit unions would also experience revenue reductions. For each group, the percentage change in lender revenues from originating mortgages is given by the 11.0%-14.0% reported above. This percentage loss in revenues refers to both small and large lenders and small and large credit unions.

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<sup>68</sup> The 40% share for lenders includes originations by credit unions.

<sup>69</sup> If the revenue share for small lenders is 20% (26%), the dollar range for GFE transfers is \$370-\$470 million (\$481-\$611 million).

If lender fees are 2.0% instead of 1.75%, then lender revenues and the above figures for consumer savings and revenue transfers are increased by the ratio of 2.00/1.75, or 1.143. Revenue transfers for all lenders (including credit unions) would be \$2.11-\$2.69 billion, assuming 11%-14% savings, and revenue transfers for small lenders (including credit unions) would be \$482-\$612 million, assuming a small business share of 22.8%, and \$422-\$698 million assuming the 20%-26% range in small lender estimates. Again, these revenue transfers for both groups (all lenders and small lenders) would represent 11.0%-14.0% of their revenues from originating single-family mortgages.

### **III.B.5.d. Share of Mortgage Originations Accounted for by Lenders: Disaggregated Analysis**

Section III.B.5.b explained that data are not available that allocate lender retail (or non-broker) originations among banks, thrifts, and mortgage banks. For this reason, the analysis of the revenue impacts on lenders in the above section considered lenders as a group, rather than as separate industries (banks, thrifts, and mortgage banks). This section relies on an earlier HUD analysis to project the market shares for the separate lender groups. The section uses 2001 HMDA data and other information to derive a range of estimates for retail originations for the major lender groups (banks, thrifts, and mortgage banks, as well as credit unions). Results from this section's analysis are then applied to 2005 data to obtain an updated distribution of retail mortgages across the various lender groups. As will become clear, there is some uncertainty around these estimates.

The Mortgage Bankers Association of America (MBA) estimated that mortgage originations totaled \$2,030 billion in 2001, and Olson (2002) estimated that brokers originated 65% of 2001 mortgages and lenders, the remaining 35%. Thus, the lender (retail or non-broker) share of the 2001 mortgage market was \$710.5 billion. The question is how to distribute this \$710.5 billion among the three lender groups and credit unions.

One might start by using HMDA data, which reports \$1,793.7 billion in mortgage originations during 2001. Although HMDA does not cover all originations, its high coverage rate (88.4% of the MBA-reported \$2,030 billion in origination volume for 2001) lends it some credibility. Row 1 of Table 5-12 shows that banks, thrifts, and mortgage banks reported \$1,752.2 billion in originations (97.7%) under HMDA, while credit unions reported the remaining \$41.3 billion (2.3%). Row 2 expands the HMDA data in row 1 to make it consistent with total mortgage originations of \$2,030 billion reported by the MBA.<sup>70</sup> Row 3 deducts the 65% share for brokers from the origination figures in row 2, leaving a total of \$710.5 billion (or 35%) for lender originations (including credit unions). Notice that the credit union figure (\$46.767 billion) in row 3 is the same as in row 2, which assumes that credit unions purchase no loans on a wholesale basis.<sup>71</sup> The entire broker amount (\$1,319.5 billion) is taken from the

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<sup>70</sup> Essentially, this involves multiplying the figures in row 1 by 1.1317 (reflecting the 88.36% coverage rate for HMDA). Thus, this assumes that HMDA's undercoverage rate is the same across the different industries; the results of an alternative assumption will be noted below.

<sup>71</sup> While this may be unrealistic, it provides a reasonable approximation given the lack of data on this question.

origination total (\$1,983.2 billion) without credit unions, and distributed across banks, thrifts, and mortgage banks, based on the HMDA-reported distribution given in row 1(b). Thus, this 2001 HMDA-based distribution of the \$710.5 billion in lender retail (non-broker) originations given in row 3 (a) is as follows: (1) 43.3% for banks; (2) 23.7% for thrifts; (3) 26.4% for independent mortgage banks; and (4) 6.6% for credit unions.

**Table 5-12. Distribution of Mortgages Originated by Lenders, 2001**

	Commercial Bank	Thrift	Mortgage Bank	Credit Union	Total
1. 2001 HMDA Data	\$812,553,264	\$443,928,847	\$495,894,752	\$41,323,206	\$1,793,700,069
(a) % Distribution	45.3%	24.7%	27.6%	2.3%	100.0%
(b) % Distribution W/O Credit Unions	46.4%	25.3%	28.3%		100.0%
2. Adjust HMDA Data to be Consistent With 2001 Originations	\$919,598,072	\$502,411,510	\$561,223,342	\$46,767,076	\$2,030,000,000
3. Estimated Lender (Non-broker) Originations	\$307,763,909	\$168,143,165	\$187,825,850	46,767,076	\$710,500,000
(a) % Distribution	43.3%	23.7%	26.4%	6.6%	100.0%
4. NMN Wholesale Mortgages	\$554,645,000	\$300,468,000	\$248,421,000	\$0	\$1,103,534,000
(a) % Distribution	50.3%	27.2%	22.5%	0.0%	100.0%
5. Estimated Non-Wholesale Mortgages (W/O Credit Unions) (#2-#4)	\$364,953,072	\$201,943,510	\$312,802,342	\$0	\$879,698,924
(a) % Distribution	41.5%	23.0%	35.6%	0.0%	100.0%
6. Retail Distribution Based on NMN Data	\$275,357,128	\$152,366,398	\$236,009,398	46,767,076	\$710,500,000
(a) % Distribution	38.8%	21.4%	33.2%	6.6%	100.0%
7. Retail Distribution Based on HMDA Data (From #3)	\$307,763,909	\$168,143,165	\$187,825,850	46,767,076	\$710,500,000
(a) % Distribution	43.3%	23.7%	26.4%	6.6%	100.0%

Notes: Row 2 increases the amounts in row 1 by the ratio of total mortgage originations (\$2,030,000,000) to HMDA-reported originations (\$1,793,700,069). This adjustment for HMDA under coverage assumes that the four lender groups have the same HMDA coverage rate.

The above calculations assume that purchases of brokered loans by warehouse lenders are distributed across the three lender groups in the same manner as their HMDA-reported mortgage originations.<sup>72</sup> This may or may not be a good assumption. It could be that large wholesale

<sup>72</sup> Recall that large banks (e.g., Bank of America), thrifts (e.g., Washington Mutual), and independent mortgage banks (e.g. Countrywide in 2001) report under HMDA not only loans that they originate on a retail basis, but also loans that they table fund and loans where they make the credit decision -- but HMDA does not separately identify these different types of loans.

lenders are more heavily concentrated among banks than they are among (say) independent mortgage banks. If this were the case, using the HMDA-based distribution of lender-reported originations as a proxy for the distribution of retail loans among lenders would overstate (understate) the retail share of originations by banks (independent mortgage banks). The remainder of this section attempts to shed some light on this issue.

HUD obtained data on wholesale lending from the National Mortgage News (NMN). The NMN data is based on a survey of large prime and subprime lenders -- it covered the top 55 (42) prime (subprime) lenders that fund mortgages of brokers and the top 44 (20) prime (subprime) lenders that purchase mortgages from correspondents. Thus, the NMN survey probably covered the bulk of all wholesale lending. HUD disaggregated the NMN data for 2001 into the three lender groups (banks, thrifts, and independent mortgage banks); the wholesale lending for each of these three groups is reported in row 4 of Table 5-12. As shown in row 4 (a), NMN's data for wholesale lending are distributed as follows: (1) 50.3% for banks; (2) 27.2% for thrifts; (3) 22.5% for independent mortgage banks. As can be seen by comparing these shares with those from row 1(c) in Table 5-12, the purchases of brokered and correspondent loans by warehouse lenders are not distributed across the three lender groups in the same manner as HMDA-reported mortgage originations. Wholesale purchases are more (less) concentrated among banks and thrifts (mortgage banks) than are mortgage originations reported under HMDA. Based on these comparisons, the HMDA-based distribution of retail originations given in row 3(a) may overstate (understate) the retail share for banks and thrifts (mortgage banks) in 2001.

Row 5 of Table 5-12 reports an estimate of non-wholesale originations, obtained by subtracting wholesale lending in row 4 from total mortgage originations in row 2. This serves as one estimate of retail originations by lenders. As shown in row 5(a), the distribution of non-wholesale (or retail) originations suggested by the NMN data differs from that suggested by HMDA reported in row 3(a). The following are the two sets of estimates for the percentage shares of retail originations:

	<u>NMN-Based Distribution</u>	<u>HMDA-Based Distribution</u>
Banks	38.8%	43.3%
Thrifts	21.4%	23.7%
Mortgage Banks	33.2%	26.4%
Credit Unions	<u>6.6%</u>	<u>6.6%</u>
Total	100.0%	100.0%

Mortgage banks are credited with a larger share (33.2% versus 26.4%) of retail originations based on analysis using the NMN data for wholesale lenders.

The above percentages can be used to allocate among banks, thrifts, mortgage banks, and credit unions, the revenue transfers associated with new GFE that were reported earlier for all lenders as a group in Section III.B.5.c. This will be done in Section III.B.5.f below, entitled "Transfers as a Share of Total Revenue." In addition, Section III.B.5.e below will combine the

above analysis on lender shares with the earlier analysis of mortgages originated by small lenders, to provide disaggregated small business shares (i.e., small bank, small thrift, small mortgage bank, and small credit union) for each lender group. But before doing that, some additional technical issues are discussed with respect to the lender data.

**Additional Estimate Based on the NMN Data.** Steps 1-7 in Table 5-12 provided one method for estimating the distribution of non-broker loans across the various lender groups. HUD also used the information on retail lending provided by NMN to estimate lender shares of non-broker loans. Briefly, this approach used the following information from NMN and HMDA:

- (a) NMN reports that the 113 large lenders included in their sample originated \$716.4 billion in mortgages on a retail basis during 2001.
- (b) HUD disaggregated NMN's retail originations for large lenders as follows: \$385.3 billion for commercial banks (53.8%); \$119.8 billion for thrifts (16.7%); \$206.4 billion for mortgage banks (28.8%); and \$4.9 billion for credit unions (0.7%).
- (c) HUD deducted the originations of NMN's large lenders from 2001 HMDA data. In HMDA, NMN's 113 large lenders were represented by 276 HMDA reporters (parents and subsidiaries). These 276 lenders accounted for \$1,258.4 billion of the \$1,793.7 billion in mortgage originations reported to HMDA in 2001.
- (d) The remaining \$535.3 billion (\$1,793.7 minus \$1,258.4) of HMDA-reported originations were distributed as follows: \$173.0 billion for commercial banks (32.3%); \$135.0 billion for thrifts (25.2%); \$191.7 billion for mortgage banks (35.8%); and \$35.6 billion for credit unions (6.7%). These lenders will be referred to as the "smaller lenders" (recognizing that they are not defined as small businesses but are not included in NMN's sample of "large lenders").
- (e) Finally, it was assumed that the HMDA undercount of \$236.3 billion (i.e., MBA's origination projection of \$2,030 billion for 2001 minus HMDA's total of \$1,793.7 billion) was distributed across the lenders, in the same pattern as noted above.<sup>73</sup> This resulted \$249.4 billion for commercial banks (32.3%); \$194.6 billion for thrifts (25.2%); \$276.3 billion for mortgage banks (35.8%); and \$51.4 billion for credit unions (6.7%).<sup>74</sup>

According to (b), commercial banks account for the largest share (53.5%) of retail loans originated by NMN's sample of large retail lenders. According to (d), mortgage banks account

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<sup>73</sup> This assumes that the large lenders in NMN's sample accurately reported their originations to HMDA, which is probably a reasonable assumption. The undercounted HMDA loans could be due both to "smaller lenders" not reporting under HMDA and to underreporting on the part of those that do report under HMDA. Also, it may have been more realistic to assume that the undercount of \$236.3 billion did not include loans for credit unions; however, including credit unions in the analysis does not affect the overall results.

<sup>74</sup> Thus, the MBA's estimate of \$2,030 billion in total originations for 2001 is divided between (a) \$1,258.4 billion reported by NMN sample of larger lenders and (b) \$771.7 billion allocated to "smaller lenders" not included in NMN's sample. As the text explains, HMDA data are used to allocate the \$771.7 billion among banks, thrifts, mortgage banks, and credit unions.

for the largest share (35.8%) of the originations of the smaller lenders not included in NMN's sample. These patterns are consistent with the earlier discussion in this section. But the purpose of the above data manipulations is to develop an alternative estimate of the distribution of lender retail (or non-broker) originations among banks, thrifts, mortgage banks, and credit unions. The NMN data in (b) provide the distribution of retail loan originations across the various lender types for larger lenders. The distribution in (d) can be used as one estimate of the retail distribution for smaller lenders, although it is recognized that the loans in (d) include some wholesale as well as retail loans. Combining the various weights in (b) and (d) and assuming that total lender retail (non broker) originations for 2001 were \$710.5 billion (see earlier discussion) produces the following estimate of the percentage distribution for these retail loans: 41.4% for commercial banks; 20.5% for thrifts; 31.5% for mortgage banks; and 6.6% credit unions.<sup>75</sup> This distribution, using an alternative estimation approach, is very similar to the "NMN-based Distribution" derived earlier and reported in row 6 of Table 5-12.<sup>76</sup> The main point from all these analyses that use the NMN data is that the HMDA-based distribution places too much weight on commercial banks relative to mortgage banks.

**Questions About Broker and Lender Shares of Mortgage Originations.** The NMN data raise some issues concerning the broker and lender shares of the mortgage market. This Regulatory Impact Analysis relies on the extensive survey work conducted by David Olson, who places the broker share of the mortgage market at 65% in 2001 (or \$1,319.5 billion, assuming that total originations are the MBA-reported \$2,030 billion). This leaves 35%, or \$710.5 billion, for lenders. At first glance, this 35% figure appears small – that is, one would think the retail operations of major banks such as Bank of America, Washington Mutual, and Countrywide, combined with the originations of community banks and thrifts and small mortgage bankers would amount to more than 35% of the mortgage originations. The NMN data for retail originations lend some support to this intuition. As noted in (a) above, NMN reports that the 113 large lenders included in its sample originated \$716.4 billion in mortgages on a retail basis during 2001 – a figure slightly larger than the \$710.5 billion derived above by applying Olson's 35% lender share to MBA's total origination figure. Adding some (undetermined) amount from (d) to reflect retail originations by smaller lenders not included in NMN's sample would place the total retail (non broker) figure substantially higher than that (\$710.5 billion) based on Olson's analysis. The source of this discrepancy does not appear to be with the overall originations, as MBA's estimate (\$2,030 billion) is consistent with estimates by Fannie Mae and others. The discrepancy may result from different definitions used by NMN and Olson, or there may be some other reason for the rather large differences in the two estimates of lender retail originations.

The method for estimating non-wholesale loans (a proxy for retail loans) described in Table 5-12 can also be compared with Olson's figures. Essentially, that method subtracted NMN's data for wholesale loans (\$1,103.5 billion in row 4 of Table 5-12) from the MBA's total origination estimate (\$2,030 billion), yielding \$879.7 billion as one estimate of the non-wholesale portion of the market (see row 5 in Table 5-12). This \$879.7 billion is higher than the

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<sup>75</sup> This calculation fixes the credit union share at 6.58%, as explained earlier in discussing the "HMDA-based distribution" and "NMN-based distribution".

<sup>76</sup> Although it is recognized that if the weights from (d) were reduced to reflect the (unknown) presence of wholesale loans, the distribution would shift back toward commercial banks.

\$710.5 billion figure based on Olson's estimate that the non-broker share of the mortgage market was 35% in 2001 (although it is not even clear from the available information if these two measures are even the same concepts).<sup>77</sup> There could be several reasons for this discrepancy. For instance, NMN and Olson are probably using different definitions (e.g., Olson's broker definition does not include independent mortgage banks while NMN's correspondent definition probably does). In addition, the \$879.7 billion estimate of non-wholesale lending based on NMN's analysis might be slightly lower if all wholesale lending were included in NMN's data (rather than just the wholesale lending of large lenders).

It would be difficult to reconcile these different estimates of the broker, non-wholesale, retail, and lender shares of the mortgage market without more information about underlying definitions and the consistency across the various data sets. As noted above, this Regulatory Impact Analysis uses Olson's estimates as a starting point because his data are based on large surveys of the broker industry. If the estimates of the broker market used in this Regulatory Impact Analysis are too high, that will result in an overestimate of the small business share of revenue transfers, which seems preferable to underestimating those shares. To reflect any uncertainty with the broker estimates, Chapter 3 conducts sensitivity analyses for lower and higher shares of the broker market.

Concerning NMN's data, the important insight is that the percentage distribution of non-wholesale lending among lenders differs from the percentage distribution of HMDA-reported loans. Therefore, this Regulatory Impact Analysis relies heavily on the "NMN-based Distribution" (see above) for disaggregating the lender results among banks, thrifts, and mortgage banks.

Below, the results of this section based on 2001 data will be combined with updated data for 2005.

### **III.B.5.e. Share of Mortgage Originations Accounted for by Small Lenders: Disaggregated Analysis**

Section III.B.5.b reported a range of estimates for mortgages originated by small banks, small thrifts, small mortgage banks, and small credit unions -- the differences among the various estimation techniques were summarized in Table 5-11. As explained earlier, the estimate that small lenders account for 23% (with a 20%-26% range) of all lender originations was not disaggregated for the separate lender groups. For example, there was no separate estimate of the percentage of commercial bank originations accounted for by small commercial banks -- the numerator (originations by small banks) is available (because it was estimated in Section III.B.5.b above) but there is no estimate of the denominator (retail originations by all banks). But Section III.B.5.d derived a range of estimates for lender retail originations, which means that estimates for the small business share of the separate industries (banks, thrifts, and mortgage banks) can now be presented.

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<sup>77</sup> If the broker share of the market had been 60% in 2001, then the lender figure would have been \$812 billion, which is not too far from the NMN-based estimate of \$879.7 billion in Table 5.12.

First, Table 5-13 repeats the analysis of Table 5-12 using updated HMDA and mortgage origination data. Although the NMN data are not included for 2005 (rows 4 and 5 of Table 5.12 are dropped), the 2001 NMN retail distribution has been adjusted using 2005 HMDA data and is reported in row 6 of Table 5.13. The adjustment was made as follows:

Step 1: the 2001 HMDA distribution without credit unions was obtained from row 1(b) of Table 5.12: (a) banks, 46.4%; (b) thrifts, 25.3%; (c) mortgage banks, 28.3%.

Step 2: the NMN retail distribution without credit unions was derived from row 6 of Table 5.12: (d) banks, 41.5%; (e) thrifts, 23.0%; (f) mortgage banks, 35.6%.

Step 3: in order to determine the relationship between the two distributions, the NMN distribution was divided by the HMDA distribution to obtain: (g) banks, 0.894; (h) thrifts, 0.909; (i) mortgage banks, 1.257.<sup>78</sup>

Step 4: the 2005 HMDA distribution without credit unions was obtained from row 1(b) of Table 5.13: (j) banks, 45.2%; (k) thrifts, 18.6%; (l) mortgage banks, 36.3%. As can be seen by comparing the 2001 and 2005 HMDA distributions from Steps 1 and 4, there has been a shift in HMDA-reported loans toward mortgage banks and away from thrifts.

Step 5: in order to obtain an estimate of the NMN distribution that reflects this shift in HMDA-reported loans toward mortgage banks, the ratios from Step 3 are applied to the 2005 HMDA distribution from Step 4 producing an updated estimate of the retail distribution of mortgage originations based on NMN data:<sup>79</sup> (m) banks, 39.2%; (n) thrifts, 16.4%, and (o) mortgage banks, 44.4%.

Step 6: credit unions, which accounted for 6.3% of retail originations (see row 3 of Table 6.13), are included in the analysis to produce the following 2005 estimated NMN distribution of retail loans: (p) banks, 36.8%; (q) thrifts, 15.4%, (r) mortgage banks, 41.6%; and (s) credit unions, 6.3%.

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<sup>78</sup> As explained earlier, the fact that this mortgage banker figure is greater than 1 indicates that HMDA underestimates the retail origination share of mortgage banks (relative to banks and thrifts).

<sup>79</sup> Applying the Step 4 ratios produces a retail distribution that sums to greater than one (1.029), so the resulting figures for banks, thrifts, and mortgage banks had to be divided by 1.029 to obtain the figures reported in Step 5.

**Table 5-13. Distribution of Mortgages Originated by Lenders, 2005**

	<u>Commercial Bank</u>	<u>Thrift</u>	<u>Mortgage Bank</u>	<u>Credit Union</u>	<u>Total</u>
1. 2005 HMDA Data	\$1,201,500,000	\$494,000,000	\$965,400,000	\$54,600,000	\$2,715,500,000
(a) % Distribution	44.2%	18.2%	35.6%	2.0%	100.0%
(b) % Distribution W/O Credit Unions	45.2%	18.6%	36.3%		100.0%
2. Adjust HMDA Data to be Consistent With 2005 Originations	\$1,366,316,332	\$561,764,684	\$1,097,829,203	\$62,089,781	\$3,088,000,000
3. Estimated Lender (Non-broker) Originations	\$418,156,777	\$171,926,299	\$335,987,143	\$62,089,781	\$988,160,000
(a) % Distribution	42.3%	17.4%	34.0%	6.3%	100.0%
4. NMN Wholesale Mortgages (a) % Distribution	--	--	--	--	--
5. Estimated Non-Wholesale Mortgages (W/O Credit Unions) (#2-#4) (a) % Distribution	--	--	--	--	--
6. Retail Distribution Based on Adjusted NMN Data (see above)	\$364,091,496	150,998,301	\$410,980,423	62,089,781	\$988,160,000
(a) % Distribution	36.8%	15.3%	41.6%	6.3%	100.0%
7. Retail Distribution Based on HMDA Data (From #3)	\$418,156,777	\$171,926,299	\$335,987,143	62,089,781	\$988,160,000
(a) % Distribution	42.3%	17.4%	34.0%	6.3%	100.0%

Notes: Row 2 increases the amounts in row 1 by the ratio of total mortgage originations (\$3,088,000,000) to HMDA-reported originations (\$2,715,500,000). This adjustment for HMDA under coverage assumes that the four lender groups have the same HMDA coverage rate.

As can be seen from rows 6 and 7 of Table 5.13, the two estimated retail (non-broker) distributions of loans among the four lender groups for 2005 are as follows:

	<u>NMN-Based Distribution</u>	<u>HMDA-Based Distribution</u>
Banks	36.8%	42.3%
Thriffs	15.4%	17.4%
Mortgage Banks	41.6%	34.0%
Credit Unions	<u>6.3%</u>	<u>6.3%</u>
Total	100.1% (rounding)	100.0%

These two retail distributions will be used below, with the NMN-based distribution being the base case.

Table 5-14 reports the data for the baseline case of a 22.8% share of mortgage originations for small lenders. This baseline case uses the "share of stock approach" and assumes that small mortgage banks originated \$146.8 billion during 2005, or 65.1% of all originations by small lenders (including credit unions). The estimates for retail originations by each lender group are also included in the table -- first based on the 2005 HMDA Distribution and second based on the Adjusted NMN Distribution (which is derived above in Steps 1-6). These additions allow the computation of the "Small Lender Share" of originations for each separate industry. The estimated origination shares for small businesses range from 13.8% (HMDA-Based Distribution) to 15.9% (Adjusted NMN Distribution) for banks, from 7.2% to 8.2% for thrifts, and from 43.7% to 35.7% for mortgage banks. The rather wide range for mortgage banks is due to the estimated origination share for mortgage banks being significantly higher under the Adjusted NMN Distribution (41.6%) than under the "HMDA-Based Distribution" (34.0%). Given that the estimated amount for small mortgage banks is fixed in this table (at the base case of \$146.8 billion), the share for small mortgage banks is necessarily lower when retail originations by all mortgage banks are estimated using the Adjusted NMN Distribution (35.7%) than when using the HMDA distribution (43.7%). The small business shares for banks and thrifts are much lower than the small business share for mortgage banks, and they also exhibit much less variation between the HMDA-Based and Adjusted NMN Distributions.

**Table 5-14. Lender Originations Under Different Distributions, 2005****I. Share of Stock Approach- Disaggregated**

	Projected Originations							
	Small Lenders		All Lenders: HMDA Distribution			All Lenders: Adjusted Distribution		
	\$	%	\$	%	Small Lender	\$	%	Small Lender
Billions	of Total	Billions	of Total	Share	Billions	of Total	Share	
1. Banks	57.9	25.7%	418.157	42.3%	13.8%	364.091	36.8%	15.9%
2. Thrifts	12.4	5.5%	171.926	17.4%	7.2%	150.998	15.3%	8.2%
3. Mortgage Banks	146.8	65.1%	335.987	34.0%	43.7%	410.980	41.6%	35.7%
4. Credit Unions	8.4	3.7%	62.090	6.3%	13.5%	62.090	6.3%	13.5%
5. All	225.5	100.0%	988.160	100.0%	22.8%	988.160	100.0%	22.8%

**II. Share of Stock Approach- Aggregated**

	Projected Originations							
	Small Lenders		All Lenders: HMDA Distribution			All Lenders: Adjusted Distribution		
	\$	%	\$	%	Small Lender	\$	%	Small Lender
Billions	of Total	Billions	of Total	Share	Billions	of Total	Share	
1. Banks	72	29.8%	418.157	42.3%	17.2%	364.091	36.8%	19.8%
2. Thrifts	14.5	6.0%	171.926	17.4%	8.4%	150.998	15.3%	9.6%
3. Mortgage Banks	146.8	60.7%	335.987	34.0%	43.7%	410.980	41.6%	35.7%
4. Credit Unions	8.4	3.5%	62.090	6.3%	13.5%	62.090	6.3%	13.5%
5. All	241.7	100.0%	988.160	100.0%	24.5%	988.160	100.0%	24.5%

Note: See text for explanation of "HMDA Distribution" and "Adjusted Distribution".

The above small business estimates, based on mortgage origination activity, are higher than the Census-Bureau-based estimates reported earlier based on revenue data. According to the Census of Business, small banks account for 4.9% of bank revenues, compared with 15.9% of mortgage originations based on the disaggregated share of stock approach combined with the adjusted NMN distribution. Under the same assumptions, the estimate of the small business share for thrifts was 8.2%, also higher than the Census-Bureau-based estimate that small thrifts account for 3.7% of thrift revenues.

The estimates of the small business share for mortgage banks exhibit much greater variation, due to the wide variation in projected originations for small mortgage banks (from \$80.3 billion to \$160.3 billion). However, the range from 35.7% (Adjusted NMN Distribution) to 43.7% (HMDA Distribution) for the base case of \$146.8 billion probably represents a

reasonable range for the small business share of retail originations by mortgage banks; of course, it is recognized there is some uncertainty here. These small business estimates for mortgage banks are considerably higher than the Census-Bureau-based estimate that small businesses account for 6.7% of the revenue of the Real Estate Credit Industry (which includes mortgage banks). Finally, the estimate of the small business share for credit unions is 13.5%, which is less than the 32.2% figure from the Census Bureau -- obviously, those credit unions engaged in mortgage activity are larger than the average credit union.

Chapter 3 includes a small lender share of 22.8% as the base case, with a 20%-26% range. If the Census-Bureau-based small business revenue estimates had been used for the separate industries, the overall small lender share would have been 7.0% using industry weights from the "HMDA-based Distribution", and 7.2% using industry weights from the "Adjusted NMN Distribution." Thus, the small lender share used in the baseline projections in Chapter 3 is three times any estimate based on revenue data from the Census Bureau.

**Number of Mortgages.** The revenue analysis in Chapter 3 is based on dollar volumes, so mortgage originations (expressed in dollars) is the appropriate concept for that analysis, as explained above. However, certain analyses of regulatory burden and compliance costs are based on number of loans (see Chapter 6). Therefore, it is useful to have loan-based percentage distributions for the lender groups and their respective small business sectors. Therefore, the above 2001 NMN<sup>80</sup> and HMDA analysis was repeated but on a loan-number basis rather than a mortgage-dollar basis. The following are the two sets of estimates for the percentage shares of the number of lender retail (non-broker) mortgages obtained for 2001:

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<sup>80</sup> In addition to the caveats mentioned in the above analysis based on mortgage dollars, there are additional ones when the analysis switches to the number of mortgages. The "share of stock" and "originations-to-stock ratio" approaches for estimating the small business share of the dollar-based originations by banks and thrifts relied on the outstanding stock of mortgages for those banks and thrifts that did not report any mortgage originations under HMDA. The data on the outstanding mortgage stock were only available on a dollar basis (i.e., not available on a number-of-loans basis). Thus, the estimation techniques for the small bank and thrift percentages of the number of loans expressed loans as a share of outstanding mortgage dollars, rather than as a share of outstanding mortgage loans. In addition, the NMN data for wholesale mortgages were also only available on a dollar basis. However, NMN data on both dollar volume and number of loans were available for combined wholesale and retail originations. In addition, HMDA data (both dollar volume and number of loans) were available for NMN's lenders. Thus, average loan amounts for banks, thrifts, and mortgage banks were estimated using those NMN and HMDA data, producing the following results (with HMDA data in parentheses): \$144,038 (\$140,751) for commercial banks; \$178,578 (\$169,427) for thrifts; and \$135,123 (\$138,817) for mortgage banks. As can be seen the NMN and HMDA data provide somewhat similar results. The average loan amounts from the NMN data are used here, as they place a greater weight on wholesale lending than the HMDA data.

	<u>NMN-Based Distribution</u>	<u>HMDA-Based Distribution</u>
Banks	41.1%	44.8%
Thrifts	19.5%	20.3%
Mortgage Banks	31.0%	26.5%
Credit Unions	<u>8.4%</u>	<u>8.4%</u>
Total	100.0%	100.0%

In the base case,<sup>81</sup> the small business share of the number of lender (non-broker) loans was 25.6%, which was almost six percentage points greater than the 2001-derived small business share (20%) of the dollar amount of mortgages originated by lenders. This meant that during 2001 small lenders originated loans of lower average amounts than large lenders. In the base case, and assuming the Adjusted NMN Distribution (rather than the HMDA Distribution), the small business share of loans for each of the lender groups in 2001 were as follows: (1) 19.0% for commercial banks; (2) 12.3% for thrifts; (3) 41.6% for mortgage banks; and (4) 29.1% for credit unions.

The above 2001 data, combined with 2005 data from HMDA and some of the 2005 dollar-based results reported above, were used to estimate the 2005 retail distribution of loans among lenders and the corresponding 2005 small business percentages. This was done as follows: Step 1: the above 2001 small lender percentages based on numbers of loans were divided by the 2001 small lender percentages based on dollars of originations, yielding the following ratios: (a) banks, 1.62; (b) thrifts, 1.36; (c) mortgage banks, 1.14; and (d) credit unions, 1.33. Step 2: the ratios in Step 1 were multiplied by the 2005 small lender percentages based on dollars to obtain the following 2005 small lender percentages based on numbers of loans: (a) banks, 25.8%; (b) thrifts, 8.2%; (c) mortgage banks, 40.8%; and (d) credit unions, 21.9%. Step 3: the 2005 HMDA-based retail distribution of the number of loans was obtained (similar to the approach in row 3(a) of Table 5.12), yielding: (a) banks, 42.1%; (b) thrifts, 14.9%; (c) mortgage banks, 34.1%; and (d) credit unions, 8.9%. Step 4: to obtain an NMN-based retail distribution of the number of loans in 2005, lender-specific ratios of the 2001 NMN-to-HMDA-based retail loan distributions were applied to 2005 HMDA-retail loan distribution from Step 3 to obtain the following 2005 estimate of the NMN-based retail distribution of the number of loans: (a) banks, 37.9%; (b) thrifts, 14.1%; (c) mortgage banks, 39.2%; and (d) credit unions, 8.9%. Step 5: the overall small lender share of the number of loans was obtained by multiplying the four small lenders shares from Step 2 by the four retail market shares from Step 4, to obtain 29.3% for the overall NMN-based small lender share of loans originated. Thus, the small lender share based

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<sup>81</sup> The 2001 analysis was based on a disaggregated, origination-to-stock ratio approach with small mortgage bank originations of \$85.783 billion.

on numbers of loans (29.3%) is 6.5 percentage points greater than the small lender share based on dollars of loans (22.8%)

To conclude, the following are the two sets of estimates for the percentage shares of the number of lender retail (non-broker) mortgages obtained for 2005:

	<u>NMN-Based Distribution</u>	<u>HMDA-Based Distribution</u>
Banks	37.9%	42.1%
Thrifts	14.1%	14.9%
Mortgage Banks	39.2%	34.1%
Credit Unions	<u>8.9%</u>	<u>8.9%</u>
Total	100.0%	100.0%

### **III.B.5.f. Transfers as a Share of Total Revenue: Lenders**

Section II.B of this chapter included an analysis relating Census-Bureau-based historical information on broker revenue to broker revenue projected by applying a percentage origination fee (e.g., 1.75%) to the broker share of mortgage originations. Because practically all broker revenue derives from the origination fee, the two revenue figures (historical and fee-based) matched reasonably well. Such would not be the case for lenders because lenders, such as banks, earn a substantial portion of their revenues from non-mortgage-origination-related activities. Even mortgage banks -- the lender group that most focuses on single-family mortgages -- earn substantial revenue from servicing mortgages and from their secondary market activities, as well as from their multifamily and other businesses. Still, it would be interesting to relate the revenue transfers from the RESPA rule to available information about industry revenues.

#### **III.B.5.f.(1) Commercial Banks**

As discussed in Section B.1 above, it is estimated that commercial banks earned \$496.9 billion in 2004, with small businesses earning \$24.35 billion (4.9%) of that revenue. These revenue estimates can be compared with the expected revenue transfers from banks under the RESPA rule. As discussed in Section III.B.5.c above, projected transfers for lenders as a group are \$1.85 billion (11% savings rate) to \$2.35 billion (a 14% savings rate), assuming a 1.75% origination fee. As shown in Table 5-14, commercial banks are estimated to account for 36.8%-42.3% of lender retail originations. Assuming the low end (\$1.85 billion) of the transfer range for lenders, the commercial bank share of transfers would be \$0.680-\$0.782 billion; assuming the high end (\$2.35 billion) of the transfer range, the commercial bank share of transfers would be \$0.865-\$0.995 billion. Using the high-end transfer figure for all lenders (\$2.35 billion), the estimated revenue transfers for banks due to the GFE are 0.17%-0.20% of the \$496.9 billion of

bank revenues in 2004. These GFE transfers are based on \$2.4 trillion in mortgage originations; the transfers can be placed in the context of year 2004 by multiplying them by 1.15, which is equal to mortgage originations in 2004 (\$2.762 trillion) divided by projected mortgage originations (\$2.4 trillion). Thus, if the GFE had been in existence in 2004, transfers would have been 0.20%-0.23% of bank revenues. These revenue impacts would vary under different circumstances; for example, if the average origination fee were 2.0% (1.50%) instead of 1.75%, the revenue impacts would be changed by a factor of 1.14 (0.86). Thus, assuming the high-end transfer estimate, the revenue impacts for the new GFE on commercial banks would be \$0.777-\$0.894 billion with a 2.0% origination fee and \$0.583-\$0.670 billion with a 1.50% origination fee.

Under the GFE, projected transfers for small lenders are \$422-\$537 million (see Section III.B.5.c). In the base case, small banks account for 25.6% of these transfers from small lenders, or \$108-\$138 million. The estimated revenue transfers are 0.44%-0.57% of the \$24.35 billion in small bank revenues in 2004. Again, multiplying by 1.15 places the small bank transfers in the context of year 2004 (0.51%-0.66%). These revenue impacts on small banks would vary under different circumstances; for example, if the average origination fee were 2.0% (1.50%) instead of 1.75%, the revenue impacts would be changed by a factor of 1.14 (0.86). For estimates of the allocation of consumer savings of the GFE by size of firm, see Table A.2. In addition, Table A.2 shows estimates of the allocation of consumer savings per firm for the GFE.

### **III.B.5.f.(2) Savings Institutions or Thrifts**

As discussed in Section B.2 above, it is estimated that thrifts earned \$92.5 billion in 2004, with small businesses earning \$3.42 billion (3.7%) of that revenue. As noted above, projected transfers for lenders as a group are \$1.85-\$2.35 billion, assuming a 1.75% origination fee. As shown in Table 5-14, thrifts are estimated to account for 15.4%-17.4% of lender retail originations. Assuming the low end (\$1.85 billion) of the transfer range for lenders, the thrift share of transfers would be \$0.28-\$0.32 billion; assuming the high end (\$2.35 billion) of the transfer range, the thrift share of transfers would be \$0.36-\$0.41 billion. Using the high-end transfer figure for all lenders (\$2.35 billion), the estimated revenue transfers for thrifts due to the GFE are 0.39%-0.44% of the \$92.5 billion of thrift revenues in 2000. These GFE transfers are based on \$2.4 trillion in mortgage originations; the transfers can be placed in the context of year 2004 by multiplying them by 1.15.<sup>82</sup> Thus, if the GFE had been in existence in 2004, transfers would have been 0.45%-0.51% of thrift revenues. These revenue impacts would vary under different circumstances; for example, if the average origination fee were 2.0% (1.50%) instead of 1.75%, the revenue impacts would be changed by a factor of 1.14 (0.86). Thus, assuming the high-end transfer estimate, the revenue impacts for the new GFE on thrifts would be \$0.41-\$0.47 billion with a 2.0% origination fee and \$0.31-\$0.35 billion with a 1.50% origination fee.

Under the GFE, projected transfers for small lenders are \$422-\$537 million. In the base case, small thrifts account for 5.5% of these transfers from small lenders, or \$23-\$30 million.

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<sup>82</sup> The factor, 1.15, is equal to mortgage originations in 2004 (\$2.762 trillion) divided by projected mortgage originations (\$2.4 trillion).

The estimated revenue transfers are 0.67%-0.88% of the \$3.42 billion in small bank revenues in 2000. Again, multiplying by 1.15 places the small thrift transfers in the context of year 2004 (0.77%-01.01%). These are rather small effects; readers can gauge the effects of a larger share for small thrifts by adjusting the results reported for 5.5% share. Of course, the revenue impacts on small thrifts could vary for other reasons. For example, if the average origination fee were 2.0% (1.50%) instead of 1.75%, the revenue impacts would be changed by a factor of 1.14 (0.86). For estimates of the allocation of consumer savings of the GFE by size of firm, see Table A.2. In addition, Table A.2 shows estimates of the allocation of consumer savings per firm for the GFE.

### **III.B.5.f.(3) Independent Mortgage Banks**

Under the GFE, the projected transfers for lenders as a group are \$1.85-\$2.35 billion, assuming a 1.75% origination fee. As shown in Table 5-14, mortgage banks are estimated to account for 34.0%-41.6% of lender retail (non-broker) originations. Assuming the low end (\$1.85 billion) of the transfer range for lenders, the mortgage bank share of transfers would be \$0.628-\$0.768 billion; assuming the high end (\$2.35 billion) of the transfer range, the mortgage bank share of transfers would be \$0.800-\$0.978 billion. These revenue impacts would vary under different circumstances; for example, if the average origination fee were 2.0% (1.50%) instead of 1.75%, the revenue impacts would be changed by a factor of 1.14 (0.86). As discussed in Section B.3, the Census category (Real Estate Credit) that includes mortgage banks reports 9,502 firms with employees, which means that it includes firms in addition to the approximately 1,300 mortgage banks. Thus, it would be inappropriate to compare the revenue transfers under the new GFE with the revenue of the Real Estate Credit category. If revenue data were available for mortgage banks, the transfers associated with the new GFE would represent a much higher percentage of mortgage bank revenues than they did of commercial bank and thrift revenues. This is because mortgage bank revenue is more closely tied to mortgage origination activity than is either commercial bank or thrift revenue.

Under the GFE, projected transfers for small lenders are \$422-\$537 million. In the base case, small mortgage banks account for 65.1% of these transfers from small lenders, or \$275-\$349 million. As emphasized earlier, the mortgage bank share of projected small lender transfers is subject to some uncertainty. The base case just presented assumes that small mortgage banks originated \$146.8 billion in mortgages during 2005. While this base case of \$146.8 billion is probably reasonable, sensitivity analysis can be used to show the range of impacts for mortgage banks. If small mortgage banks had originated \$160.3 billion in 2005, and given the other assumptions of the base case (mainly the disaggregated share of stock approach in Table 5-11), small lenders would have accounted for 24.2% (instead of 22.8%) of mortgage originations by all lenders, and small mortgage banks would have accounted for 67.1% of originations by small lenders. In this case, projected transfers are \$447-\$569 million for small lenders and \$300-\$382 for small mortgage banks. These revenue impacts on small mortgage banks could vary for other reasons as well. For example, if the average origination fee were 2.0% (1.50%) instead of 1.75%, the revenue impacts would be changed by a factor of 1.14 (0.86). The revenue impacts on small mortgage banks would be \$314-\$398 (instead of \$275-\$349) million if origination fees are 2.0% and \$203-\$300 million if origination fees are 1.50%. For estimates of the allocation of consumer

savings of the GFE by size of firm, see Table A.3. In addition, Table A.3 shows estimates of the allocation of consumer savings per firm for the GFE.

### **III.B.5.f.(4) Credit Unions**

As discussed earlier, there were 8,801 credit unions in 2005 and the Census estimates that 7,900 (90%) of them qualify as a small business. Small credit unions account for 22%-32% of industry revenue, according to the Census Bureau. But as shown in Table 5-7, only 3,969 credit unions reported mortgage originations during 2005. These are the credit unions that are likely to be affected by the RESPA rule. HUD estimates that 78% (or 3,097) of these are small credit unions and that they account for 13.9% of industry mortgage originations.

Under the GFE, the projected transfers for lenders as a group are \$1.85-\$2.35 billion, assuming a 1.75% origination fee. As shown in Table 5-14, credit unions are estimated to account for 6.3% of lender retail originations (including credit unions). The credit union share of transfers would be \$0.116-\$0.148 billion.<sup>83</sup> While most credit unions are not engaged in mortgage activity, one can still compare the transfer estimates with industry revenue. Based on Census Bureau data, it is estimated that industry revenue was \$44.8 billion during 2004. The estimated revenue transfers (\$0.116-\$0.148 billion) for credit unions due to the GFE are 0.26%-0.33% of the \$44.8 billion of credit union revenues in 2004. These GFE transfers are based on \$2.4 trillion in mortgage originations; the transfers can be placed in the context of year 2004 by multiplying them by 1.15 (see above). Thus, if the GFE had been in existence in 2004, transfers would have been 0.30%-0.38% of credit union revenues.

Under the GFE, projected transfers for small lenders are \$422-\$537 million. As shown in Table 5-14, small credit unions account for 3.7% of the transfers from small lenders, or \$16-\$20 million. The estimated revenue transfers are 2.92%-3.72% of the \$14.430 billion in small credit unions revenues in 2004. Again, multiplying by 1.15 places the small credit union transfers in the context of year 2004 (3.36%-4.28%). These revenue impacts on small credit unions would vary under different circumstances; if the average origination fee were 2.0% (1.50%) instead of 1.75%, the revenue impacts would be changed by a factor of 1.14 (0.86). For estimates of the allocation of consumer savings of the GFE by size of firm, see Table A.3. In addition, Table A.3 shows estimates of the allocation of consumer savings per firm for the GFE.

For a discussion of the competitive impacts of the RESPA reform on lenders, see Section VIII.B of Chapter 3. See Chapter 6 for a description of the compliance costs and regulatory burden of the rule.

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<sup>83</sup> These revenue impacts on small mortgage banks could vary for several reasons. For example, if the average origination fee were 2.0% (1.50%) instead of 1.75%, the revenue impacts would be changed by a factor of 1.14 (0.86).

### **III.B.5.g. Workers Engaged in Mortgage Origination Activity at Lender Firms**

Chapter 6 examines compliance costs and regulatory burden associated with the RESPA rule. The number of employees engaged in mortgage origination activity is needed for that analysis, for example, to estimate the number of employees that would need to be trained in the new RESPA rule. Employment data for banks, thrifts, and credit unions were reported earlier in Sections III.B.1, III.B.2, and III.B.4, respectively. The problem with those data is that a substantial portion of bank, thrift, and credit union employees are not engaged in mortgage origination activities – thus, using those data would substantially overstate the number of employees affected. As explained in Section III.B.3, data for mortgage banks are included in the much larger “Real Estate Credit” industry, which means that estimates of workers employed by mortgage banks are not available from that source. Thus, some method is needed to estimate the number of lender employees that are engaged in mortgage origination activities.

Section II.B.3 discussed estimates of the “the average number of loans originated per employee in the broker industry” – one being 20 loans per employees based on Olson’s 2004 survey and approximately 23 (22.7) loans per employee based on Olson’s 2002 survey. This section applies these and other estimates to the projected originations of commercial banks, thrifts, and mortgage banks, and credit unions in order to estimate the number of employees working on origination activities in these industries. While the method is subject to a number of caveats, it provides a starting point for examining the compliance and regulatory impacts that are related to the number of employees. The following steps are involved in developing the estimates.

(1) Section II.B.3 projects that brokers originate 20 loans for each worker they employ, based on Olson’s 2004 survey. As a starting point, the analysis below will assume that lenders also originate at 20 loans per worker but will also consider lower (18) as well as higher estimates (23). The lower lender estimate (18) is consistent with the widely held belief that brokers are more efficient than lenders and also errs on the side of including more employees, which seems preferable to estimating too few employees being affected by the RESPA rule. The higher lender estimate (23) reflects Olson’s 2002 estimate for brokers. Sensitivity analyses can show the effects of alternative assumptions.

(2) Lenders are expected to originate \$960 billion of the projected \$2,400 billion in mortgage originations; in terms of the number of loans, lenders are expected to originate 5,000,000 of the 12,500,000 mortgages originated. As explained in Section III.B.5.d, these loans can be distributed based on the Adjusted Distribution or the HMDA Distribution (in parenthesis) as follows: (a) 7,402 commercial banks, 1,895,141 (2,104,947) mortgages; (b) 1,279 thrifts, 702,811 (745,528) mortgages; (c) 1,287 mortgage banks, 1,958,443 (1,705,920) mortgages; and (d) 3,969 credit unions, 443,605 (443,605) mortgages.

(3) As estimate of “20 loans per employee” would yield 250,000 lender (non-broker) employees originating mortgages. Applying the 20 average to (a)-(d) yields the following estimates of employees engaged in mortgage origination activity (i.e., at the retail level) for the four lender groups: (e) commercial banks, 94,757 (105,247); (f) thrifts, 35,141 (37,276); (g) mortgage banks, 97,222 (85,296); and (h) credit unions, 22,180 (22,180) – for a total of 250,000 employees. The 94,757 (105,247) employees for banks represent 5.8% (6.4%) of total bank

employment (1,631,328) during 2004. The 35,141 (37,276) employees for thrifts represent 14.1% (15.0%) of total thrift employment (248,962) during 2004. Employment data are not available for mortgage banks, as well as for credit unions that originate mortgages.

(4) As discussed in Section III.B.5.a, there are 4,426 small banks, 641 small thrifts, 1,077 small mortgage banks (in base case), 3,097 credit unions, or 9,241 small lenders. As explained in Section III.B.5.d, it is estimated that these small lenders, as a group, account (in the base case) for 29.3% of all mortgage loans originated by lenders. Section III.B.5.d also reported the small business shares of mortgages for each of the four industries. The following small business shares are based on the Adjusted Distribution of mortgages: (i) 25.8% for commercial banks; (j) 11.2% for thrifts; (k) 40.8% for mortgage banks; and (l) 21.9% for credit unions. As explained in Section II.B.3, these “shares of originations” can be used as a proxy for “shares of employees.” Applying these percentages to the Adjusted Distribution figures in (e)-(h) suggests that the following numbers of employees in small firms: (m) 24,446 for commercial banks; (n) 3,921 for thrifts; (o) 39,974 for mortgage banks; and (p) 4,858 for credit unions. Thus, it is estimated that 73,198 workers<sup>84</sup> are employed in mortgage origination activity by the small banks, small thrifts, small mortgage banks, and small credit unions.

(5) There is a degree of uncertainty with the above estimates – in addition to the issues discussed above in Section III.B.5.d concerning the overall size of the non-broker share and the difficulty of allocating non-broker originations among different lender groups, there is the issue of whether the “20 employees per worker” is appropriate for lenders. As discussed in Section II.B.3, the average number of loans per worker in the broker industry was approximately 23 in 2002. It also may be appropriate to use a smaller number for lenders such as “18 employees per loan”. In addition to the uncertainty due to the variation of this figure within the broker industry, there is also the uncertainty associated with applying a relationship from the broker industry to the lender industry. Sensitivity analysis can be used to show the effects of alternative assumptions. If the broker average (23 loans per worker) were used instead of 20, the estimated number of employees engaged in origination activity in the lending (non-broker) industry would be 217,391 employees. If a smaller average (say 18) were used, the estimated number of employees engaged in origination activity in the lending (non-broker) industry would be 277,778 employees. In these two cases, employees in small lender firms would total 63,651 and 81,331, respectively (assuming that the small lender share is 29.3%).

There is also the issue of the overall volume of mortgage activity. Projecting a higher origination volume of 15,500,000 (instead of 12,500,000) and assuming 20 loans per worker would increase the number of lender (non-broker) loans to 620,000 and the number of employees to 310,000, assuming the lender market share remained at 40 percent. If the lender share dropped to 35 percent (more consistent with recent high volume origination years), then the number of lender (non-broker) loans would rise moderately from 5,000,000 to 5,425,000 and the number of employees from 250,000 to 271,250. In this case, employees in small lender firms would total

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<sup>84</sup> 73,198 non-broker employees in small firms divided by 250,000 total non-broker employees gives the overall small business percentage of 29.2793% (which is the 29.3% reported in the text).

79,420 (assuming that the small lender share is 29.3%). If 23 loans per worker were used,<sup>85</sup> the number of employees engaged in mortgage origination activity would be 269,569 assuming a 40-percent lender origination share and 235,870 assuming a 35-percent-lender origination share. In these two cases, employees in small lender firms would total 78,983 and 69,110, respectively (assuming that the small lender share is 29.3%).

#### **IV. Settlement and Title Services**

Section IV.A provides an overview of the title insurance industry, including a review of the literature on market issues related to the title industry. Section IV.B then presents Census Bureau data on the economic characteristics of each of the four industry sectors: title and settlement agents (B.1), lawyers (B.2), escrow firms (B.3), and large title insurers (B.4). The Census Bureau data are important because they report the proportion of each title and settlement group that is small business. Section IV.B.5 includes several technical analyses related to estimating (a) the share of industry revenue among the separate title and closing-related sectors and (b) the small business share of revenue for the title industry as a whole. That section compares Census and industry data, derives the revenue share for each of the four title and settlement groups, and describes the consumer savings and revenue transfers under the new GFE for each group (including transfers from small firms).

The American Land Title Association (ALTA) claims there are no significant potential savings in title-related fees. This Regulatory Impact Analysis disagrees with ALTA. Readers are referred to Section V.B of Chapter 2 for anecdotal and statistical evidence that title fees can be reduced. That more detailed discussion in Chapter 2 is summarized in Step (8) of Section VII.E.1 in Chapter 34. As discussed in Chapter 2, there is substantial evidence that title, closing, and other settlement fees can be reduced.

#### **IV.A. Overview of Industry**

Residential real estate transactions are consummated at settlement. Settlement is where sellers actually convey their property to buyers and where loan documents are executed. In the absence of rescission, transactions are final at the end of the settlement process. Settlement agents orchestrate the settlement process. In some parts of the country settlement agents are usually attorneys; in other parts they are not. In California and other Western states, settlement agents are commonly referred to as escrow agents. Clients are frequently referred to settlement agents by loan originators and real estate agents, but this is not always the case.

The range of specific services provided by settlement agents varies widely. At a minimum, settlement agents facilitate the consummation of transactions by performing a variety of clerical functions. One such clerical function is the assembly of documents provided by various other parties for review and signature. For example, in routine sales transactions,

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<sup>85</sup> Based on Olson's survey data, the number of loans per worker in the broker industry increases during higher volume years such as those characterized by high levels of refinance activity. Thus, it may be appropriate to consider even higher "loan per worker" figures.

settlement agents may amend a generic deed to reflect the details of the conveyed property and conveyor. As a further example, after receiving loan documents from lenders, settlement agents explain the documents to borrowers and show borrowers where to sign. A second clerical function performed by settlement agents is arranging the collection and disbursement of monies from various parties including lenders, real estate agents, purchasers and sellers. In addition to these clerical functions that settlement agents almost always perform, there are many other functions settlement agents frequently perform as part of the settlement process.<sup>86</sup> Most of these additional functions relate to establishing title and can be categorized as title services. The extent to which settlement agents perform various title services varies widely across the states and even within states. Title services often performed by settlement agents include title research and examination, arranging the purchase of title insurance, and title insurance sales. Title services often performed by settlement agents also include underwriting title insurance and occasionally participating in the maintenance of private repositories of title records known as title plants. Since title services constitute an important component of the bundle of services provided by many settlement agents, it is useful to more fully describe what title services entail.

In order to convey real estate, one must have title to it. In simpler language, in order to sell real estate, one must own it. Purchasers of real estate should make sure that the seller actually owns what is being sold. Furthermore, purchasers should verify that the property they are buying is not encumbered by undeclared liens or problematic easements. Moreover, real estate lenders usually require these verifications.

The first step in making these verifications is to perform a title search. The American Land Title Association (ALTA) describes a title search as follows: “A title search includes examining records in the offices of recorders or registers of deeds, clerk of courts and other municipal and county officials, or similar records housed in a title company’s ‘title plant’.”<sup>87</sup> In general, for every real estate transaction requiring settlement, settlement agents either perform a title search themselves, or cause a title search to be performed by another party. In cases where the title search is performed by another party, it is commonly performed by a party called an abstracter. The abstracter produces a report, routinely called an abstract, which summarizes the history of the property “including all conveyances, interest, liens, and encumbrances that affect title to the property.”<sup>88</sup>

The results of the title search are used to assess the title’s marketability. This assessment is not an ultimate, unequivocal determination of marketability because there are a variety of problems that can affect marketability that are not shown in public records.<sup>89</sup> These problems may include forged deeds, claims against a property by a previously undisclosed heir, recording

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<sup>86</sup> Because many settlement agents are experts in real estate issues, there are many functions that they may perform that are related to real estate, but are not directly part of the settlement process. For example, a settlement agent who is a real estate attorney may be involved with zoning petitions. Such activity is not part of the ordinary settlement process.

<sup>87</sup> ALTA, “Facts About Title Insurance,” [http://www.alta.org/govt/issues/02/respack\\_1108e.htm](http://www.alta.org/govt/issues/02/respack_1108e.htm).

<sup>88</sup> *Blacks Law Dictionary*, Seventh Edition, 1999, page 9.

<sup>89</sup> The determination can be ultimate and unequivocal under the Torrens System; however, the Torrens System is only very rarely used in the United States.

errors, and mechanics liens which were not recorded at the time the title search was performed. Because marketability cannot be unequivocally known, real estate lenders generally require title insurance.<sup>90</sup> ALTA describes title insurance as insurance that “provides protection against problems affecting real estate titles.”<sup>91</sup> There are two types of title insurance: lender’s insurance and owner’s insurance. Lender’s insurance protects the lender in the event that a title problem surfaces; lender’s insurance remains in force until the insured lender’s lien is removed, either because the property is sold or because it was refinanced. Owner’s insurance protects the owner’s equity in the event that a title problem surfaces. Title insurance is typically required by lenders in both purchase and refinancing transactions; premiums can be substantially lower in the case of refinancing. A key reason why premiums are lower in the case of refinancing is that the title search process is frequently less exhaustive than it is with purchases. As discussed below, some private firms are beginning to experiment with less expensive alternatives to title insurance.

Title insurance is issued by regulated insurance carriers. Title insurance carriers are generally large, “monoline” companies that specialize in issuing title insurance policies. As insurance carriers, title insurers are generally exempt from federal prohibitions against collusive activity by the McCarran-Ferguson Act. In exchange for receiving this exemption, the carriers are subject to regulation by state insurance commissions. The state insurance commissions generally seek to ensure that rates are not unfairly discriminatory, excessive, or inadequate. Premiums must be sufficiently large, or adequate, to ensure that the insurer will be able to satisfy future claims without being bankrupted. Various states impose assorted regulatory requirements on title insurance carriers. The carriers are heavily regulated in some states, lightly regulated in others. Title insurance rates are promulgated by some state insurance commissions, but it is more common for carriers to propose rates. In some states proposed rates can be used only after explicit approval from the insurance commission; in other states rates can be used without explicit approval. In these some states, title insurance carriers must allow the insurance commission a certain amount of time to review the proposed rates before the proposed rates can actually be charged.

Data from the 2002 Economic Census indicate that the eight largest Direct Title Insurance Carriers account for 87.8% of the sector’s revenue. Large title insurance carriers include LandAmerica (which owns the Commonwealth Land Title Insurance Company, the Lawyers Title Insurance Company, and the Transnation Title Insurance Company), Fidelity National Financial (which owns Fidelity National Title and Chicago Title), Stewart Title, First American Title Insurance, and Old Republic Title. Title insurance carriers sell their insurance through both retail outlets that they directly own in part or in whole, and independent sales agents widely known as “title agents.” In 2006, 61% of title insurance sales were channeled through non-affiliated title insurance agents.<sup>92</sup>

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<sup>90</sup> Home equity lenders generally do not require title insurance and some lenders are willing to accept title insurance alternatives as discussed below.

<sup>91</sup> ALTA, “Facts About Title Insurance” [http://www.alta.org/govt/issues/02/respack\\_1108e.htm](http://www.alta.org/govt/issues/02/respack_1108e.htm).

<sup>92</sup> ALTA, “2006 Market Share by Family and States” [http://www.alta.org/industry/06\\_ALL/2006\\_market\\_famstate-dis.xls](http://www.alta.org/industry/06_ALL/2006_market_famstate-dis.xls).

Settlement agents arrange to have title insurance purchased on behalf of lenders and owners. In addition to arranging the purchase of title insurance, settlement agents frequently arrange its sale. Settlement agents who double as title agents can sell directly. Alternatively, settlement agents can sell title insurance indirectly through affiliated business arrangements. For example, a settlement agent may purchase title insurance from a spouse or other close family member. Some settlement agents do not sell title insurance, either directly or indirectly. These settlement agents purchase title insurance from title agents with whom they have no affiliation other than that of being a customer.

ALTA reports that title insurance premiums “go towards searching, examining and maintaining title records [i.e. title plants], resolving or clearing title defects, attorney fees and other costs associated with defending a lender or homeowner against title-related issues, and the payment of actual claims.”<sup>93</sup> Many of these costs relate to underwriting; the costs of searching, examining, and maintaining records are underwriting costs. Title insurance carriers bear these underwriting costs when they sell their policies to lenders and homebuyers directly, without the use of an independent title agent, and when they sell their policies through “limited-service agents” whose primary role is that of marketing title insurance products.<sup>94</sup> In general, when title insurance carriers do not sell directly and do not use limited-service agents, they do not bear the costs of underwriting. Rather, the carrier’s agent does the underwriting and is compensated for doing so by means of a sales commission. Sales commissions constitute about half of the total expenses incurred by title insurers.<sup>95</sup>

As with most insurance, title insurance is frequently sold by agents who are compensated through sales commissions that are based on the premiums the agent generates. Typical commission rates for property and casualty insurance are approximately 20% of gross premiums. Commission rates for title insurance are much higher, approximately 80% gross premiums.<sup>96</sup> Most states do not regulate title insurance commission rates.<sup>97</sup> There are two explanations for this difference in commission rates. First, title insurance agents do perform costly underwriting tasks for which they must be compensated. Second, title insurance carriers do not market their products directly to their customers; rather, they market them to their sales agents, otherwise known as title agents. This practice is akin to the “reverse competition” that pervades the credit insurance industry and is blamed for causing excessive rates.<sup>98</sup> Competition for title agents leads title insurance carriers to increase the commissions they pay to title agents. Lipshutz describes this practice as follows:

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<sup>93</sup> ALTA, “Facts About Title Insurance,” [http://www.alta.org/govt/issues/02/respack\\_1108e.htm](http://www.alta.org/govt/issues/02/respack_1108e.htm).

<sup>94</sup> Lipshutz describes limited-services agents as follows: “The idea here was that an insurer could retain an agent whose sole function was to market (quaintly dubbed ‘solicit’ in [Pennsylvania’s] enabling statute) title insurance, pay that agent a reduced commission, and conduct the insurance functions itself or through one of its full-service agents. Various objections to this form of commission as a thinly disguised kickback have been raised over the years, and its popularity has waned.” Lipshutz, *The Regulatory Economics of Title Insurance*, p. 41.

<sup>95</sup> Lipshutz, *The Regulatory Economics of Title Insurance*, p. 35.

<sup>96</sup> Lipshutz, *The Regulatory Economics of Title Insurance*, p. 37.

<sup>97</sup> The exceptions are Connecticut, Florida, New Mexico, South Carolina, and Texas.

<sup>98</sup> Consumers Union, *Credit Insurance: The \$2 Billion a Year Rip-Off*, 1999.

[T]he relationship between local real estate professionals and the remote title insurer head office remains tenuous at best. Accordingly, customer loyalty runs primarily to the producer [i.e. title agent], not the insuring company as such, and so competition among insurers for established producers is intense...and in the competition to attract these agents, the primary competitive tool is the commission rate. As institutional loyalties throughout the country have eroded, switching among insurers by agents has become more common and has led to the perception that the prevailing commission rates have crept upward.

Title insurance commissions add substantially to the cost of real estate settlement (also see discussion in Chapter 2). According to a survey of title insurance rates in a California, insurance companies are quoting rates averaging approximately \$750 for a \$250,000 refinancing.<sup>99</sup> Assuming a commission rate of 80%, as suggested by Lipshutz, the sales commission received by title agent on this policy is \$600.<sup>100</sup> The title agent is frequently also the settlement agent. Unless the settlement agent purchases the insurance through an unaffiliated title agent, this \$600 commission provides the settlement agent, or his business affiliate, with additional income that is not itemized at settlement on the HUD-1 and is seldom otherwise disclosed to the borrower.

In addition to potentially receiving income from title insurance sales commissions, settlement agents can receive income through assessing a variety of different charges on purchasers, sellers, and refinancers. In many cases the largest fee levied by settlement agents is billed as either an “attorney fee” or “settlement fee” or, in the case of California, an “escrow fee.” These fees are frequently supplemented with fees such as “document preparation fees,” “notary fees,” “endorsement fees,” and other miscellaneous fees. If the settlement agent hired an abstracter, the settlement agent will likely charge an “abstract fee.” Many of these fees compensate the settlement agent for specific expenses incurred. Such is the case when a settlement agent passes through the cost of obtaining an abstract.

While title insurance commissions are higher than those associated with most other types of insurance, loss payments are relatively small. In 2001 the industry paid claims totaling 4.7% of revenue; between 1992 and 2001 claims averaged 5.2% of revenue. In contrast, the corresponding figures for property and casualty insurers paid claims of 87.3% and 79.6%.<sup>101</sup> The American Land Title Association (ALTA) explains the low pay-out rates as follows:

Title companies make substantial efforts to correct and eliminate all problems before insuring. That’s why most homeowners don’t have to experience title problems. To use an analogy, saying that low claims means we don’t need title insurance is like

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<sup>99</sup> Consumers Union, *California Title Insurance Rates Remain High*, 2003.

<sup>100</sup> As explained in a recent article, Ken Harney quotes James R. Maher of the American Land Title Association (ALTA) as saying the average national “split” of the premium charged at closings is 70-72 percent to the title or settlement agency, and the balance to the title insurance company. The splits go as high as 92.5 percent to the agent or attorney and just 7.5 percent for insurance, according to Maher. See Kenneth R. Harney, “How to Save 50 to 60 Percent on Title Insurance When Refinancing,” *Realty Times*, June 17, 2002.

<sup>101</sup> A.M. Best, *A.M. Best Special Report: Title Insurance and Industry Statistics – 2001*, 2002.

saying that you don't need to sterilize the equipment in a hospital operating room because of the low incidence of infections.<sup>102</sup>

An ALTA press release quotes ALTA President James R. Maher stating “the title industry spends more than 10 times the amount it pays in claims to perform title searches and cure these title problems to avoid claims.”<sup>103</sup> The same press release suggests title problems arise in one out of every four real estate transactions, but does not describe what the most common problems are or how much effort or expense is needed to resolve them.

Individual settlement and title service providers tend to work within relatively small geographic territories. These territories may frequently encompass no more than several counties. According to the 2002 ALTA survey 67% of Abstracters and Title Agents operate in just one county. Only 16% of them operate in three or more counties. A key reason for this is that service providers need to have a detailed understanding of local settlement practices and how they vary across individual counties, cities, and towns. Furthermore, individual settlement and title service providers frequently need to physically travel to various local government offices and title plants to perform title research and record deed and liens.

Direct title insurance carriers are increasingly investing in computerized title plants and many government recording offices are also moving towards digitized title records. Technological advances have caused the need for physical travel to decline over recent years. As technology continues its advance, it is expected that the need for physical travel will decline even further. In a report on direct title insurance carriers, the insurance rating agency A.M. Best stated,

The acquisition and maintenance of title plants is gradually becoming more cost effective as the business becomes more computerized. Modern title insurance companies feature the computerization of order taking, title search and examination, and policy issuance. These advances have permitted companies to dramatically increase premium volume capacity with only a modest increase in personnel. This capability not only enhances the profitability of the title company, but also makes it easier to manage expenses during slow real estate markets.<sup>104</sup>

Providers of settlement and title services are represented by a variety of state and national industry organizations. The most prominent national organization is ALTA. ALTA's membership is composed of 2,400 title insurance companies, their agents, independent abstracters and attorneys who search, examine, and insure land titles. Many of these companies also provide additional real estate information services, such as tax search, flood certification, tax filing, and credit reporting services. A second major national organization is the American Bar Association Section of Real Property, Probate, and Trust Law. A small sample of the state

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<sup>102</sup> www.alta.org.

<sup>103</sup> www.alta.org.

<sup>104</sup> A.M. Best, *A.M. Best Special Report: Title Insurance and Industry Statistics*, 2000, p. 11.

organizations includes the Escrow Institute of California, the New York Land Title Association, and the Massachusetts Conveyancers Association.

#### **IV.A.1. Reports on the Title Industry**

There are several reports examining various aspects of the title industry. Key findings of these reports are summarized below.

**ALTA Abstracter and Title Agent Operations Survey: 2002.** This survey was conducted by Fetzer-Kraus on behalf of ALTA and queried select ALTA members regarding key aspects of their firm. Specifically ALTA members that were either abstracters or title agents were queried. There were 286 respondents. The respondents were not geographically representative of the distribution of the nation's population or mortgage market. A relatively large number of responses were obtained from the West North Central region; relatively few responses were obtained from New England and the Pacific region. Key finding from the survey include:

- Gross revenue and number of orders received are highly correlated. 71% of companies that received fewer than 500 orders in 2001 reported revenue of less than \$250,000.
- 82% of respondents reported revenue from title insurance. Among these companies, sales of title insurance policies accounted for an average of 63% of 2001 total revenue.
- 74% of respondents reported revenue from escrow and closing functions. Among these companies, escrow and closing function revenue averaged 22% of 2001 total revenue.
- 56% of respondents reported revenue from abstracts. Among these companies, abstracts accounted for an average of 43% of 2001 total revenue.
- 6% of respondents reported revenue from practicing law. Among these companies, revenues from practicing law accounted for an average of 27% of total 2001 revenue.
- One-fourth of respondents reported having three or fewer full-time employees. One-fourth of respondents reported fifteen or more fulltime employees.
- One-third of respondents wrote business for only one title insurance carrier in 2001. Another 23% of companies wrote business for two insurers.

**A.M. Best Special Reports on the Direct Title Insurance Carriers.**<sup>105</sup> These annual reports provide an industry overview and current and historical financial details about the title

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<sup>105</sup> A.M. Best, *A.M. Best Special Report: Title Insurance and Industry Statistics – 2001, 2002.*

insurance industry. Unlike the ALTA report discussed above, which focused on title agents and abstracters, these reports focus on direct title carriers. Highlights from the most recent report include

- Largely because of low mortgage rates and the high level of refinancing, the title industry experienced its sixth consecutive year of profitability in 2001.
- The title industry has unique characteristics compared with property/casualty insurers. Title insurance revenue is more volatile and reflects regional and national economic conditions. The industry's revenues are largely tied to mortgage rate trends, but the industry's cost structure is relatively fixed.
- The industry is evolving rapidly because of consolidation through mergers and acquisitions, entry into new lines business and international expansion.
- Both property / casualty insurers and title insurers must physically produce policies, but the processes and requirements have significant differences. A typical property/casualty policy might involve filling out a few blanks on a form, while the title policy might require the transcription of a complex legal description unique to the insured property.
- In property and liability insurance lines, agents' commissions are generally in the range of 10% to 25% of premium on policies that agents write. In title insurance, the agent retains a much larger proportion of the amount charged. Arguably, because of the high level of effort title agents put into underwriting, commissions for title agents should be more properly described as agent's retention or agent's labor or work charges.
- The title insurance activity of search and examination generally is carried out locally, because the public records to be searched are usually only available locally. This activity might be done by directly owned branch operations or title agents.
- The typical property/casualty insurance company operates with a loss and loss-adjustment expense ratio between 60 and 80 percent depending on its lines of business. This compares with a typical title insurance company's loss and loss-adjustment expense ratio of 5 to 10 percent.

**Industry Report Card: US Mortgage and Title Insurers.**<sup>106</sup> This Standard and Poor's report examines not only the title industry in general, but also investigates specific firms.

- In contrast with the mortgage insurance market, the title insurance market excels when mortgage rates decline. While refinancing frequently results in the

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<sup>106</sup> Standard and Poor's, *Industry Report Card: U.S. Mortgage and Title Insurers*, 2003.

cancellation of mortgage insurance, it results in issuance of additional title insurance.

- Title insurers have been expanding into other product-lines, many of which are related to real estate. Regardless of the level of revenue generated from nontitle segments, however, much of it is real estate related and therefore sensitive to interest rates.
- Title companies have sought to rationalize expenses through investments in infrastructure and information technology.
- Some title insurers have increased their direct sales operations by increasing investments in personnel and infrastructure to meet the increasing title order volume associated with the currently low interest rates.
- S&P concludes that HUD’s proposed RESPA rule “could place downward pressure on title rates.” (page 2)

**Government Reports.** The GAO<sup>107</sup> examined in more detail issues which had been previously raised (in an earlier GAO report) as worthy of further study, concerning the nature of competition in the title insurance industry and the impact on consumers. Section V.B.2 of Chapter 2 contains a full review of this report.

#### **IV.A.2. Radian Lien Protection**

Although it ultimately was disapproved and not allowed to go forward, the recent attempt by Radian to offer a less expensive title insurance product is an interesting case study about the title industry. Therefore, it is summarized below.

Some private sector financial institutions believe title insurance premiums are too high. Against considerable opposition from existing title insurers, Radian Guaranty introduced a title insurance alternative called Radian Lien Protection (RLP). RLP was designed to take the place of traditional lenders’ title insurance. Radian claimed its lien protection product was comparable to traditional title insurance, but cost several hundred dollars less. Specifically, Radian stated:

Radian Lien Protection was developed as an innovative, cost-saving product that can reduce closing costs by more than 50 percent on refinances, second mortgages and home equity loans. A mortgage insurance pool policy, Radian Lien Protection is designed to provide coverage for a range of losses arising from defaults, including losses due to undisclosed liens.<sup>108, 109</sup>

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<sup>107</sup> U.S. General Accountability Office, *Title Insurance: Actions Needed to Improve Oversight of the Title Industry and Better Protect Consumers* (Report to the Ranking Member, Committee on Financial Services, House of Representatives), April 2007.

<sup>108</sup> [http://www.radiangroupinc.com/RadianGroup/MortgageInsurance/RadianGuaranty/products/mi\\_products\\_radianlien.asp](http://www.radiangroupinc.com/RadianGroup/MortgageInsurance/RadianGuaranty/products/mi_products_radianlien.asp)

<sup>109</sup> Unlike traditional title insurers, Radian would not have attempted to correct any title problems that it discovered.

Radian believed its lien protection product could save consumers an estimated \$3 billion per year.<sup>110</sup> After selling its product for a brief period prior to receiving explicit regulatory approval from any state insurance commissioner, Radian suspended sales pending explicit regulatory approval.<sup>111</sup> Prior to its suspension, about half a dozen lenders have used RLP and the investment banking firm Lehman Brothers accepted RLP as an alternative to title insurance on asset-backed and mortgage-backed securities. Fannie Mae was also reportedly “looking at” alternatives to traditional title insurance.<sup>112</sup> Both the Community Financial Resource Center and the National Community Reinvestment Coalition supported Radian’s efforts to reduce the cost of title insurance.

The mechanics of the RLP have been described as follows:

RPL is a form of mortgage guaranty pool insurance pool insurance with additional coverage for mortgage defaults involving undisclosed liens. Coverage for loans insured with RLP is intended to provide 100% of the lender’s loss upon a borrower default up to a per loan limit of \$650,000. Additionally, the total aggregate amount of coverage for mortgage guaranty losses for a lender’s pool of loans is equal to 0.01% of the total aggregate sum of loan balances delivered under the policy. The total aggregate amount of coverage for losses from undisclosed liens on a lender’s pool of loans is equal to 0.5% of the total aggregate sum of loan balances delivered under the policy....Radian would offer RLP as an alternative to lenders title insurance in only certain situations: 1) for home refinancings, 2) for second liens, and 3) for home equity loans. In the purchasing of properties, the primary option for lenders would continue to be traditional lenders title insurance.<sup>113</sup>

RPL proved to be quite controversial and the subject of two expert technical analyses. One of these analyses was very much in favor of RPL; the other was very much against it.

Liu finds that RPL could save refinancing borrowers in California an average of \$272 dollars. He estimates that for mortgages under \$650,000, the average refinancing title insurance was \$548 in 2001, and the average RPL fee would have been \$276. Applying the average saving of \$272 to certain assumption regarding future mortgage activity in California, Liu estimates that RPL could increase consumer surplus in the state by at least \$1.38 billion. Liu finds nothing negative associated with RPL.<sup>114</sup>

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<sup>110</sup> *The Legal Description*, April 1, 2002.

<sup>111</sup> The Radian Group Inc. failed to get regulatory approval to sell Lien Protection in California. In July, 2003, the head of California’s Department of Insurance, John Garamendi, upheld a ruling barring Radian from offering the product in California. See Jody Shenn and Erick Bergquist, “Clearer Signs of Shakeout in the Mortgage Business,” *American Banker*, January 5, 2004, pp. 1, 18.

<sup>112</sup> *The Legal Description*, May 16, 2002.

<sup>113</sup> Paul Liu, “The Increase in Consumer Surplus From Radian Lien Protection: The California Market,” 2003.

<sup>114</sup> Paul Liu, “The Increase in Consumer Surplus From Radian Lien Protection: The California Market,” 2003.

In sharp contrast, Lipshutz argues that consumers would actually pay more for RPL than they would for traditional title insurance. He states that Liu's calculations were not based on the discounted rates that many California title insurers offer to many refinancing borrowers under certain circumstances. For example, Lipshutz states that California title insurers offer lower rates in conjunction with electronic order submissions. He argues that if Liu considered currently existing discounts such as the electronic order submission discount, then he would have found that traditional title insurance costs between \$25 and \$50 less than RLP, depending on the insured amount. Lipshutz also argues that the adoption of RLP would slowly damage the quality of title records because these records would be searched, and corrected, less often. Lipshutz further argues that the adoption of RLP would hinder efforts to collect child support payments from delinquent parents because homes encumbered by child support could be refinanced even if the lien is not removed.<sup>115</sup>

Interestingly, Fidelity National Financial, the nation's largest title insurance carrier, was planning to offer a new insurance product that essentially mimicked RLP and cost as little as \$275 per transaction.<sup>116</sup> This suggested that when confronted with the possibility of competition, title insurers can reduce the cost of their products. Fidelity's action was also interesting given the vigorous resistance the title industry exhibited towards Radian's product. While Ernest Smith of Fidelity believed the firm's new product was not suitable in every situation, according to Jody Shenn of American Banker, Smith believed that the new product made sense for certain lenders, particularly those planning to self-insure against title risk or refinancing existing loans.<sup>117</sup>

#### **IV.A.3. Literature Review of Market Issues in the Title Industry**

Chapter 2 provides a thorough literature review of market issues in the title industry. Rather than repeating that review here, readers are referred to section V.A of Chapter 2.

#### **IV.A.4. Can Title Fees Be Reduced?**

Chapter 2 discusses the issue of whether there is any "fat" or excess in title fees; that is, is there any potential for the new GFE to reduce title fees? While all third-party fees are the subject of that discussion, the focus is on title and settlement fees, which make up the bulk of third party fees.<sup>118</sup> ALTA claims there are no significant potential savings in title-related fees.

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<sup>115</sup> Nelson Lipshutz, "Consumer Impacts of Substituting Radian Lien Protection Coverage For Refinance Lender's Title Insurance," 2003

<sup>116</sup> According to *Inside Mortgage Finance*, unlike RLP, the Fidelity National Financial product would not have required the borrower to certify that no liens had been placed on the financed property and would not have required the borrower to be sufficiently creditworthy. *Inside Mortgage Finance*, June 6, 2003, page 9.

<sup>117</sup> Jody Shenn, "Title Insurer Transforms Debate Over Lien Policies", *American Banker*, June 18, 2003, page 1.

<sup>118</sup> As explained in Chapter 3, this analysis uses \$1,435 as the cost of closing and title services, based on industry data; this \$4,435 represents 72.5% of all third party fees. A Progressive Policy Institute report (see Ham and Atkinson, 2003) estimated typical closing and title costs on a \$150,000 home purchase to be \$1,650 (consisting of \$350 for title search, \$800 for title insurance, and \$500 for settlement fees); no source was provided for this estimate. Title and closing fees averaged \$1,336 in 2001 based on FHA data. The 2006 Bankrate survey reported \$1,256 in title and closing fees.

This Regulatory Impact Analysis disagrees with ALTA. Readers are referred to Chapter 2 for both anecdotal, industry, and statistical evidence on this issue. As discussed in Chapter 2, there is substantial evidence that the title industry is non-competitive and that title, closing, and other settlement fees can be reduced. This Regulatory Impact Analysis reviews studies showing the existence of relatively high fees and a wide variability of prices in this industry.

Rather than repeating that discussion here, readers are referred to Section V.B of Chapter 2 for evidence that title fees are excessive and can be reduced. That more detailed discussion in Chapter 2 is summarized in Step (8) of Section VII.E.1 in Chapter 3.

## **IV.B. Description of Economic Data**

The National Technical Information Service of the Bureau of Commerce classifies most settlement and title service providers in one of four possible categories: Title Abstract & Settlement Offices (NAIC 541191), Offices of Lawyers (NAIC 541110), Direct Title Insurance Carriers (NAIC 524127), or Other Activities Related to Real Estate (NAIC 531320). In some states Offices of Lawyers are the sole provider of settlement services. In many states Offices of Lawyers play a limited role in providing settlement services; in these states the work is done primarily by Title Abstract & Settlement Offices or by the escrow agents that are classified in the Other Activities Related to Real Estate category. Due to data limitations, it is not known what percentage of residential real estate settlement and title services are provided by the various types of firms.

Along the same lines as Section III for lenders, this section uses data from the Census Bureau to describe the characteristics of the four title and closing-related industries. The Census Bureau data cover industry characteristics such as the number of firms, payroll, revenue, and small business shares. Data relating to Title Abstract & Settlement Offices are presented first, beginning with the Census Bureau data and proceeding to data collected by ALTA (Subsection IV.B.1). Then data relating to Offices of Lawyers are presented (IV.B.2), followed by data relating to Other Activities Relating to Real Estate (IV.B.3) and Direct Title Insurance Carriers (IV.B.4).

After the basic characteristics of each industry are discussed, Subsection IV.B.5 provides several technical analyses that incorporate industry data to estimate an overall small business share for the title and closing industry. The revenue transfers for each title and closing industry are then examined for that industry as a whole and for small businesses within that industry. Where possible, the transfers are expressed on a per firm basis and as a percentage of industry revenue. Numerous sensitivity analyses are presented in Subsection IV.B.5 to reflect the uncertainty around the various estimates.

### **IV.B.1. Title Abstract and Settlement Offices**

The National Technical Information Service defines Title Abstract and Settlement Offices as “establishments (except offices of lawyers and attorneys) primarily engaged in one or more of the following activities: (1) researching public land records to gather information relating to real estate titles; (2) preparing documents necessary for the transfer of title, financing

and settlement; (3) conducting final real estate settlements and closings; and (4) filing legal and other documents relating to the sale of real estate. Real estate settlement offices, title abstract companies, and title search companies are included in this industry.” Census Bureau data from the year 2004 indicate Title Abstract and Settlement Offices employed 79,819 people at 8,008 firms. These firms had an estimated annual revenue of \$8.9 billion. Thus, in 2004 Title Abstract and Settlement Offices averaged 10.0 employees per firm and had estimated annual revenue of \$1,113,369. The majority, 66.4%, of Title Abstract and Settlement office employees worked at firms employing fewer than 100; 39.2% worked at firms employing fewer than 20. In addition to the 8,008 Title Abstract and Settlement Office employer firms, according to the Census Bureau there were 6,203 Title Abstract and Settlement Office nonemployer firms. While the data do not provide many details about these non-employer firms, Census methodology ensures that nonemployers meet a reasonable definition of small.<sup>119</sup>

Census Bureau data from 2002 provide somewhat more detailed information about Title Abstract and Settlement Offices. In 2002 the sector employed 65,833 people at 6,252 firms. These firms had annual revenue of \$7.6 billion. In contrast with the revenue estimate for 2004, the 2002 revenue figure is taken directly from Census publications. As is the case in 2004, Title Abstract Offices averaged approximately 10.5 employees per firm. Average revenue per firm was \$1,215,678, which, after adjusting for inflation,<sup>120</sup> is \$1,270,038, approximately equal to the 2004 estimate of \$1,113,369. In addition to the 6,252 Title Abstract and Settlement Offices that had employees in 2002, there were an estimated 5,778 Title Abstract and Settlement Offices nonemployer firms.<sup>121</sup>

#### **IV.B.1.a. Census Bureau Data for Small Businesses: Title Abstract and Settlement Offices**

The greater financial detail provided in the 2002 data makes the 2002 data better suited for the task of determining how many firms meet the SBA’s definition of small. The 2002 size standard for Title Abstract and Settlement Offices is \$6 million. The Census Bureau, however, reports data for firms earning less than \$5 million and firms earning \$5 million to \$10 million. Of the firms in this sector that had employees, it is estimated that 96.9% had annual revenues less than \$6 million and are considered small by the SBA. Of all firms in this sector (employer and nonemployer), 98.5% had annual revenues less than \$6 million and are considered small by the SBA.<sup>122</sup> These small businesses account for 49.8% of the revenue earned by the Title Abstract and Settlement Offices sector.<sup>123</sup>

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<sup>119</sup> See technical appendix for details of this methodology.

<sup>120</sup> See technical appendix for details on inflation adjustment.

<sup>121</sup> See technical appendix for estimation details.

<sup>122</sup> The percentage of all firms that are small according to the SBA’s definition is derived by adding the estimated 5,778 nonemployer firms to the 5,094 employer firms operating the entire year that meet SBA size standards and dividing by the sum of all 5,258 employer firms operating the entire year and the number of nonemployer firms.

<sup>123</sup> The revenue share of small firms is calculated by adding the revenue earned by employer firms operating the entire year considered small by SBA standards, \$3,552,142,000, to the estimated revenue earned by nonemployer firms, \$297,785,000, and dividing by the total revenue across all firms, which is equal to the estimated revenue of

**“Very Small” Title and Settlement Firms.** An alternative method of characterizing a small business is by the number of employees. Although this is not the Small Business Administration’s method of defining a small business, Census data on firms with less than twenty employees reveals the characteristics of those firms that are “very small.” In 2004, employer firms, employing less than twenty employees, accounted for 90.5% of all employer firms in the Title Abstract and Settlement industry and received 35.1% of its (estimated) revenue. Including nonemployer firms would yield that “very small” firms constitute 94.7% of all Title Abstract and Settlement firms in 2004 and earn 37.4% of the industry’s (estimated) revenue.

**Number of Employees.** Analysis in Chapter 6 will require an estimate of the number of workers in the industry as a whole and in small firms within the industry. For the year 2004, adding the 79,819 employees in employer firms to 6,203 (which assumes one worker for each non-employer firm) yields 86,022 as one estimate of the number of workers in the industry. The 2002 data on the percentage of employees in small employer firms (60.0%) can be applied to the 2004 data to arrive at an estimate for the number of workers in small firms. Multiplying the number of employees (79,819) by 0.600 yields an estimated 47,913 employees in small employer firms in 2004 which, when added to 6,203 (which assumes one worker for each non-employer firm), yields 54,116 workers in small firms in 2004. Small firms represent 99.2% of all industry firms in 2004.

#### **IV.B.1.b. Comparisons of Census Bureau Data with ALTA Data**

It is interesting to compare the Census Bureau data with data collected by ALTA through a voluntary survey of its title agent and abstractor members. There is at least one major difference between the universe covered by the ALTA survey and the universe categorized by the Census Bureau as Title Abstract and Settlement Offices. Not all Title Abstract and Settlement Offices are represented by ALTA. For example, lawyers who provide settlement services may choose to be represented by the American Bar Association Section of Real Property, Probate, and Trust Law instead of ALTA.<sup>124</sup> A relatively small number of title agents and abstractors, 286, participated in the 2002 survey conducted by Fetzer and Kraus. The Census Bureau reports there were 6,252 title abstract and settlement agents in 2002, so the response rate for the ALTA survey seems relatively low. That being said, ALTA believes the survey results provide “a credible and reliable snapshot of abstractor and title agent company characteristics.” Like the Census data, the survey data indicates a preponderance of small firms: 86% of the respondents had twenty-five or fewer employees; and 91% of the respondents had revenues of \$3 million or less. (The survey did not include a greater than \$5 million category.) The respondents derived their revenue from four main sources: selling title insurance, performing abstracts, performing escrow and closing functions, and practicing law. The largest source of revenue for most firms came from selling title insurance. Among the 286 survey participants, title insurance revenue accounted for 63% of 2001 revenue.

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nonemployer firms plus \$7,433,115,000 earned by all employer firms operating the entire year. Note that the nonemployer firms account for only five percent of the sector’s total revenue.

<sup>124</sup> Alternatively, they may be represented by both groups or neither group.

## **IV.B.2. Office of Lawyers**

The National Technical Information Service defines Other Activities Related to Real Estate as “offices of legal practitioners known as lawyers or attorneys (i.e., counselors-at-law) primarily engaged in the practice of law.” Many, if not most, of these offices do not earn a significant portion of their revenues from providing residential real estate settlement services. Unfortunately, due to data limitations, it is not possible to know how many Offices of Lawyers are extensively involved in residential real estate settlement.

Census Bureau data from the year 2004 indicate Offices of Lawyers employed 1,122,723 at 166,704 firms. The majority, 68.9%, of those employed by Offices of Lawyers worked at firms employing fewer than 100; 46.0%, worked at firms employing fewer than 20. In addition to the 166,704 Offices of Lawyers employer firms, the Census Bureau reports that there were 234,849 Offices of Lawyers nonemployer firms. While the data do not provide many details about these nonemployer firms, Census Bureau methodology ensures that nonemployers meet a reasonable definition of small.<sup>125</sup>

Census Bureau data from 2002 provide somewhat more detailed information about Offices of Lawyers. In 2002 the sector employed 1,080,428 people at 162,593 firms.<sup>126</sup> In addition to the employer firms, there were an estimated 218,777 Offices of Lawyers nonemployer firms.<sup>127</sup>

### **IV.B.2.a. Census Bureau Data for Small Businesses: Offices of Lawyers**

The greater financial detail provided in the 2002 data, makes the 2002 data better suited for the task of determining how many firms meet the SBA’s definition of small. The size standard effective October 1, 2002 for Offices of Lawyers is \$6 million in revenue. Of the firms in this sector that had employees, it is estimated that 97.5% had annual revenues less than \$6 million and are considered small by the SBA. Of all firms in this sector (employer and nonemployer), 99.1% had annual revenues less than \$6 million and are considered small by the SBA.<sup>128</sup> <sup>129</sup>These small businesses account for 47.8% of the revenue earned by Offices of Lawyers.<sup>130</sup>

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<sup>125</sup> See technical appendix for details of this Census Bureau methodology.

<sup>126</sup> All of the Office of Lawyer data are for establishments that are taxable.

<sup>127</sup> See technical appendix for estimation details.

<sup>128</sup> Firms that are small according to the SBA’s definition is derived by adding the estimated 218,777 nonemployer firms to the estimated 133,570 employer firms operating the entire year that meet SBA size standards and dividing by the sum of all 136,934 employer firms operating the entire year and the number of nonemployer firms.

<sup>129</sup> The 2002 data on the percentage (97.5%) of employer firms that are small can be applied to the 2004 data reported in the text to arrive at an updated estimate for the number of small firms. Multiplying the number of

**“Very Small” Lawyer Firms.** An alternative method of characterizing a small business is by the number of employees. Although this is not the Small Business Administration’s method of defining a small business, Census data on firms with less than twenty employees reveals the characteristics of those firms that are “very small.” In 2004, employer firms, employing less than twenty employees, accounted for 95.2% of all employer firms in the Office of Lawyers industry and received 38.6% of its (estimated) revenue. Including nonemployer firms would yield that “very small” firms constitute 98.0% of all Office of Lawyers firms in 2004 and earn 42.8% of the industry’s (estimated) revenue.

**Number of Employees.** Analysis in Chapter 6 will require an estimate of the number of workers in the industry as a whole and in small firms within the industry. For the year 2004, adding the 1,122,723 employees in employer firms (from Table 5-51) to 234,849 (which assumes one worker for each non-employer firm) yields 1,357,572 as one estimate of the number of workers in the industry. The 2002 data on the estimated percentage of employees in small employer firms (58.6%) can be applied to the 2004 data to arrive at an estimate for the number of workers in small firms. Multiplying the number of employees (1,122,723) by 0.586 yields an estimated 657,749 employees in small employer firms in 2004 which, when added to 234,849 (which assumes one worker for each non-employer firm), yields 892,598 workers in small firms in 2004. Workers in small firms represent 65.7% of all industry workers (1,357,572) in 2004. As discussed in Chapter 6, not all these workers are engaged in single-family mortgage activity.

#### **IV.B.3. Other Activities Related to Real Estate**

The National Technical Information Service defines Other Activities Related to Real Estate as “establishments primarily engaged in performing real estate related services (except lessors of real estate, offices of real estate agents and brokers, real estate property managers, and offices of real estate appraisers). Examples of establishments in this industry are: real estate escrow agencies, real estate fiduciaries offices, and real estate listing services.” This classification of firms is included in this analysis of settlement and title service providers primarily because it includes real estate escrow agencies. Real estate escrow agencies are the primary provider of settlement and title services in California and other Western states. Many of these firms categorized as Other Activities Related to Real Estate do not earn a significant portion of their revenues from providing residential real estate settlement and title services. Unfortunately, due to data limitations, it is not possible to know how many firms categorized as Other Activities Related to Real Estate are extensively involved in residential real estate settlement.

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employer firms in 2004 (166,704) by 0.975 yields an estimated 162,536 small employer firms which, when added to the number of non-employer firms (234,849) in 2004, yields 397,385 small firms in 2004. These small firms represent 98.9% of all firms (401,553) in 2004.

<sup>130</sup> The revenue share of small firms is calculated by adding the estimated revenue earned by employer firms operating the entire year considered small by SBA standards, \$73,799,026,000, to the estimated revenue earned by nonemployer firms, \$12,477,720,000, and dividing by the total revenue across all firms, which is equal to the estimated revenue of nonemployer firms plus \$168,013,231,000 earned by all employer firms operating the entire year.

Census Bureau data from the year 2004 indicate that the Other Activities Related to Real Estate industry employed 67,274 people at 15,136 firms. These firms had an estimated annual revenue of \$10.5 billion. Thus, in 2004 Other Activities Related to Real Estate averaged 4.4 employees per firm and had estimated annual revenue per firm of \$691,097. Within the Other Activities Related to Real Estate Industry 45.6% of employees worked at firms employing fewer than 20. In addition to the 15,136 employer firms from the Other Activities Related to Real Estate Industry offices in 2004, the Census reports there were 448,409 nonemployer firms. While the data do not provide many details about these nonemployer firms, Census Bureau methodology ensures that nonemployers meet a reasonable definition of small.<sup>131,132</sup> The average annual revenue of nonemployer firms in 2004 was \$66,144 (the total revenue was \$29.7 billion).

Census Bureau data from 2002 provide more detailed information about Other Activities Related to Real Estate Industry. In 2002, the sector employed 57,123 people at 13,908 firms. These firms had annual revenue of \$8.24 billion. In 2002, the Other Activities Related to Real Estate Industry averaged 4.1 employees per firm. Average revenue per employer firm was \$592,371 (\$622,006 in 2004 dollars). However, more relevant is the annual revenue per firm of firms operating the entire year, which is \$831,981 (\$873,603 in 2004 dollars). In addition to the 13,908 employer firms from the Other Activities Related to Real Estate industry in 2002, there were 335,115 nonemployer firms. The average revenue of the nonemployer firm in 2002 was \$65,789 (\$69,080 at 2004 prices). The total revenue of nonemployer firms in 2002 was \$2 billion.

#### **IV.B.3.a. Census Bureau Data for Small Businesses: Other Activities Related to Real Estate**

The greater financial detail provided in the Economic Census of 2002 data make the 2002 data better suited for the task of determining how many firms meet the SBA's definition of small. The 2002 size standard for Other Activities Related to Real Estate Industry was \$1.5 million in revenue (it was increased to \$2 million on July 31, 2006). Although the data are not broken down in such a manner as to allow the calculation of the percentage of employer firms earning less than \$1.5 million, a generous estimation of the number of small businesses can be obtained by examining those firms earning less than \$2.5 million.

Firms earning less than \$2.5 million represent 95.4% of the firms operating in Other Activities Related to Real Estate, account for 46.4% of the payroll, and earn 46.5% of the revenue. An insight into size standards can be gained by examining the characteristics of employer firms earning less than \$2.5 million in 2002: the average number of employees was 3.8 and the average revenue was \$405,107 (\$425,374 at 2004 prices).

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<sup>131</sup> See technical appendix for details of this Census Bureau methodology.

<sup>132</sup> A firm in the Other Activities Related to Real Estate was considered "small" by the SBA if its annual revenue was less than \$1.5 million. The current size standard for Other Activities Related to Real Estate (as of July 31, 2006) is \$2 million.

Continuing to use a cutoff of \$2.5 million instead of \$1.5 million, an upper-bound estimate of the proportion of all Other Real Estate firms that are small is calculated to be 99.9%. This percentage is derived by adding the 335,115 nonemployer firms to the 8,225 employer firms operating the entire year that meet SBA size standards and dividing by the sum of all 8,620 employer firms operating the entire year and the number of nonemployer firms. These small businesses account for 86.9% of the revenue earned by the Other Real Estate Activities Industry.

**“Very Small” Firms.** An alternative method of characterizing a small business is by the number of employees. Although this is not the Small Business Administration’s method of defining a small business, Census data on firms with less than twenty employees reveals the characteristics of those firms that are “very small.”<sup>133</sup> In 2004, employer firms, employing less than twenty employees, accounted for 95.6% of all employer firms in the Other Activities Related to Real Estate industry, employed 45.6% of its employees, and received 50.3% of its (estimated) revenue. Including nonemployer firms would yield that “very small” firms constitute 99.8% of all firms in the Other Activities Related to Real Estate industry in 2004 and earn 87% of the industry’s (estimated) revenue.

**Number of Employees.** Analysis in Chapter 6 will require an estimate of the number of workers in the industry as a whole and in small firms within the industry. For the year 2004, adding the 67,274 employees in employer firms (from Table 5-74) to 448,409 (which assumes one worker for each non-employer firm) yields 515,683 as one estimate of the number of workers in the industry. The 2002 data on the percentage of employees in small employer firms (59.6% from Table 5-76) can be applied to the 2004 data to arrive at an estimate for the number of workers in small firms. Multiplying the number of employees (67,274) by 0.596 yields an estimated 40,074 employees in small employer firms in 2004. Adding this estimate of employees working for small employer firms to the number of nonemployer firms (448,409) yields 488,483 workers in small firms in 2004. Workers in small firms represent 94.7% of all industry workers (515,683) in 2004. As discussed previously, not all these workers are engaged in single-family mortgage-related activity.

#### **IV.B.4. Direct Title Insurance Carriers**

There are relatively few Direct Title Insurance Carriers, and even fewer large carriers, but the large carriers dominate the market. Data from the 2002 Economic Census indicate that the four largest Direct Title Insurance Carriers account for 80.9% of the sector’s (estimated) revenue and 74.6% of its employees. According to the American Land Title Association’s 2001 Company Summary, five national families of affiliated title insurance companies accounted for 87% of the title insurance business written. Despite the dominance of a few large firms, Census Bureau data indicate there were 1,959 Direct Title Insurance Carriers in 2004. There are several possible explanations for the divergence between the relatively small number of large title

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<sup>133</sup> Note that one could consider an office of twenty employees “large” compared to our estimate of the average number of employees (3.8) working for a firm that met the SBA size standard in 2002. However, the average number of employees working for an firm in the Other Activities Related to Real Estate Activities industry in 2004 is 2.1.

insurance carriers and the relatively large number of carriers reported by the Census Bureau. First, since the title insurance carriers frequently assign underwriting responsibilities to their agents, it is likely that some agents who are not really insurance carriers erroneously indicated they are title insurance carriers. Second, attorneys and other professionals may warrant the merchantability of titles. While such warranties are not title insurance *per se*, it is possible these warrantors erroneously indicated they are title insurance carriers. Third, some of those that indicated they are direct title insurance carriers may be relatively unknown, niche players that focus on commercial transactions or transactions outside the United States. In 2004, employer firms in the Direct Title Insurance Carrier industry employed 75,702 people, had a payroll of \$4.8 billion, and an estimated annual revenue of \$18 billion. Firms with one hundred or more employees accounted 2.9% of all employer firms' but 86.1% of the employees and 92.5% of the estimates revenue of employer firms in 2004.

#### **IV.B.4.a. Census Bureau Data for Small Businesses: Direct Title Insurance Carrier Industry**

Census Bureau data from 2002 provide somewhat more detailed information about Direct Title Insurance Carriers. In 2002, the sector employed 63,278 people at 1,201 employer firms. In contrast with the revenue estimate for 2004, the 2002 revenue figure is not estimated but taken directly from the Economic Census. The greater financial detail provided in the Economic Census of 2002 makes the 2002 data better suited for the task of determining how many firms meet the SBA's definition of small and what percentage of the industry's revenue they earn. The 2002 size standard for Direct Title Insurance Carriers was an annual revenue of \$6 million (the size standard has since been increased to \$6.5 million). It is estimated that employer firms that met the SBA's definition of small accounted for 94.6% of employer firms and 4.8% of its revenue.<sup>134</sup> Including our estimates of nonemployer firms (135) does not significantly change the proportion of the industry that would be considered small by the SBA. Firms earning less than \$6 million account for 95.2% of all firms but only 4.8% of all revenue.

**“Very Small” Firms.** An alternative method of characterizing a small business is by the number of employees. Although this is not the Small Business Administration's method of defining a small business, Census data on firms with less than twenty employees reveals the characteristics of those firms that are “very small.” In 2004, employer firms, employing less than twenty employees, accounted for 90.8% of all employer firms in the Direct Title Insurance Carrier industry, employed 8.4% of its employees, and received 4.4% of its (estimated) revenue. Including nonemployer firms would yield that “very small” firms constitute 91.8% of all Direct Title Insurance Carrier firms in 2004 and earn 4.4% of the industry's (estimated) revenue.

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<sup>134</sup> To estimate these proportions for employer firms in 2002, the number of firms earning less than \$5 million (887 firms earning a total of \$577 million in revenue) to estimates for firms earning between \$5 million and \$6 million. The Economic Census tells us that there were 23 firms earning between \$5 million and \$10 million with an aggregate revenue of \$160 million. Assuming that all firms are equally distributed over the range yields five firms earning between \$5 million and \$6 million. In addition, assuming that these firms earn the maximum revenue for this range (\$6 million) yields an aggregate revenue for firms earning between \$5 million and \$6 million of \$30 million. Our estimate of the proportion of employer firms that are small is achieved by dividing by the total number of firms operating the entire year in 2002.

**Number of Employees.** Analysis in Chapter 6 will require an estimate of the number of workers in the industry as a whole and in small firms within the industry. To do this, we estimate the proportion of employees working for small employer firms using the 2002 Economic Census data and apply it to the 2004 data. There were 5,702 employees working for employer firms (9% of employer firms operating the entire year). We estimate the number of employees working for firms earning between \$5 million and \$6 million, using our estimates of the aggregate revenue of these firms (\$30 million) and the revenue per employee for firms earning between \$5 million and \$10 million (\$124,131). Assuming that this ratio applies to all firms within this range, a reasonable estimate is that there were 242 employees employed by firms earning between \$5 million and \$6 million in 2002. Thus, the proportion of employees working for small title insurance employer firms in 2002 was 9.4%.

Multiplying the number of employees (75,702) by 0.094 yields an estimated 7,116 employees in small employer firms in 2004 which, when added to 135 (which assumes one worker for each non-employer firm), yields 7,251 workers in small firms in 2004. Workers in small firms represent 9.6% of all industry workers (75,837) in 2004. As noted earlier, industry data suggest that Census Bureau data concerning small businesses in the Direct Title Insurance Industry are not likely to be accurate.

#### **IV.B.5. Title and Settlement Industry: Revenue Estimates, Small Business Transfers, and Additional Data Considerations**

This section examines numerous technical issues that are important for determining (a) the share of revenue among the various sectors of the title and settlement industry and (b) the overall small business estimate for this industry. In addition, the section reports the revenue impact of the RESPA rule on small title and settlement agents. Unlike Chapter 3, which conducted the small business analysis for title and settlement agents as a group, this section also conducts the revenue transfer analysis on a disaggregated basis, that is, for each separate sector of the industry. Specifically, this section:

- Determines the overall small business share of the title and settlement industry by exploring various methods for weighting the relative importance of each of the separate sectors. Several sensitivity analyses are conducted to show the impact on the overall small business estimate of different weights for the different sectors. (Subsection III.B.5.a)
- Reports the revenue transfers under the new GFE for separate industry groups and for small businesses within each group, and where possible, on a per firm basis and as a share of industry revenue. (Subsections III.B.5.b and III.B.5.c)

When estimating the various industry revenue shares for the different title and settlement groups, this section pulls together data from several sources, which introduces some degree of uncertainty into the various estimates. In most cases, the discussion below shows the effects on key parameters (such as the small business percentage) of a number of alternative approaches. This provides the basis for sensitivity analyses when examining the revenue impacts of the new GFE on small title and settlement agents.

#### IV.B.5.a. Determining the Overall Small Business Share of the Settlement and Title Industry

Table 5-15 provides a summary of information from the Census Bureau for the four components of the title and closing industry -- Direct Title Insurance Carriers, Title Abstract and Settlement Offices, Offices of Lawyers, and Other Activities Related to Real Estate (such as escrow). These data were discussed above in Sections B.1-B.4. Ideally, it would be possible to precisely determine the overall proportion of revenue that accrues to small settlement and title service providers by combining the information for the four industries presented in Table 5-15. However, this is not possible for several reasons. First, it is not possible to know what proportion of Offices of Lawyers is primarily engaged in residential real estate settlement. Real estate probably accounts for a small portion of the billions in revenues of this industry. Second, it is not known what proportion of the firms classified as Other Activities Related to Real Estate are primarily engaged in real estate settlement (see Section B.3). Third, the large Direct Title Insurance Carriers are involved in many other businesses besides underwriting single-family residential title insurance in the United States. For example, they underwrite commercial title insurance and foreign title insurance. Some are also involved in businesses such as automobile title insurance, employment screening, homeowners insurance, and banking.<sup>135</sup> Fourth, since approximately 80% of title insurance premiums are paid out as commission, there is a problem relating to double counting. In the Census Bureau data, some dollars are counted as revenue for both Direct Title Insurance Carriers and the title insurance sales agents that are classified under the headings Title Abstract & Settlement Offices, Offices of Lawyers, or Other Activities Related to Real Estate. Despite these problems, the analysis below provides a range of estimates that probably approximates the small business share of this industry.

**Table 5-15. Summary Statistics of Industries in Title and Settlement Services**

Industry	Year	Number of Firms			Revenue (\$ billions)			Small Business	
		Non-Employer	Employer	Total	Non-Employer	Employer	Total	Firms	Revenue
Direct Title Insurance Carriers	2004	1,959	135	2,094	18.09	0.003	18.09		
	2002	1,201	126	1,327	12.81	0.004	12.81	95.2%	4.8%
	2002	8 largest	0	8	11.24	0.00	11.24		
	2002	20 largest	0	20	11.83	0.00	11.83		
Title Abstract and Settlement Offices	2004	8,008	6,203	14,211	8.92	0.33	9.25		
	2002	6,252	5,778	12,030	7.60	0.30	7.90	98.5%	49.8%
Offices of Lawyers	2004	166,704	234,849	401,553	189.58	13.99	203.57		
	2002	162,593	218,777	381,370	172.86	12.48	185.34	99.1%	47.8%
Other Activities Related to Real	2004	15,136	448,409	463,545	10.46	29.66	40.12		
	2002	13,908	335,115	349,023	8.24	22.05	30.29	99.9%	86.9%

\* The small business share is based on data from the 2002 Economic Census and SBA size standards in effective October 1, 2002. For the first three industries, the small business cut-off was \$6 million revenue, for which the Census provided data. For Other Activities, the size standard was \$1.5 million in revenue, for which data were not available to determine the proportion of small businesses. Instead, the small business share for Other Activities Related to Real Estate was estimated using data on firms earning less than \$2.5 million.

<sup>135</sup> Information about these non-title insurance operations is contained in the annual reports of the five major carriers.

As noted above, the title and settlement industry has four components with varying small business shares: (a) Direct Title Insurance Carriers (4.8%); (b) Title Abstract and Settlement Offices (49.8%); (c) Offices of Lawyers (47.8%); and (d) Other Activities Related to Real Estate (86.9%). To obtain an overall small business percentage, one has to weigh the relative importance of these four industries, which is particularly difficult given that single-family real estate activities may represent a small percentage of an industry such as (c), and that the single-family-real-estate-related firms in such an industry may have a different small business make-up than the other firms in that industry. There is also the problem mentioned above of the double counting of title insurance commissions, rendering it difficult to estimate the revenue of Direct Title Insurance Carriers. Because the Direct Title Insurance Carriers industry is dominated by large businesses, their treatment in the analysis can significantly affect the overall small business percentage for the title and settlement industry. With respect to this issue, this section attempts to estimate the share of title and related work done by the Direct Title Insurance Carriers. Because there is some uncertainty surrounding the various estimates, sensitivity analyses are provided to present a range of estimates.

#### **Discussion of Direct Title Insurance Carriers Industry Revenue Share Estimates.**

HUD estimated the share of title industry revenue earned from residential transactions by the 5 large Direct Title Insurance Carriers (DTIC) using information gleaned from their 2005 annual reports and SEC filings (form 10-K). Data from the consolidated financial statistics of DTIC firms compiled by the American Land Title Association (ALTA) was used for total market comparisons, and as the data source for the collection of small regional DTIC firms. The 5 major DTICs, Fidelity National Title, First American, Land America, Old Republic, and Stewart, provided different levels of detail in their reports and filings. To fill in missing elements, a number of calculations and assumptions were made as detailed below. HUD estimates that in 2005, the 5 largest DTICs accounted for 42.6 percent of the \$24.8 billion revenue attributable to the title and closing process for 16.5 million residential lending transactions.

This discussion traces the computations for Fidelity National Title as its 2005 annual report provided the most complete data among the 5 large DTICs. Some Fidelity National Title figures were used as parameters to compute figures for the other DTICs where data were less complete. The table below illustrates the firm-by-firm computation for Fidelity National Title. Numbers in plain text are copied from the annual report, while numbers in *italics* are HUD calculations. DTICs derive title-related revenue from 3 sources: premiums on title policies sold by independent agents, premiums on policies sold directly by DTIC employees (this includes what ALTA characterizes as “affiliated agents”); and fees on title-related and closing services performed by their employees. In the table, these three sources are: Agent Premiums; Direct Premiums; and Title, Escrow and Other Fees. Fidelity National Title was the only DTIC to separately report Direct Premiums and Title, Escrow and Other Fees. All companies reported Agent Premiums. The other big 4 reported either total revenue or total direct revenue (from which the opposing figure could then be derived). The key factor “Direct Premium percent of Direct Revenue” for the other big 4 is assumed to be the same 65 percent derived from Fidelity National Title (Old Republic reported a figure for Title, Escrow and Other Fees, but as derived from its computed figure for direct revenue, the residual appeared to be only the pure insurance portion of Direct Premiums, whereas Fidelity’s figure appeared to be similar to a full agent premium including agent commissions).

Although all of the DTICs emphasized the importance of commercial title transactions (orders) to the results of their direct operations, only Fidelity provided figures on the number of commercial orders and the revenue generated. As shown in the table, Fidelity indicated that 8.1 percent of direct revenue (\$270,000,000 out of \$3,347,337,000) and 1.6 percent of direct orders (35,000 out of 2,169,656) were commercial. These figures were applied to the other big 4 firms. This allows the derivation of direct residential orders (2,134,656) and direct revenue (\$3,077,377,000). Commercial Revenue as a percent of Direct Revenue (8.1 percent) was used to derive Commercial Premiums (\$176,244,014) and Residential Direct Premiums (\$2,008,748,986).

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**Illustrative Computation of DTIC Revenue Share  
Fidelity National Title, 2005**

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<b>Revenue</b>	<b>\$6,111,310,000</b>
<b>Agent Premiums</b>	<b>\$2,763,973,000</b>
<b>Direct Revenue</b>	<b>\$3,347,337,000</b>
<b>Direct Premiums</b>	<b>\$2,184,993,000</b>
<b>Title, Escrow and Other Fees</b>	<b>\$1,162,344,000</b>
<b>Direct Commercial Revenue</b>	<b>\$270,000,000</b>
<b>Direct Residential Revenue</b>	<b>\$3,077,337,000</b>
<b>Direct Premium percent of Direct Revenue</b>	<b>65%</b>
<b>Total Direct Orders Closed</b>	<b>2,169,656</b>
<b>Commercial Orders</b>	<b>35,000</b>
<b>Residential Direct Orders</b>	<b>2,134,656</b>
<b>Comm. Orders as Pct of Direct</b>	<b>1.6%</b>
<b>Average Total Direct Revenue per Order</b>	<b>\$1,543</b>
<b>Average Commercial Revenue per Order</b>	<b>\$7,714</b>
<b>Average Direct Residential Revenue per Order</b>	<b>\$1,442</b>
<b>Commercial Revenue as Percent of Direct</b>	<b>8.1%</b>
<b>Direct Premiums</b>	<b>\$2,184,993,000</b>
<b>Commercial Premiums</b>	<b>\$176,244,014</b>
<b>Residential Direct Premiums</b>	<b>\$2,008,748,986</b>
<b>Direct Premium per Order</b>	
<b>Average Commercial Premium per Order</b>	<b>\$5,036</b>
<b>Average Residential Direct Premium per Order</b>	<b>\$941</b>
<b>Average Title, Escrow and Fees per Direct Order</b>	<b>\$501</b>
<b>Agent Orders</b>	<b>2,937,217</b>
<b>Agent Total Revenue</b>	<b>\$4,234,315,208</b>
<b>Agent Commissions</b>	<b>\$2,140,912,000</b>
<b>Net Agent Premiums</b>	<b>\$623,061,000</b>
<b>Agent Title, Escrow and Fees</b>	<b>\$1,470,342,208</b>

<b>Total Residential Orders</b>	5,071,873
<b>Total DTIC Residential Revenue</b>	\$3,700,398,000
<b>Total Title Function Residential Revenue</b>	\$7,311,652,208
<b>Percent of Title Function Revenue to DTIC</b>	50.6%

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Fidelity reported “fee per direct order” as “almost \$1,500”. Based on other data, the figure for Average Direct Revenue per Order was \$1,543. First American and Land America reported figures of \$1,472 and \$1,657 respectively. Based on the assumption that 75 percent of their reported orders closed in 2005, average revenue per order for Stewart was estimated at \$1,575. The average of these four figures (\$1,562) was used as the figure for Old Republic.

Average Commercial Premium per Order (\$5,036) and Average Residential Direct Premium per Order (\$941) were derived by dividing respective total premium revenues by the number of orders. Under the assumption that the average premium per agent order is the same as Average Residential Direct Premium per Order (implicit is the assumption that agents do not handle commercial orders), the number of Agent Orders (2,937,217) is Agent Premiums (\$2,763,973,000) divided by Average Residential Direct Premium per Order (\$941).

Average Title, Escrow, and Fees per Direct Order (\$501) results from subtracting Average Residential Direct Premium per Order (\$941) from Average Direct Residential Revenue per Order (\$1,442). Again, assuming that agent orders have the same average cost profile as direct residential orders, Agent Title, Escrow, and Fees (\$1,470,342,208) is equal to Average Title, Escrow, and Fees per Direct Order (\$501) times Agent Orders (2,937,217). Added to Agent Premiums (displayed broken out between Agent Commissions of \$2,140,912,000 and Net Agent Premiums of \$623,061,000), this figure results in Agent Total Revenue associated with title insurance policies issued by Fidelity of \$4,234,315,208.

Total Residential Orders (5,071,873) is the sum of Residential Direct Orders (2,134,656) and Agent Orders (2,937,217). Fidelity’s share of Total DTIC Residential Revenue (\$3,700,398,000) is the sum of Direct Residential Revenue (\$3,077,337,000) and Net Agent Premiums (\$623,061,000). Total Title Function Residential Revenue attributable to title policies sold directly or through agents by Fidelity (\$7,311,652,208) is the sum of Fidelity’s share of Total DTIC Residential Revenue (\$3,700,398,000), Agent Commissions (\$2,140,912,000) and Agent Title, Escrow and Fees (\$1,470,342,208). Fidelity retained 50.6 percent of the Total Title Function Residential Revenue attributable to title policies it sold in 2005.

As stated above, a similar analysis was performed for the other 4 of the big 5 DTICs based on their 2005 annual reports or SEC filings, as well as on data from ALTA on the small regional DTICs in 2005. Important figures from the national totals are reported below.

– Total Residential Orders (a proxy for loan closings):	16,476,713; <sup>136</sup>
– Total Residential Orders for “Big 5”:	16,120,486;
– Average Direct Residential Revenue per Order:	\$1,459;
– Residential Direct Premium per Order:	\$938;
– Title, Escrow and Fees per Direct Order:	\$521;
– Total DTIC Residential Revenue for “Big 5”:	\$10,573,392,295;
– Total Title Function Residential Revenue:	\$24,823,392,649;
– Percent of Title Function Revenue to “Big 5” DTICs:	42.6 percent.

The baseline analysis will assume that Direct Title Insurance Carriers account for 43% of industry revenues.

Before proceeding, a few comments should be made about some of the other estimates. Consider the Offices of Lawyers category, which had a small business percentage of 47.8%. It seems reasonable to assume that lawyers that do single-family real estate are mainly small businesses (rather than the large corporate firms), which suggests that the 47.8% substantially understates the small business percentage for lawyers doing single-family real estate work. Also consider the "other activities" category, which includes escrow firms but also other unrelated firms (fiduciaries, multiple listing services, etc.). While this category has a large small business share (86.9%), its share of the single-family real estate settlement and closing market is not known. Given these issues, HUD assumed that small businesses accounted for 90% of the revenue of single-family real-estate-related firms these two industries and that these two industries together accounted for one-third of industry revenue remaining after the large insurers. The 90% assumption favors small businesses. It is assumed that the "title agent" category, with its 49.8% small business share, accounts for the remaining two-thirds revenues (after the large insurers). In particular, it is assumed that the remaining 53% of revenue is split 2/3-1/3 between the title agent and combined lawyers/other activity industries.<sup>137, 138</sup> This results in the following distribution of revenues: (a) 43.0% for Direct Title Insurance Carriers; (b) 38.0% for Title Abstract and Settlement Offices; and (c) 19.0% for the combined "lawyers" and "other activities" categories. Multiplying these revenue shares by the respective small business percentages (4.8%, 49.8%, and 90.0%) gives 38.1% as the small business estimate for the overall settlement and title industry; this is considered the baseline in the analysis below.

Table 5-16 includes several sensitivity analyses expressing the overall small business percentage (first column of data) as a function of the revenue share for Direct Title Insurance

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<sup>136</sup> The Office of Federal Enterprise Oversight (OFHEO) estimates that originations were \$3,120 billion in 2005; using an average loan amount of \$187,485 from HMDA yields 16,641,336 in loans originated, a figure strikingly close to the estimate (16,476,713) derived from the above analysis of title industry reports. In addition, the average origination estimate for 2005 from Fannie Mae, Freddie Mac, and the Mortgage Bankers Association of America was \$3,088 billion, which translated into 16,470,656 mortgages, again practically the same as the 16,476,713 derived in the text..

<sup>137</sup> The term “title agent” will frequently be used to refer to the Title Abstract and Settlement Offices industry.

<sup>138</sup> The assumption of a 1/3-2/3 split between title agents and the combined lawyers/other real estate activities industries is subject to sensitivity analysis below. For example, an equal split is considered.

Carriers, or DTIC (see first 3 rows). If the DTIC share of industry revenue is as high as 50%, then the small business share of industry revenues falls to 34.0% (see #3). The small business share is 42.8% if the DTIC revenue share is 35%. Thus, as the DTIC share increases from 35% to 50%, the small business share of industry revenue declines by approximately 9 percentage points, from 42.8% to 34.0%.

**Table 5-16. Sensitivity Analysis of Small Business Revenues in the Title and Settlement Industry**

	Estimated Small Business % for Overall Industry	Small Business Share of Total Transfers Under GFE (\$ Billions) <sup>1</sup>		
		\$1.35 Billion in Total Transfers	\$1.79 Billion in Total Transfers	\$2.5 Billion in Total Transfers
1. 35% DTIC Share <sup>2</sup>	42.8%	\$0.58	\$0.77	\$1.07
2. <b>BASE CASE:</b> 43% DTIC Share	38.1%	\$0.51	\$0.68	\$0.95
3. 50% DTIC Share	34.0%	\$0.46	\$0.61	\$0.85
4. Base With 60/40 Split for Title Agents and Lawyers/ Escrow	39.6%	\$0.53	\$0.71	\$0.99
5. Base With 50/50 Split for Title Agents and Lawyers/ Escrow	41.9%	\$0.57	\$0.75	\$1.05
6. 35% DTIC Share and 60/40 Split	44.5%	\$0.60	\$0.80	\$1.11

Note: Scenarios 1-3 assume a 66/33 split for title agents and lawyers/escrow. Scenarios 4 and 5 assume a 53% share for DTIC.

<sup>1</sup> The \$1.35 billion figure corresponds to GFE savings of 7.5% of title and settlement costs while \$1.79 billions corresponds to 10% savings in title and settlement costs. The \$2.5 billion corresponds to \$2.00 per loan savings.

<sup>2</sup> DTIC is Direct Title Insurance Carriers.

The small business percentage used for the title and settlement industry in the economic analysis of the 2002 proposed rule was 80%<sup>139</sup> – a figure much higher than the upper end (42.8%) of the above range. The proposed rule did not include the effects of the large insurers. If the DTIC share is placed at zero in the above analysis, then the small business share is 63.2%.<sup>140</sup> Obviously, excluding large insurers from the analysis (as they were in the economic analysis of the proposed rule), overestimates the small business share of the title and settlement industry. As explained above, this economic analysis<sup>141</sup> attempts to estimate the share of larger insurers and provide a more realistic estimate of the small business percentage for the title and settlement industry, although one subject to some uncertainty. An additional change since the 2002 proposed rule is that the Census-based small business share of the Title Abstract and Settlement Offices industry fell from 64.1% (1997 Census of Business) to 49.8% (2002 Census of Business). Including this effect, as well as zeroing out the DTIC industry, would increase the small business share to 72.7 percent.

#### **IV.B.5.b. Consumer Savings and Transfers under the New GFE: Title and Settlement Industry**

**Title and Closing Fee Estimates.** To estimate savings from the new GFE, one has to have a measure of the expected dollar volume of title and settlement activity. As explained in Section VII.E of Chapter 3, HUD estimated third party fees using mainly a sample of FHA loans and the analysis of industry data from the title industry (see above). The following mean values for third party fees are used:<sup>142</sup> (a) \$350 for appraisal, (b) \$25 for credit report, (c) \$70 for tax service, (d) \$15 for the flood certificate, (e) \$26 for pest inspection, (f) \$58 for survey, and (g) \$1,435 for title insurance and settlement agent charges. Combined, these charges come to \$1,979.<sup>143</sup> The average price of the first six items is \$544 per loan, or 31.5 percent of total third-party fees. The title insurance and settlement agent charges average \$1,435, or 72.5 percent of third-party fees, or \$17.938 billion in aggregate fees. Third party fees (\$24.738 billion) are

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<sup>139</sup> See Section V.C of Chapter 3 of the Economic Analysis of the 2002 proposed rule for the derivation of the 80% estimate. As noted in the text, that estimate did not include the effect of larger title insurers. The analysis in this section includes the effect of large insurers.

<sup>140</sup> This results in the following distribution of revenues: (a) 0.0 percent for Direct Title Insurance Carriers; (b) 66.66 percent for Title Abstract and Settlement Offices; and (c) 33.3 percent for the combined "lawyers" and "other activities" categories. Multiplying these revenue shares (a-b) by the respective small business percentages (4.8%, 49.8%, and 90.0%) yields the overall small business percentage of 63.2 percent.

<sup>141</sup> The term "Economic Analysis" is used throughout this document to refer to the Regulatory Impact Analysis and the Final Regulatory Flexibility Analysis together.

<sup>142</sup> As explained in Section III.E of Chapter 3, the mean values are taken over all loans; this is why flood, survey, and pest inspections may appear low. .

<sup>143</sup> The average price for all third-party fees in the 2002 proposed rule was \$1,583, but that did not include pest inspections (\$26) and surveys (\$58). Including these two latter figures yields \$1,667,.

1.03% of total mortgage volume (\$2.4 trillion), and title and settlement charges, 0.75%. These figures point to the importance of the title and settlement industry in processing mortgages.<sup>144</sup>

Chapter 3 (Sections IV, V, and VII) explains how the new GFE will reduce third party fees, especially title and settlement fees. Section V of Chapter 2 summarizes the evidence that title and settlement fees are too high in today's market and that they could be reduced with the new GFE. Chapter 3 provides numerous estimates of consumer savings from the new GFE. Step (8) of Section VII.E.1 of Chapter 3 provides support for the projected \$200 savings (the "title approach") and the 7.5%-10% savings in title and settlement fees with the new GFE. The projections are reasonable given the benefits of the GFE and evidence of excess costs in the settlement and closing industry. The GFE with its tolerances and discounting will encourage lenders to enter into volume-discount and other business arrangements that substantially reduce settlement and closing costs. Techniques such as average cost pricing will also be used to lower the costs of producing a mortgage. As discussed above, title and settlement fees are projected to total \$17.938 billion (assuming \$2.4 trillion in originations) – this is the amount that would come under the effect of the new GFE. Under the GFE, a 7.5%-10% reduction in title and settlement costs would save borrowers \$1.35-\$1.79 billion (see Section VII.E of Chapter 3). Based on the information presented in Chapter 3, these projected consumer savings of title and settlement fees are reasonable, if not conservative.

Because title and settlement fees have the most potential of all third-party fees for reduction, Chapter 3 also discuss an analysis of savings from the new GFE based on lowering title and settlement fees. This approach (called the "title approach") projects savings in title and settlement fees of \$150-\$200 per loan transaction under the new GFE. Step (8) of Section VII.E.1 of Chapter 3 provides evidence supporting the GFE savings. A \$150-\$200 reduction in title and settlement fees from the new GFE would represent aggregate savings of \$1.875- \$2.50 billion (assuming 12.5 million loan originations). The analysis below will first focus on the savings of 7.5%-10% for the GFE and then key results for the title approach will be discussed.

**Consumer Savings and Revenue Transfers for Title and Settlement Firms Under the New GFE.** Section VII.E of Chapter 3 conducted analyses with respect to consumer savings in title and settlement costs and transfers from title and settlement firms due to the new GFE. The first set of estimates ranged from 7.5% to 10.0%, or from \$1.35 billion to \$1.79 billion, given the projection of \$17.938 billion in total revenues for the title and settlement industry.<sup>145</sup> For the case of \$1.79 billion in transfers, Table 5-16 show how transfers from small businesses vary depending on the revenue share of Direct Title Insurance Carriers (DTIC). As the DTIC share

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<sup>144</sup> As explained in Chapter 3, origination costs were estimated to be 1.75 percent of total mortgage originations, or \$42.0 billion. Thus, total settlement costs (origination costs and third party fees) are estimated to be \$66.738 billion, or 2.78 percent of the mortgage amount. (The \$66.738 billion includes yield spread premiums paid indirectly by the borrower.)

<sup>145</sup> The earlier analysis of the annual reports of major title companies estimated \$24.823 billion in residential revenues for the title industry, or 0.80 percent of total 2005 mortgage originations (\$3.1 billion). In this analysis, mortgage originations are projected to fall to \$2.4 trillion, which explains why projected title revenues (\$17.9 billion) are less than estimated 2005 title revenues (\$24.8 billion).

increases from 35% to 50%, the small business share of transfers under the new GFE falls from \$765 million to \$609 million, a decline of \$156 million. For the case of \$1.35 billion in transfers, the small business share of transfers falls from \$577 million to \$459 million, as the DTIC share increases from 35% to 50%.<sup>146</sup>

The transfers associated with the new GFE can be allocated to the different components of the title and settlement industry, subject to the uncertainty discussed earlier. (See Table 5-16.) In the case of \$1.79 billion in transfers (a 10% fee reduction) and assuming a DTIC share of 43%, the transfers would be allocated as follows: (a) \$770 million for Direct Title Insurance Carriers; (b) \$680 million for Title Abstract and Settlement Offices; and (c) \$340 million for the combined "lawyers" and "other activities" categories (hereafter referred to as the lawyer-escrow category). In this case, the \$682 million in transfers from small businesses is allocated as follows: (a) \$37 million<sup>147</sup> for Direct Title Insurance Carriers; (b) \$339 million for Title Abstract and Settlement Offices; and (c) \$306 million for the lawyer-escrow category. These transfer allocations depend importantly on the DTIC share of industry revenue and the split of the remaining revenue between (b) and (c). For example, if the DTIC revenue share is 35% (instead of 43%) and if remaining industry revenue is split on a 60/40 basis (instead of a 66/33 basis) between (b) and (c), then transfers from small title and settlement agents increase moderately to \$797 million (from \$682 million) and are allocated as follows: (a) \$30 million for Direct Title Insurance Carriers; (b) \$348 million for Title Abstract and Settlement Offices; and (c) \$419 million for the lawyer-escrow category. Table 5-17 reports several additional sensitivity analyses, some of which will be discussed later.

In the case of the title approach that projects \$150-\$200 in savings per loan under the new GFE, aggregate savings would be \$1.875-\$2.50 billion. Using the \$200 projection (see Table 5-17) and the above the base case (DTIC share of 43%), the \$2.50 billion savings would be allocated as follows: (a) \$1,075 million for Direct Title Insurance Carriers; (b) \$950 million for Title Abstract and Settlement Offices; and (c) \$475 million for the lawyer-escrow category. In this case, small business transfers would be \$0.95 billion, allocated as follows: (a) \$52 million for Direct Title Insurance Carriers; (b) \$473 million for Title Abstract and Settlement Offices; and (c) \$428 million for the lawyer-escrow category. Under the title approach, small business transfers increase from \$0.85 billion to \$1.07 billion as one reduces the DTIC share from 50% to 35%.

#### **IV.B.5.c. Transfers as a Share of Revenue for Industry Components**

The section takes a closer look at the revenue and transfer estimates for the three component industry categories. As has been emphasized, the lawyer-escrow group earns a substantial portion of its revenues from non-mortgage-origination-related activities. In addition,

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<sup>146</sup> While data for 35% and 50% are presented, it is likely that the former is too small and the latter, too large. The best estimate is 43%, as discussed earlier. The range is presented for sensitivity reasons, given the 43% estimate is subject to some parameter assumptions.

<sup>147</sup> As was noted earlier, the Census-Bureau-reported small businesses in this category are probably errors, as title insurance companies are large firms.

as discussed above, it is difficult to estimate the mortgage-related revenues of large title insurers because they not only engage in other businesses but their revenue data include commissions that are returned to local title agents. Still, it is interesting to relate the revenue transfers from the RESPA rule to available information about industry revenues.

**(1) Large title insurers.** As discussed in Section IV.B.4 of this chapter, it is estimated that large title insurers had revenues of \$18.087 billion in 2004 and \$12.805 billion in 2002 (but as noted above, these revenue figures include amounts that are returned to local title agents as commissions). The firms in this industry are large -- in 2002, the top 8 firms accounted for 87.7% of industry revenue, according to data from the Census Bureau (see Table 5-15).

Therefore, there is no small business issue with this industry. Various estimates of mortgage-related revenues and transfers for the DTIC industry have already been discussed and several estimates for both the new GFE are presented in the sensitivity analyses reported in Tables 5-17.

## **V. Other Third Party Settlement Services**

Other third party settlement services include appraisals, surveys, pest inspections, credit reports, tax services and flood plain certifications. This section includes overviews of the appraisal (V.A), surveying (V.B), pest inspection (V.C), and credit reporting industries (V.D). There is also a description of the economic statistics for each industry, with an emphasis on each industry's share of small business activity. In addition, estimates of the consumer savings and revenue transfers from the RESPA rule are developed using the economic statistics represented. In each case, the small business share of revenue transfers is highlighted.

### **V.A. Appraisers**

#### **V.A.1. Overview of Appraisal Industry**

Real estate appraisers are specialists in the business of assessing the value of real estate. The central task for an appraiser is to prepare a written description of the land or real property and submit an estimate of its market value. Ideally, a valuation would be based on a careful examination of the property itself as well as the surrounding neighborhood and a consideration of market trends in the area. The most reliable method of appraising the value of a home is to analyze the prices of similar properties ("comparables") that have been recently sold. However, an acceptable appraisal practice is to base the value of real estate on the cost of construction less depreciation.

The appraisal is useful for a wide variety of parties: buyers, sellers, lenders, insurers, brokers, and officials of local governments. A potential homebuyer may want a house appraised to ensure that the selling price is not inflated beyond what is a normal market price. Property owners may hire an appraiser to challenge the assessment of property value by tax assessors. The role of the appraiser in the settlement process is to provide a lender with an estimate that would allow the lender to verify whether the selling price is high enough to justify the loan requested.

Given the potentially conflicting interests in the appraised value of a property, professional ethics (Uniform Standards of Professional Appraisal Practice) emphasize the appraiser's role as an objective, independent, and unbiased third party. Every state has an appraiser regulatory law and requires that unbiased individuals who have been licensed or certified prepare appraisals.<sup>148</sup> The appraisal industry is highly localized. In a recent article in *Secondary Marketing Executive*, Keen argues, "(i)t is not economically feasible to send an appraiser from Atlanta to provide services in Birmingham, Alabama. The appraiser may have a lower rate for the actual appraisal, but the additional travel expense would consume the rate differential."<sup>149</sup>

The introduction of information technology into the appraisal industry may lead to significant changes in business practices. The combination of statistical methodology, large data sets on housing prices, and advances in computer power allows the estimation of the value of a house with information on its location and a few other characteristics. These hedonic pricing models, referred to as automated valuation models (AVMs) in the real estate industry, have proven useful in supplanting traditional appraisals for home equity and home improvement loans. In addition, some lenders make use of AVMs for first mortgages. However, electronic appraisals have not been used as significantly for first mortgages, despite their lower cost (electronic appraisals range from \$2 to \$70 while human appraisals range from \$200 to \$400) and convenience (an electronic appraisal can be delivered electronically within a matter of minutes while a full appraisal can take up to three weeks to complete and requires the homeowner to be on-site).<sup>150</sup> Developing econometric models and expanding databases used for AVMs is an ongoing process and may have not reached the point where AVMs are universally trusted. However, both technological progress and the expansion of data sets are improving automated valuations and they are becoming more accepted in the market. In 2000, ten percent of all new originations in the residential mortgage market had an AVM, either in place of or in addition to a human appraisal. The number of major AVMs has increased from four in 1998 to nine today. When introduced, AVMs were employed only as a tool for quality control but they are now being used as the only source of an appraisal in some cases.<sup>151</sup> Whether AVMs will be able to replace a substantial amount of the work done by appraisers or simply be used as a complement to a traditional appraisal is an important issue for the appraisal industry. Secondary market agencies will likely play an important role in the future use of AVMs. Freddie Mac, for example, is a leading proponent of AVMs, and has contributed to the development of the technology.

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<sup>148</sup> Appraisal Institute, *Appraising Residential Properties*, 3<sup>rd</sup> Edition, 1999.

<sup>149</sup> Jeff Keen, "New RESPA Regulations Would Shift More Power to Service Providers", *Secondary Marketing Executive*, December 2002.

<sup>150</sup> H. Stan Banton, "The Growing Debate Over Appraisal Technology," *Mortgage Banking*, October 2002.

<sup>151</sup> RatingsDirect, "As RMBS Issuance Growth Persists, Regulatory Changes and Technological Advances Emerge", Standard and Poor's, [www.standardandpoors.com/ratingsdirect](http://www.standardandpoors.com/ratingsdirect), 23 April 2003.

## V.A.2. Description of Economic Data: Appraisal Industry

Census Bureau data from the year 2004 indicate that the real estate appraisal industry<sup>152</sup> employed a total of 45,021 people at 15,689 operating firms in the U.S. These employer firms had an estimated total annual revenue of \$4.96 billion.<sup>153</sup> In 2004, an Office of Real Estate Appraisers averaged 2.9 employees per firm with estimated revenue of \$316,080 per firm. Ninety percent of real estate appraiser employees worked at firms employing fewer than 100 employees; a vast majority (82%) worked at firms employing fewer than 20 employees. In addition to the 15,689 employer firms in 2004, the Census reports that there were 49,802 non-employer real estate appraisers yielding a total of 65,491 appraisal firms. Most of the non-employer firms are sole proprietorships.<sup>154</sup> While the data do not provide many details about these non-employer firms, Census methodology ensures that nonemployers meet a reasonable definition of small.

Census Bureau data from 2002 provide somewhat more detailed information about the Office of Real Estate Appraiser industry. In 2002, 42,040 people were on the payroll of 13,579 employer firms, compared to 45,021 people working at 15,689 employer firms in 2004. These firms generated an estimated annual revenue of almost \$5 billion in 2004 and a total revenue of \$4.6 billion in 2002 (\$4.8 billion in 2004 dollars). The average number of employees per firm was 3.1 in 2002 compared to 2.9 in 2004. The average revenue per firm in 2002 was \$339,620 (\$356,610 in 2004 dollars) with an average payroll of \$37,024 per employee (almost \$38,890 in 2004 dollars). The 2004 estimates were lower: \$316,080 average revenue per firm and average payroll of \$38,235 per employee. In addition to the 13,579 firms from the Office of Real Estate Appraisers that had employees in 2002, the Census recorded 39,727 non-employer firms. In 2004, the Census reported 49,802 non-employer firms.

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<sup>152</sup> The Census defines the appraisal industry as follows: “This industry comprises establishments primarily engaged in estimating the fair market value of real estate.”

<sup>153</sup> If the average cost for a full appraisal is \$350 and the number of appraisals equaled the number of single-family originations in 2004, which amounted to 15,873,505 (based on estimates by Fannie Mae, Freddie Mac and the Mortgage Bankers Association) then the revenues generated from single-family originations would be \$5.6 billion. This figure is greater than the estimated revenue. Indeed, one would expect the revenue from single-family loan originations to be *lesser* than the total revenue of the industry. Appraisers earn revenue from commercial and multifamily real estate appraisals activities and other revenue-generating activity by appraisers in the residential sector (e.g., doing appraisals for local governments as part of their tax assessment activities). In addition, some single-family mortgage transactions, such as appraisals for home equity lines of credit or second mortgages, are not included in this analysis. There are a few potential explanations for the discrepancy between our estimates of the industry’s revenue in 2004. First, our estimate of \$5.6 billion from single-family originations may be too large: perhaps many appraisers charge a fee of less than \$350. For example, a fee of \$300 would be consistent with our estimated revenue of the real estate appraisal industry using census figures. Another possibility is that the number of originations that generate revenue for appraisers is overstated. Some mortgages do not require a traditional appraisal. Reducing the number of settlements requiring an appraisal by only 11% would account for the difference between the two estimates. Second, it is possible that we underestimated the revenue of real estate appraisers in 2004. The estimate for 2004 is based on offices’ of real estate appraisal share of “Activities Related to Real Estate.” A increase of this share would account for the difference between the two estimates.

<sup>154</sup> See the technical appendix for a definition of nonemployer establishments.

## V.A.2.a. Census Bureau Data for Small Businesses: Real Estate Appraisal

An insight into size standards for small business can be gained by estimating the number of employees of a firm at the size standard limit. Dividing our size standard of \$2.5 million<sup>155</sup> by the estimated revenue per employee for 2004 yields an approximate size standard of 23 employees for the appraisal industry in 2004.<sup>156</sup>

The greater financial detail provided in 2002 data make the 2002 data better suited for the task of determining how many firms meet the SBA's definition of small. Unfortunately, the breakdown of the 2002 Economic Census data by revenue does not allow us to calculate the share of firms earning less than \$1.5 million (the SBA size standard in 2002) or \$2 million (the SBA size standard as of 2006). However, a generous approximation of the percentage of small businesses can be obtained by calculating the share of firms earning less than \$2.5 million. Of the total employer firms operating for the entire year, 99.0% had annual revenues less than \$2.5 million, which approximates the SBA definition of small. These small employer firms accounted for 75.1% of revenue, 82.8% of employees, and 78.4% of annual payroll. Of all firms in the appraisal industry, employer and nonemployer, 99.8% are small.<sup>157</sup> <sup>158</sup> These small businesses account for 83.1% of the revenue earned by the appraisal industry.<sup>159</sup>

Examining data on industry concentration is an alternative way of understanding the extent to which the appraisal industry is characterized by small firms. The four largest firms in the appraisal industry account for only 0.2% of establishments, 10% of revenue, and 5% of employees. Even the fifty largest firms account for as little as 0.9% of the establishments, 19.8% of the revenue, and 12.9% of employees.

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<sup>155</sup> Note that the size standard for Real Estate Appraisal in 2002 was \$1.5 million and is currently \$2 million (since July 31, 2006). The larger size standard of \$2.5 million is used for consistency with the revenue data from the Economic Census of 2002. This will slightly overestimate the proportion of firms that are small businesses.

<sup>156</sup> A similar calculation using 2002 data also yields an alternative definition of small of 23 employees.

<sup>157</sup> The percentage, 99.8 percent, of all firms that are considered small (approximating SBA's definition of a small business) is derived by adding the 39,727 nonemployer firms to the 10,685 employer firms operating the entire year that meet the approximation of SBA size standards and dividing by the sum of all 10,791 employer firms operating the entire year and the number of nonemployer firms.

<sup>158</sup> The 2002 data on the percentage (99.0%) of employer firms that are small can be applied to the 2004 data reported in the text to arrive at an updated estimate for the number of small firms. Multiplying the number of employer firms in 2004 (15,689) by 0.99 yields an estimated 15,532 small employer firms which, when added to the number of non-employer firms (49,802) in 2004, yields 65,334 small firms in 2004. These small firms represent 99.8% of all firms in 2004. (As noted in the text, these calculations define a small employer business as an employer firm with revenue less than \$2.5 million annually.)

<sup>159</sup> The revenue share of small firms (83.1%) is calculated by adding the revenue earned by employer firms in 2002 operating the entire year that meet an approximation of the SBA standard, \$3.2 billion, to the revenue earned by nonemployer firms, \$2 billion, and dividing by the total revenue across all firms, which is equal to \$3.4 billion earned by all employer firms operating the entire year plus the revenue of nonemployer firms. The percentage small by the SBA definition will be less than 83.1 percent because the approximation, \$2.5 million, of the size standard is greater than the size standard itself, \$1.5 million.

**Table 5-17. Concentration of Largest Firms 2002: Real Estate Appraisers**

	Number of Establishments	Share of Establishments	Share of Revenue	Share of Annual Payroll (\$1,000)	Share of Employees
<b>All Firms</b>	13,770	100.0%	100.0%	100.0%	100.0%
<b>4 Largest Firms</b>	22	0.2%	10.0%	6.4%	5.0%
<b>8 Largest Firms</b>	30	0.2%	12.9%	8.0%	6.7%
<b>20 Largest Firms</b>	67	0.5%	16.3%	11.6%	9.7%
<b>50 Largest Firms</b>	128	0.9%	19.8%	15.7%	12.9%

“Very Small” Appraisal Firms. A final method of characterizing a small business is by the number of employees. Although this is not the Small Business Administration’s method of defining a small business, Census data on firms with less than twenty employees reveals the characteristics of those firms that are “very small.” In 2004, employer firms, employing less than twenty employees, employed an average 2.4 employees, accounted for 98.8% of all employer firms in the Real Estate Appraisal industry, employed 82.2% of its employees, and received 80.6% of its (estimated) revenue. Including nonemployer firms would yield that “very small firms” constitute 99.7% of all Real Estate Appraisal firms in 2004 and earn 86.8% of the industry’s (estimated) revenue.

**Number of Employees.** Analysis in Chapter 6 will require an estimate of the number of workers in the industry as a whole and in small firms within the industry. For the year 2004, adding the 45,021 employees in employer firms (from Table 5-58) to 49,802 (which assumes one worker for each non-employer firm) yields 94,823 as one estimate of the number of workers in the industry. The 2002 data on the percentage of employees in small employer firms (82.8% from Table 5-60) can be applied to the 2002 data to arrive at an estimate for the number of workers in small employer firms. Multiplying the number of employees (45,021) by 0.828 yields an estimated 37,227 employees in small employer firms in 2002 which, when added to 49,802 (which assumes one worker for each non-employer firm), yields 87,079 workers in small firms in 2002. Workers in small firms represent 91.8% of all industry workers (94,823) in 2004.

### **V.A.3. Consumer Savings, Revenue Estimates and Small Business Transfers: Appraisal Industry**

The predicted cost savings for consumers of appraisal services determines the economic impact of the reforms on the appraisal industry. The projected revenue for the appraisal industry from settlements is \$4.375 billion (\$350 average fee times 12,500,000 projected mortgage originations). Appraisal services represent 17.7% of all third-party settlement fees. As explained in Chapter 3, the new GFE will encourage originators and packagers to seek cost reductions in all third-party services. These cost reductions will likely come from increased and innovative use of new technology, volume discounts, and mutually advantageous business arrangements. The cost savings for consumers of the GFE are estimated to be from 7.5% to 10% (or \$35 per appraisal) of current fees. This translates to a transfer of \$328 million-\$438 million from the appraisal industry. Small appraisal firms account for 83.1% of industry revenues. Therefore, transfers from small appraisal firms would have been \$273 million-\$364 million. These two sets of transfer estimates, respectively, represent 4.5%-6.0% of total industry revenue and 4.5%-6.0% of small industry revenue in 2004, based on estimated industry revenue from the Census Bureau (\$7.3 billion in the case of large industries and \$6.1 billion in the case of small industries).

If the RESPA rule had been in effect in 2004, the savings and transfers would have been larger because of the larger volume of mortgages: \$417 million-\$556 million for the total industry and \$347 million - \$462 million for small appraisal firms. In these cases, the estimates represent 5.7%-7.6% of 2004 revenue. That these transfer rates are less than the projected savings rates (7.5%-10% for the GFE) stem from appraisers having other income-producing activities than settlement services for residential mortgage originations.<sup>160</sup>

For estimates of the allocation of consumer savings of the GFE by size of firm, see Table A.6. In addition, Table A.6 shows estimates of the allocation of consumer savings per firm for the GFE.

Earlier, it was estimated that, in 2002, small business accounted for 83.1% of the industry's total revenue. Assuming that this ratio applies to the revenue from settlement services, small appraisal firms earn \$6.1 billion from settlement services. It is not expected that small business in the appraisal industry will bear a disproportionate share of the price decrease. Since appraisals are locally provided services, small firms are just as competitive as larger ones. Because it is not expected that small business will bear a greater burden of the reform than large business, the estimates of the economic impact of the GFE will be from \$273 million to \$364 million, as noted above.

The local orientation of the appraisal industry could change over time. For example, the necessity of appraisers visiting homes could be rendered unnecessary in some cases by the automated valuation appraisal, which is currently being used by some lenders and permitted by Fannie Mae and Freddie Mac. However, it is unlikely that RESPA reform would be the catalyst, as the technology advances seem to be taking place in any event. Yet, according to Don Kelley, vice president of the Appraisal Institute, AVMs will not be a threat to the appraisal industry because of the need for local expertise in the real industry. He said that "(i)t's hard to calibrate local variations. This is obvious because no one is doing nationwide models with great success."<sup>161</sup> Thus, the only change that RESPA reform will introduce is that appraisals will occur at lower prices negotiated between providers and originators. Lenders will always need appraisers with local expertise to verify that the property in question is sufficiently valuable. Since large originators will have to deal with multiple appraisal firms in order to ensure complete geographic coverage, and large multi-jurisdictional appraisal firms have no apparent cost advantages over smaller providers (and may have location-related cost disadvantages), there is no reason to believe that small appraisal firms will be excluded from any business transactions.

Those who will bear the burden of the price decreases expected from the rule will be those who charged noncompetitive prices to begin with. There is no reason to believe that a

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<sup>160</sup> The adjustment for 2004 in the text uses a ratio of 1.27, which is 15,873,505 (estimated 2004 mortgages, based on the average mortgage origination estimates for 2004 by Freddie Mac, Fannie Mae, and the Mortgage Bankers Association of America) divided by the projected 12,500,000 loans (which is also based on these agencies' projections for 2008). If OFHEO's 2004 mortgage origination estimate had been used, the adjustment ratio would have been 1.34 (16,783,573 divided by 12,500,000) and the adjusted 2004 transfer share of industry revenue would have been higher at 6.0%-8.4%.

<sup>161</sup> "AVMs and Appraiser Technology Advancing," *Inside Mortgage Technology*, May 19, 2003.

disproportionate percentage of small appraisal firms charge overly high prices. Therefore, there is no reason to believe that small firms will bear a disproportionate share of the burden of this reform.

## **V.B. Surveyors**

### **V.B.1. Overview of the Surveying Industry**

Surveying properties can be a highly technical task. It involves the drawing or mapping of a parcel of real property. Surveyors engage in several major activities: a determination of the size, structure, and shape of land; surveying land for the positioning of boundaries and demarcations; design and administration of geographic information systems for mapping and charting reports; a visible and evaluative assessment of the environment and the general surroundings of the property; an assessment of the land value; and an assessment of potential or future construction projects.<sup>162</sup> For a single-family real estate transaction, lenders and other parties rely on the survey for demarcating the property. A dispute concerning property boundaries may result in a significant loss for the property owner who loses. However, the lender will suffer only when the loss is greater than the homeowner's equity. To guard against this possibility, survey coverage is often part of the title insurance policy that a lender will purchase. As a result of lenders being able to insure themselves against property line disputes through title insurance, many lenders do not request a survey before closing a loan. In a small sample of FHA loans, 110 out of 212 had a survey. While FHA loans may or may not be representative of all loans with respect to the use of surveys, the data do show that they are not usually required.

### **V.B.2. Description of Economic Data: Surveying and Mapping**

Census Bureau data from the year 2004 demonstrate that the Surveying & Mapping Services industry employed 61,623 in 9,028 firms.<sup>163</sup> These firms had estimated annual revenue of almost \$4.9 billion. In 2004, the Surveying and Mapping Services industry averaged 6.8 employees and an estimated revenue of \$540,082 per firm. Approximately 90% of surveying and mapping employees worked at firms employing fewer than 100 employees; well over half (62%) worked at firms employing fewer than 20 employees. In addition to the 9,028 employer firms, the Census reports a total of 9,196 non-employer firms.

Census 2002 figures provide somewhat more detailed information about Surveying and Mapping Services. In 2002, the sector employed 59,174 people at 8,856 operating firms in the

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<sup>162</sup> Plog et al., "What Every Real Estate Professor Should Know About Surveys." Report produced by MXP Land Surveying, <[www.markxplog.com](http://www.markxplog.com)>, 2001.

<sup>163</sup> The data reported by the Census fall within a broad definition of surveying; this industry comprises establishments primarily engaged in performing surveying and mapping services of the surface of the earth, including the floor. These services may include surveying and mapping of areas above or below the surface of the earth, such as the creation of view easements or segregating rights in parcels of land by creating underground utility easements.

U.S. These firms generated an aggregate revenue of almost \$4.3 billion. The average number of employees per firm was 6.7 compared to 6.8 in 2004. The average revenue per firm in 2002 was \$483,027, which is \$507,192 in 2004 dollars,<sup>164</sup> and less than the 2004 estimate of \$540,082. In addition to the 8,856 employer firms from the Surveying and Mapping industry in 2002, there were an estimated 8,651 nonemployer firms. The grand total of both employer and nonemployer operating firms for 2004 was 18,224; the total for 2002 was 17,507 according to the Census.

### **V.B.2.a. Census Bureau Data for Small Businesses: Surveying and Mapping**

The greater financial detail provided for 2002 makes the 2002 data better suited for the task of determining how many firms meet the SBA's definition of small. An insight into size standards can be gained by estimating the number of employees of a firm at the size standard limit. Dividing our size standard of \$5 million<sup>165</sup> by the estimated revenue per employee for 2004 yields an approximate size standard of 63 employees for the Surveying and Mapping industry.<sup>166</sup> As mentioned we can reach a more accurate definition of "small" using the 2002 revenue data. Of the total employer firms, 99.1% had annual revenues less than \$5 million and are considered small by the SBA definition.<sup>167, 168</sup> In 2002, 99.6% of all survey firms (including nonemployers) were small according to the SBA's definition.<sup>169</sup> These small businesses account for 81.3%<sup>170</sup> of the revenue earned by the surveying and mapping services industry.<sup>171</sup>

Examining data on industry concentration is an alternative way of understanding the extent to which the surveying and mapping industry is characterized by small firms. The four

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<sup>164</sup> See Technical Appendix for the description of the price deflator used.

<sup>165</sup> Note that the size standard for Surveying and Mapping at the time was \$4 million and is currently \$4.5 million (since July 31, 2006). The larger size standard of \$5 million is used for consistency with the Census data on the revenue of firms. This may slightly overestimate the proportion of firms that are small businesses.

<sup>166</sup> A similar calculation using 2002 data yields an alternative definition of small of less than 69 employees.

<sup>167</sup> The breakdown of the 2002 Economic Census data by revenue does not allow us to calculate the share of firms earning less than \$4.5 million (the SBA size standard). However, a generous estimate of the percentage of small businesses can be obtained by calculating the share of firms earning less than \$5 million.

<sup>168</sup> The 2002 data on the percentage (99.1%) of employer firms that are small can be applied to the 2004 data reported in the text to arrive at an updated estimate for the number of small firms. Multiplying the number of employer firms in 2004 (9,028) by 0.991 yields an estimated 8,947 small employer firms which, when added to the number of non-employer firms (9,196) in 2004, yields 18,143 small firms in 2004. These small firms represent 99.6% of all firms (18,224) in 2004.

<sup>169</sup> This is derived by adding the 9,342 nonemployer firms to the 7,412 employer firms operating the entire year that meet SBA size standards and dividing by the sum of all 7,450 employer firms operating the entire year and the number of nonemployer firms.

<sup>170</sup> 81.3 percent is the percentage of firms earning less than \$5 million. The SBA size standard for surveying was \$4 million, so that the percentage of firms earning less than \$4 million would be less than 83.2 percent.

<sup>171</sup> The revenue share of small firms is calculated by adding the revenue earned by employer firms operating the entire year considered small by SBA standards, or \$3.33 billion, to the revenue earned by nonemployer firms, \$222 million, and dividing by the total revenue across all employer firms operating the entire year and nonemployers (\$4.46 billion).

largest firms in the surveying and mapping industry account for only 0.3% of establishments, 5.3% of revenue, and 3.2% of employees. Even the fifty largest firms account for as little as 1.4% of the establishments, 17.1% of the revenue, and 11.2% of employees.

**Table 5-18. Concentration of Largest Firms 2002: Surveying and Mapping (except geophysical) Services**

	Number of Establishments	Share of Establishments	Share of Revenue	Share of Annual Payroll (\$1,000)	Share of Employees
<b>All Firms</b>	9,120	100.0%	100.0%	100.0%	100.0%
<b>4 Largest Firms</b>	23	0.3%	5.3%	4.0%	3.2%
<b>8 Largest Firms</b>	30	0.3%	7.3%	5.9%	4.2%
<b>20 Largest Firms</b>	64	0.7%	11.6%	10.1%	6.9%
<b>50 Largest Firms</b>	129	1.4%	17.1%	15.4%	11.2%

**“Very Small” Surveying and Mapping Firms.** An alternative method of characterizing a small business is by the number of employees. Although this is not the Small Business Administration’s method of defining a small business, Census data on firms with less than twenty employees reveals the characteristics of those firms that are “very small.” In 2004, employer firms, employing less than twenty employees, employed an average of 4.5 employees, accounted for 93.3% of all employer firms in the Surveying and Mapping industry, employed 61.7% of its employees, and received 55.7% of its (estimated) revenue. Including nonemployer firms would yield that “very small” firms constitute 96.7% of all Surveying and Mapping firms in 2004 and earn 58.6% of the industry’s revenue.

**Number of Employees.** Analysis in Chapter 6 will require an estimate of the number of workers in the industry as a whole and in small firms within the industry. For the year 2004, adding the 61,623 employees in employer firms (from Table 5-66) to 9,196 (which assumes one worker for each non-employer firm) yields 70,819 as one estimate of the number of workers in the industry. The 2002 data on the percentage of employees in small employer firms operating the entire year (87.0% from Table 5-68) can be applied to the 2004 data to arrive at an estimate for the number of workers in small employer firms. Multiplying the number of employees (61,623) by 0.87 yields an estimated 53,612 employees in small employer firms in 2004 which, when added to 9,196 (which assumes one worker for each non-employer firm), yields 62,808 workers in small firms in 2004. Workers in small firms represent 88.7% of all industry workers (70,819) in 2004. As discussed in Chapter 6, not all these workers are engaged in single-family mortgage-related activity.

### **V.B.3. Consumer Savings, Revenue Estimates, and Small Business Transfers: Surveyors**

The predicted cost savings for consumers of surveyor services determines the economic impact of the reforms on the surveying and mapping industry. The projected revenue for the surveying and mapping industry associated with residential mortgage settlements is \$725 million, which equals \$58 (average fee over all loans including those refinance and home purchase loans without a survey) times 12,500,000 mortgage originations. This represents 2.9% of all third-party settlement fees.

While there was a scenario (the “title approach”) where this industry was not affected by RESPA reform, there were two scenarios that projected cost savings for consumers to be 7.5% and 10% of current fees. This translates to a transfer of \$54 million-\$73 million from the surveying industry. Small surveyor firms account for 81.3% of industry revenues. Therefore,

transfers from small survey firms would have been \$44 million-\$59 million. These two sets of transfer estimates, respectively, represent 1.03%-1.40% of total industry revenue and 1.03%-1.40% of small industry revenue in 2004, based on estimated industry revenue from the Census Bureau (\$5.218 billion in the case of large industries and \$4.242 billion in the case of small industries).

If the RESPA rule had been in effect in 2004, the savings and transfers would have been larger because of the higher volume of mortgages: \$69 million-\$93 million for the total industry and \$56 million - \$75 million for small survey firms. In these cases, the estimates represent 1.3%-1.8% of 2004 revenue.

For estimates of the allocation of consumer savings of the GFE by size of firm, see Table A.7. In addition, Table A.7 shows estimates of the allocation of consumer savings per firm for the GFE.

It is not expected that surveyors will bear a disproportionate burden of the price decrease from RESPA reform. The reason is that surveys are provided on-site at the mortgaged property. The transportation cost of visiting individual sites, especially the opportunity cost of the time spent in transit, adds substantially to the cost of providing the service. These transportation costs counterbalance, or even overwhelm, any scale economies that may otherwise exist in the production of these services.

Even if a surveying firm is efficient and charges low prices, it may find it difficult to compete against providers who are located sufficiently closer to the site in question. Thus, surveying services are by economic necessity provided by local firms. Reinforcing the local orientation of these third-party services are the value of local expertise and the importance of personal networks in receiving referrals.

It is not likely that the local orientation of the surveying industry will change over time. Even with advances in GIS technology, on-site surveys will always be more accurate. Thus, there will be no significant change in the local provision of surveys under packaging. Nor is it likely that there will be a reduction of the number of these services purchased since this reform will not result in a drop in the number of mortgages that require these services.

One trend of some concern to surveyors is that lenders appear to be substituting survey coverage in their title insurance for an actual survey.<sup>172</sup> If there were to be a dispute over property lines that led to a decrease in the property value, then the homeowner would bear the brunt of that loss. However, if the decrease in property value were to exceed the owner's equity, then the excess loss would be a cost paid by the lender. To avoid such a situation, lenders have traditionally required surveys before closing. An alternative strategy is for lenders to insure themselves against the remote possibility that such a loss would occur. As represented by the American Congress on Surveying and Mapping, surveyors worry that this trend could be

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<sup>172</sup> Comments from Curtis W. Sumner, President, Executive Director, American Congress on Surveying and Mapping, to Rules Docket Clerk, HUD, regarding "Docket No. FR-4627-P-01, Real Estate Settlement Procedures Act (RESPA); Simplifying and Improving the Process of Obtaining Mortgage Settlement Costs to Consumers," October 28, 2002, page 1.

hastened by the RESPA rule to the disservice of the consumers.<sup>173</sup> However, it is important to note that this practice has already become accepted and so is not likely to be affected by RESPA reform.

## **V.C. Pest Inspectors**

### **V.C.1. Overview of Industry: Pest Inspection**

The exterminating and pest control industry comprises establishments primarily engaged in exterminating and controlling birds, mosquitoes, rodents, termites, and other insects and pests (except for crop production and forestry production). Establishments providing fumigation services are included in this industry. Examples of industries include: exterminating services, fumigating services, mosquito eradication services, and termite control services.

Extermination and pest control professionals provide a valuable service for homeowners. They rely on training, expertise and sophisticated techniques to control infestations in an efficient, economical and safe manner, which in turn protects the long-term interests of the homeowner's family and environment. A preliminary inspection and surveying of the premises is conducted. The primary question is whether termites are present. Based on the inspection, pest control experts provide a description of each extermination project and a success rate estimate for each procedure. In a small sample of FHA loans, 99 out of 212 had a pest inspection. While FHA loans may or may not be representative of pest inspections, the data do show that they are not usually required.

Firms will base their fees on the scale and nature of the procedure, the potential need to alter the structure or remove walls, and the degree and complexity of pest infestation. The exterminating and pest control industry can be highly dangerous. Therefore, most pests and extermination specialists are required to undergo extensive training to obtain a license. They must also carry liability insurance to cover potential damage to property or individuals.

### **V.C.2. Description of Economic Data: Exterminating and Pest Control**

Statistics of U.S. Business 2004 indicate that the Exterminating and Pest Control industry had a total employment of 95,437 with 10,065 operating firms in the U.S. The aggregate estimated annual revenue of these firms was \$7.4 billion. In 2004, the Exterminating and Pest Control industry employed an average of 9.5 employees and recorded an average annual (estimated) revenue of \$734,931 per firm. Almost 61% of the employees worked at firms employing fewer than 100 employees, and well over a third (40.7%) worked at firms employing fewer than 20 employees. In addition to the 10,065 employer firms, the Census reports 7,935 non-employer firms, yielding a total of 18,000 firms.

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<sup>173</sup> Ibid.

Census Bureau data from 2002 provide greater detailed information about the Exterminating and Pest Control industry. In 2002 the sector employed 90,948 people at 9,618 operating firms. These firms generated aggregate revenue of \$6.6 billion. The average number of employees per firm in 2002 was 9.5 (the same as in 2004). The average revenue per firm was \$685,905 in 2002, which is \$720,219 in 2004 dollars when adjusted for inflation.<sup>174</sup> This is somewhat less than the 2004 estimate of \$734,931. In addition to the 9,618 employer firms in 2002, the Census reports 7,910 non-employer firms, bringing the grand total of firms to 17,528 for the entire Exterminating and Pest Control industry. Between 2002 and 2004, the number of firms grew by 2.7% and the number of workers grew by 4.6% (assuming one worker per nonemployer firm). Average annual growth rates were 1.4% and 2.3% respectively.

### **V.C.2.a. Census Bureau Data for Small Businesses: Exterminating and Pest Control**

The greater financial detail provided makes the 2002 data better suited for the task of determining how many firms meet the SBA's definition of small. An insight into size standards can be gained by estimating the number of employees of a firm at the size standard limit. Dividing the most recent size standard (\$6.0 million, effective October 1, 2002) by the revenue per employee for 2002 yields an approximate size standard of 83 employees per firm for the Exterminating and Pest Control Service industry. Of the total employer firms that were reported by the Census in 2002, 99.0% had annual revenues less than \$5 million and are considered small by the SBA definition. The percentage, 99.9%, of all firms (nonemployer and employer) that were small in 2002 according to the SBA's definition is derived by adding the 55,946 nonemployer firms to the 7,969 employer firms operating the entire year that meet SBA size standards and dividing by the sum of all 63,998 employer firms operating the entire year and the number of nonemployer firms.<sup>175</sup> These small businesses accounted for 57.0% of the revenue earned by the extermination services industry in 2002.<sup>176</sup>

The pest control industry is characterized by more industry concentration than most industries involved in the settlement process. The four largest firms earn 27.6% of revenues and employ 21.2% of employees.

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<sup>174</sup> See the technical appendix for information on the price deflator used to convert values to 2006 dollars.

<sup>175</sup> The 2002 data on the percentage 99.0% (Table 5-64) of employer firms that are small (earning less than \$5 million) can be applied to the 2004 data reported in the text to arrive at an updated estimate for the number of small firms. Multiplying the number of employer firms in 2004 (10,065) by 0.990 yields an estimate of 9,964 small employer firms which, when added to the estimated number of non-employer firms (58,076) in 2004, yields 68,040 small firms in 2004. These small firms represent 99.9% of all firms in 2004.

<sup>176</sup> The revenue share of small firms is calculated by adding the revenue earned by employer firms operating the entire year considered small by SBA standards, or \$3.3 billion, to the estimated revenue earned by nonemployer firms, \$904 million, and dividing by the total revenue across all employers operating the entire year and nonemployer firms, which is equal to \$7.3 billion.

**Table 5-19. Concentration of Largest Firms 2002: Exterminating and Pest Control Services**

	Number of Establishments	Share of Establishments	Share of Revenue	Share of Annual Payroll (\$1,000)	Share of Employees
<b>All Firms</b>	11,321	100.0%	100.0%	100.0%	100.0%
<b>4 Largest Firms</b>	749	6.6%	27.6%	26.0%	21.2%
<b>8 Largest Firms</b>	863	7.6%	32.1%	30.6%	24.8%
<b>20 Largest Firms</b>	1,195	10.6%	38.8%	37.9%	33.0%
<b>50 Largest Firms</b>	1,439	12.7%	44.6%	44.6%	38.7%

**“Very Small” Pest Inspection Firms.** A final method of characterizing a small business is by the number of employees. Although this is not the Small Business Administration’s method of defining a small business, Census data on firms with less than twenty employees reveals the characteristics of those firms that are “very small.” In 2004, employer firms, employing less than twenty employees, employed an average of 4.1 employees, accounted for 93.7% of all employer firms in the Exterminating and Pest Control industry, employed 40.7% of its employees, and received 37.3% of its (estimated) revenue. Including the number of nonemployer firms would yield that “very small” firms constitute 99.1% of all Exterminating and Pest Control firms in 2004 and earn 45% of the industry’s revenue.

**Number of Employees.** Analysis in Chapter 6 will require an estimate of the number of workers in the industry as a whole and in small firms within the industry. For the year 2004, add the 95,437 employees in employer firms (from Table 5-62) to the number of nonemployer firms 58,076 (assuming one worker per firm) to arrive at an estimate of 153, 513 workers in the industry. The 2002 data on the percentage of employees in small employer firms (57.5% from Table 5-64) can be applied to the 2004 data to arrive at an estimate for the number of workers in small firms. Multiplying the number of employees (95,437) by 0.575 yields an estimated 54,876 employees in small employer firms in 2004 which, when added to 58,076, yields 112,952 workers in small firms in 2004. Workers in small firms represent 73.6% of all industry workers in 2004. As discussed in Chapter 6, not all these workers are engaged in single-family mortgage-related activity.

### **V.C.3. Consumer Savings, Revenue Estimates, and Small Business Transfers: Pest Inspection**

The predicted cost savings for consumers of pest inspection services determines the economic impact of the reforms on the exterminating and pest control industry. The projected revenue for the exterminating and pest control industry from transactions associated with residential mortgage settlements is \$325 million, which equals \$26 (average fee over all loans including those refinance and home purchase loans without a pest inspection) times 12,500,000 mortgage originations. This represents 1.3% of all third-party settlement fees.

While there was a scenario (the “title approach”) where this industry was not affected by RESPA reform, there were two scenarios that projected cost savings for consumers to be 7.5% and 10% of current fees. This translates to a transfer of \$24 million-\$33 million from the pest inspection industry. Small pest inspection firms account for 53.9% of industry revenues. Therefore, transfers from small pest inspection firms would have been \$13 million-\$18 million. These two sets of transfer estimates, respectively, represent 0.31%-0.42% of total industry revenue and 0.31%-0.42% of small industry revenue in 2004, based on estimated industry

revenue from the Census Bureau (\$7.768 billion in the case of large industries and \$4.187 billion in the case of small industries).

If the RESPA rule had been in effect in 2004, the savings and transfers would have been larger because of the higher volume of mortgages: \$30 million-\$42 million for the total industry and \$17 million - \$23 million for small survey firms. In these cases, the estimates represent 0.39%-0.53% of 2004 revenue.

For estimates of the allocation of consumer savings of the GFE by size of firm, see Table A.9. In addition, Table A.9 shows estimates of the allocation of consumer savings per firm for the GFE.

Pest inspections are provided on-site at the mortgaged property. The transportation cost of visiting individual sites, especially the opportunity cost of the time spent in transit, adds substantially to the cost of providing the service. These transportation costs counterbalance, or even overwhelm, any scale economies that may otherwise exist in the production of these services. As noted above in the data description, the exterminating and pest control industry is more concentrated than other industries involved in closing such the appraisal and survey industries. This is primarily because the exterminating and pest control industry is engaged in many other activities in addition to pest inspections for settlements. However, pest inspections are by economic necessity provided by local firms.

The only change that RESPA reform will introduce is that pest inspections will occur at lower prices negotiated between inspectors and originators. There will be no significant change in the local provision of pest inspections. Nor will there be a reduction of the number of these services purchased since this reform will not result in a drop in the number of mortgages that require these services. Since large originators will have to deal with multiple settlement services providers in order to ensure complete geographic coverage, there is no reason to believe that small settlement services providers will be excluded from any business transactions.

The improved shopping for third-party services could lead to some reduction in prices for these services. There is no reason to believe that a disproportionate percentage of small firms will experience the price reduction. Therefore, there is no reason to believe that small firms will bear a disproportionate share of the burden of this reform.

## **V.D. Credit Bureaus**

### **V.D.1. Overview of Industry**

The credit bureau industry is comprised of establishments that gather information on an individual's credit and employment history. The industry also collects data on an individual's accounts with various businesses. This information is provided to financial institutions, retailers, and others who have a need to evaluate the credit worthiness of these persons. The industries involved within the Credit Bureau classification are consumer credit reporting bureaus and agencies, credit investigation services, and credit rating services. Credit bureaus also provide credit reports on businesses.

The Consumer Data Industry Association, which is a trade association for consumer information, has over 400 credit bureaus; the majority are considered small businesses. The largest entities within the credit reporting industry are the three credit bureaus, Experian, Equifax and TransUnion. Each operates a national database, which houses all consumer credit reporting information. The remaining credit bureaus receive credit-reporting information from Experian, Equifax and TransUnion. The top three credit bureaus also provide a variety of other services, but credit reporting for the purposes of evaluating applications and underwriting is the only activity included in the settlement process.

An individual's credit history is an important factor during the initial application and underwriting process. Automated underwriting systems are known to depend heavily on credit history information, such as the FICO score. Thus, the credit reporting bureaus' main role within the mortgage process occurs during the initial application process, when an individual is first applying for a loan and during the underwriting process. Credit scores are also used during the servicing process as a tool in resolving delinquent loans. At application, the lender normally chooses the application fee, which covers the initial cost of processing the loan request and checking the individual's credit history. The actual cost of obtaining an in-depth credit report from the three credit bureaus varies from \$25 to \$75. Often an important task for originators during the underwriting process is following up on issues raised by the applicant's credit history.

#### **V.D.2. Description of Economic Data**

Census Bureau data from the year 2004 indicate that the Credit Bureau Industry employed 25,555 people at 740 firms. These firms had estimated annual revenue of 5.4 billion dollars. Also, in 2004 Credit Bureau Industry averaged 34.5 employees per firm and had estimated annual revenue per firm of \$7.3 million. An estimated 23.4% of Credit Bureau Industry office employees worked at firms employing fewer than 100; 11.5% worked at firms employing fewer than 20. In addition to the 740 firms from the Credit Bureau Industry offices that had employees in 2004, there were 545 Credit Bureau Industry offices with no employees. While the data do not provide many details about these non-employer firms (see the technical appendix for a definition of nonemployer establishments), Census methodology ensures that nonemployers meet a reasonable definition of small. The average revenue of a nonemployer credit bureau is \$34,859.

Census Bureau data from 2002 provide more detailed information about the Credit Bureau industry. In 2002 the sector employed 25,957 people at 741 firms. These firms had annual revenue of over \$4.6 billion (\$4.8 billion in 2004 prices). In contrast with the revenue estimate (\$5.4 billion) for 2004, the 2002 revenue figure is taken directly from Census publications. In 2002, the Credit Bureau industry averaged 35 employees per employer firm. Average revenue per firm was \$6.2 million, which, after adjusting for inflation,<sup>177</sup> is \$6.5 million, less than the 2004 estimate of \$7.3 million. When one counts only the employer firms operating the entire year, the total number of firms falls to 641; aggregate revenue remains near \$4.6 billion; but average revenue per firm rises to \$7.1 million (\$7.5 million at the 2004 price

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<sup>177</sup> See the technical appendix for information on the price deflator used to convert 2002 to 2004 dollars.

level). In addition to the 741 firms from the Credit Bureau industry that had employees in 2002, there were 520 nonemployer firms (very small firms that make up only a fraction of this industry's revenue) with an average revenue of \$42,446 (\$44,569 at the 2004 price level).

According to the 2002 Economic Census, the four largest credit bureau firms comprised 62.3% of the revenue within the industry, an average of \$714 million each; and employed an average of 48.7% of the employees, an average of 3,159 employees per firm.

### **V.D.2.a. Census Bureau Data for Small Businesses: Credit Bureau Industry**

The greater financial detail provided in the 2002 Economic Census makes the 2002 data better suited for the task of determining how many firms meet the SBA's definition of small. The 2002 size standard for Credit Bureau Industry is \$6 million of revenue. We estimate that there were 594 employer firms that met the SBA's definition of small and that these firms accounted for 10.1% of employer firms' aggregate revenue.<sup>178</sup> Adding the 520 firms that the Census reports have no employees to the calculations, 96% of the 1,114 total meet the SBA's definition of small. These firms accounted for 10.5% of the industry's total 2002 revenue.

**“Very Small” Credit Bureaus.** An alternative method of characterizing a small business is by the number of employees. Although this is not the Small Business Administration's method of defining a small business, Census data on firms with less than twenty employees reveals the characteristics of those firms that are “very small.” In 2004, employer firms, employing less than twenty employees, employed an average of 4.7 employees, accounted for 83.8% of all employer firms in the Credit Bureau industry, employed 11.5% of its employees, and received 5.8% of its (estimated) revenue. Including nonemployer firms would yield that “very small” firms constitute 90.7% of all Credit Bureaus in 2004, employ 13.3% of its employees, and earn 6.1% of the industry's (estimated) revenue.

**Number of Employees.** Analysis in Chapter 6 will require an estimate of the number of workers in the industry as a whole and in small firms within the industry. For the year 2004, adding the 25,555 employees in employer firms (from Table 5-70) to 545 (which assumes one worker for each non-employer firm) yields 26,100 as one estimate of the number of workers in the industry. We estimate that slightly more than 20% of employees worked for small firms in 2002.<sup>179</sup> This estimate of the percentage of employees in small employer firms can be applied

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<sup>178</sup> Of the firms in this sector that had employees, there were 590 that had annual revenues less than \$5 million. These firms earned 9.6% of the aggregate revenue of firms operating the entire year. To calculate the aggregate revenue of firms earning between \$5 million and \$6 million, we make the simplifying and generous assumption that all of these firms earn the maximum of \$6 million. We further assume that the number of firms earning between \$5 million and \$6 million is one fifth of the total number of firms in the \$5 million to \$10 million range (one fifth of 20 is 4). Thus, our estimate of the aggregate revenue of firms earning between \$5 million and \$6 million is \$24 million. Adding this to the revenue data for firms earning less than \$5 million, our estimate is that small employer firms earned \$461 million in 2002 or 10.1% of the aggregate revenue of employer firms.

<sup>179</sup> By assuming that all employer firms earning revenues within the \$5 million to \$10 million range earn the same revenue per employee (\$100,392) combined with our assumption that firms earning between \$5 million and \$6 million all earn \$6 million yields an estimate of 60 employees per firm (or a total of 240). Multiplied by the number

to the 2004 data to arrive at an estimate for the number of workers in small firms. Multiplying the number of employees (25,555) by 0.2 yields an estimated 5,114 employees in small employer firms in 2004 which, when added to 545 (which assumes one worker for each non-employer firm), yields 5,659 workers in small firms in 2004. Workers in small firms represent 21.7% of all industry workers (26,100) in 2004.

### **V.D.3. Consumer Savings, Revenue Estimates, and Small Business Transfers: Credit Bureaus**

The predicted cost savings for consumers of credit reports determines the economic impact of the reforms on the credit reporting industry. The projected revenue for the credit bureaus associated with residential mortgage settlements is \$312.5 million (which equals \$25 times 12,500,000 mortgage originations). This represents 1.3% of all third-party settlement fees.

While there was a scenario (the “title approach”) where this industry was not affected by RESPA reform, there were two scenarios that projected cost savings for consumers to be 7.5% and 10% of current fees. This translates to a transfer of \$23 million-\$31 million from the Credit Bureau industry. Small credit bureaus account for 10.5% of industry revenues. Therefore, transfers from small credit bureaus would have been \$2.4 million-\$3.3 million. These two sets of transfer estimates, respectively, represent 0.42%-0.57% of total industry revenue and 0.42%-0.57% of small industry revenue in 2004, based on estimated industry revenue from the Census Bureau (\$5.425 billion in the case of large industries and \$0.569 billion in the case of small industries).

If the RESPA rule had been in effect in 2004, the savings and transfers would have been larger because of the higher volume of mortgages: \$29 million-\$39 million for the total industry and \$3.05 million - \$4.19 million for small credit bureaus. In these cases, the estimates represent 0.53%-0.72% of 2004 revenue.<sup>180</sup>

## **VI. Office of Real Estate Agents and Brokers Industry**

### **VI.A. Overview of Industry**

Although real estate agents generally do not provide settlement services *per se*, they can be involved in the settlement process in number of ways. Real estate agents provide information about the settlement process and may accompany their clients to the settlement table. Frequently real estate agents refer potential buyers to lenders and title settlement companies. While some homebuyers may limit their relationship with their real estate agent, many homebuyers depend on the real estate agent for wide-ranging advice and referrals throughout the entire purchasing

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of firms (4) within that range and added to the number of employees (4,922) working for firms earning less than \$5 million yields a total of 5,162 employees (20% of the employer total) working for small employer firms.

<sup>180</sup> That this losses are not 7.5%-10% of the industry’s total revenue stems from credit bureaus having many more income-producing activities than producing credit reports for residential mortgage originations.

process. Homebuyers usually develop a business relationship with a real estate agent prior to establishing such relationships with lender, settlement agents, or other professionals involved in the settlement process. Consequently, homebuyers tend to view real estate agents as a trusted source of information about the home-buying process. Most real estate agents and brokers are represented by the National Association of Realtors (NAR). See Section VII.D.4 of Chapter 4 for a review of NAR's comments on the 2002 proposed rule and for analysis of the competitive impacts of packaging on the real estate industry.

## **VI.B. Description of Economic Data**

### **VI.B.1. Census Bureau Data**

Census Bureau data from the year 2004 indicate that the Real Estate Agents Brokers industry employed 323,045 people at 86,258 firms. These firms had estimated annual revenue of \$92 billion. Thus, in 2004 the Real Estate Agents Brokers Industry averaged 3.7 employees per firm and had estimated annual revenue per firm of \$1.1 billion. Within the Real Estate Agents Brokers industry, 70.3% of the office employees worked at firms employing fewer than 100; 53.9% worked at firms employing fewer than 20. In addition to the 86,258 firms from the Real Estate Agents Brokers industry offices that had employees in 2004, the Census reports that there were 702,898 nonemployer firms in the Real Estate Agents Brokers industry. While the data do not provide many details about these non-employer firms, it seems likely they would meet any reasonable definition of small (the average revenue per firm was \$48,781). According to the National Association of Realtors (NAR), eighty-five percent of the residential brokerage firms have a single office; sixty-seven percent have a sales force of five or fewer agents.

Data from the 2002 Economic Census provide information on revenue. Employer firms of the Real Estate Agents Brokers industry numbered 68,649, employed a total of 280,754 employees, earned an aggregate revenue of \$63.4 billion (\$66.6 billion in 2004 dollars),<sup>181</sup> and had a payroll amounting to \$10.4 billion (\$10.9 billion in 2004 dollars). Employer firms *operating the entire year* numbered 49,089, employed a total of 263,841 employees, earned an aggregate revenue of \$59.4 billion (\$62.3 in 2004 dollars), and had a payroll amounting to \$9.8 billion (\$10.3 billion in 2004 dollars). For firms *operating the entire year* in 2002, the average number of employees was 5.4; the average payroll was \$199,000 (\$209,000 in 2004 dollars); and the average revenue per firm was \$1.2 million (\$1.3 million in 2004 dollars). In addition to the 68,649 from the Real Estate Agents Brokers industry that had employees, there were 569,949 nonemployer firms in 2002 earning an aggregate revenue of \$26 billion (\$27.3 billion in 2004 dollars).

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<sup>181</sup> See the technical appendix for information on the price deflator used to convert 2002 to 2004 dollars.

## VI.B.2. Census Bureau Data for Small Businesses: Real Estate Agents and Brokers

The greater financial detail provided in the 2002 data makes the 2002 data better suited for the task of determining how many firms meet the SBA's definition of small. Although the SBA size standard is \$1.5 million in revenue, we use a standard of \$2.5 million because it is consistent with the manner in which the 2002 Economic Census presents its data. This will have the effect of slightly overestimating the proportion of businesses that are small. It is estimated that in 2002, at least 99.5% of real estate agencies and brokerages were small businesses.<sup>182</sup> These small businesses account for 54.1% of the revenue earned by real estate agents and brokers and 84.5% of its workers.<sup>183</sup> The fifty largest firms earned only 22% of the industry's revenue and employed 16.1% of its employees.

**An Alternative Definition of Small.** An alternative method of characterizing a small business is by the number of employees. Although this is not the Small Business Administration's method of defining a small business, Census data on firms with less than twenty employees reveals the characteristics of those firms that are "very small." In 2004, employer firms, employing less than twenty employees, accounted for 97.7% of all employer firms in the Real Estate Agent and Broker industry, employed 53.9% of its employees, and received 52.3% of its (estimated) revenue. The average number of employees per firm was 2.1, which is less than the average number (2.9) of employees who worked for firms earning less than \$2.5 million in 2002, our approximation of the SBA's definition of small. Including nonemployer firms would yield that "very small" firms constitute 99.7% of all Real Estate Agent and Broker firms in 2004, earn 65.3% of the industry's (estimated) revenue, and employ 85.5% of its employees.<sup>184</sup>

NAR's comments on the 2002 proposed rule competitive nature of the mortgage market are also discussed in Section V.D of Chapter 2. See Sections II.C.5. and IV.A.2 of Chapter 6 for a discussion of similar comments on the 2008 proposed rule.

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<sup>182</sup> The numerator (615,643) is derived by adding the number of employer firms operating the entire year earning less than \$2.5 million (45,694) to the number of nonemployer firms (569,949). The denominator (619,643) is derived by adding the number of employer firms operating the entire year (49,089) to the number of nonemployer firms. Note that this method implicitly assumes that nonemployer firms operate the entire year.

<sup>183</sup> The revenue share of small firms is calculated in the same way as the share of firms. The number of people working at a nonemployer firm is assumed to be one.

<sup>184</sup> These proportions are derived by defining the amount "small" as equal to the sum of employer firms with less than twenty firms and plus nonemployer firms.

## **VII. Miscellaneous Services**

### **VII.A. New Single-Family General Contractors**

#### **VII.A.1. Overview of Industry**

The New Single-Family General Contractors industry comprises general contractor establishments primarily responsible for the entire construction of new single-family housing, such as single-family detached houses and town houses or row houses where each housing unit (1) is separated from its neighbors by a ground-to-roof wall and (2) has no housing units constructed above or below. This industry includes general contractors responsible for the on-site assembly of modular and prefabricated houses. Single-family housing design-build firms and single-family construction management firms acting as general contractors are included in this industry.

#### **VII.A.2. Description of Economic Data**

##### **VII.A.2.a. Census Bureau Data**

Census Bureau data from the year 2004 indicate that the New Single-Family General Contractors industry employed 443,667 people at 113,948 establishments<sup>185</sup>. These establishments had estimated annual revenue of \$116 billion. Thus, in 2004 the New Single-Family General Contractors industry averaged 3.9 employees per establishment and had estimated annual revenue per establishment of \$1.0 million. Within the New Single-Family General Contractors industry, 90.8% of the employees worked at establishments employing fewer than 100; 73.2% worked at establishments employing fewer than 20. In addition to the 113,948 establishments from the New Single-Family General Contractors industry offices that had employees in 2004, the Census reports that there were 167,109 nonemployer establishments in the New Single-Family General Contractors industry. While the data do not provide many details about these non-employer establishments, it seems likely they would meet any reasonable definition of small.

Data from the 2002 Economic Census provide information on revenue. Employer establishments of the New Single-Family General Contractors industry numbered 58,472, employed a total of 273,055 employees, earned an aggregate revenue of \$62.2 billion (\$65.3 billion in 2004 dollars),<sup>186</sup> and had a payroll amounting to \$8.3 billion (\$8.7 billion in 2004 dollars). In addition to the 58,472 establishments from the New Single-Family General

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<sup>185</sup> Census Data for the New Single-Family General Contractors industry is reported only for establishments. No firm data is released.

<sup>186</sup> See the technical appendix for information on the price deflator used to convert 2002 to 2004 dollars.

Contractors industry that had employees, there were 133,525 nonemployer establishments in 2002 earning an aggregate revenue of \$13.7 billion (\$14.4 billion in 2004 dollars).

### **VII.A.2.b. Census Bureau Data for Small Businesses: New Single-Family General Contractors**

The greater financial detail provided in the 2002 data makes the 2002 data better suited for the task of determining how many establishments meet the SBA's definition of small. Although the SBA size standard is \$28.5 million in revenue, we use a standard of \$10.0 million because it is consistent with the manner in which the 2002 Economic Census presents its data<sup>187</sup>. This will have the effect of slightly underestimating the proportion of businesses that are small. The need for the more detailed data is negated by the fact that the data shows that over 97 percent of the industry's establishments are small using the \$10 million threshold. It is estimated that in 2002, at least 99.6% of New Single-Family General Contractors were small businesses.<sup>188</sup> These small businesses account for 80.6% of the revenue earned by real estate agents and brokers and 91.8% of its workers.<sup>189</sup>

**An Alternative Definition of Small.** An alternative method of characterizing a small business is by the number of employees. Although this is not the Small Business Administration's method of defining a small business, Census data on establishments with less than twenty employees reveals the characteristics of those establishments that are "very small." In 2004, employer establishments, employing less than twenty employees, accounted for 97.6% of all employer establishments in the New Single-Family General Contractors industry, employed 73.2% of its employees, and received 77.9% of its (estimated) revenue. The average number of employees per firm was 2.9, which is less than the average number (4.1) of employees who worked for establishments earning less than \$10 million in 2002, our approximation of the SBA's definition of small. Including nonemployer establishments would yield that "very small" establishments constitute 99.0% of all New Single-Family General Contractors establishments in 2004, earn 84.2% of the industry's (estimated) revenue, and employ 80.5% of its employees.<sup>190</sup>

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<sup>187</sup> The Small Business Administration (SBA) published special tabulations of the 2002 economic census which provides more detailed revenue data, specifically firms earning between \$10 million and \$50 million in revenue. This data, however, is reported using the obsolete 1997 NAICS industrial classification, which defined the New Single-Family General Contractors within a broader industry titled Single Family Housing Construction, which included general contractors, operative builders and remodeling contractors. Estimates of 2002 nonemployer firms and the 2002 Economic Census are not available using these definitions. However, the data shows that over 99 percent of the industry's establishments are classified as small, negating the need for the more detailed data.

<sup>188</sup> The numerator (190,997) is derived by adding the number of employer establishments earning less than \$10 million (57,759) to the number of nonemployer establishments (133,525). The denominator (191,997) is derived by adding the number of employer establishments (58,472) to the number of nonemployer establishments.

<sup>189</sup> The revenue share of small firms is calculated in the same way as the share of firms. The number of people working at a nonemployer firm is assumed to be one.

<sup>190</sup> These proportions are derived by defining the amount "small" as equal to the sum of employer firms with less than twenty firms and plus nonemployer firms.

Alternatively, it may be appropriate to classify New Single-Family General Contractors by the number of housing starts per establishment, rather than revenue or employment size. Using housing starts to define small single-family contractors avoids inherent differences between establishments within the industry, such as worker productivity and sales price which then affects how many workers an establishment hires or how much revenue it generates. Instead, it provides a real measure of an establishment's output.

Table 5-20 shows New Single-Family General Contractor establishments by housing start size. In 2002, establishments with less than 25 housing starts accounted for 98.0% of all establishments in the New Single-Family General Contractors industry. These establishments accounted for 44.7% of all single-family housing starts.<sup>191</sup>

	Establishments	Share of Establishments	Total Single-Family Starts	Share of Single-Family Starts
All Housing Starts	58,494	100.0%	190,052	100.0%
Establishments with <25 Starts	57,344	98.0%	84,889	44.7%
Establishments with 25-99 Starts	841	1.4%	33,876	17.8%
Establishments with 100-499 Starts	275	0.5%	43,301	22.8%
Establishments with <500 Starts	34	0.1%	27,986	14.7%

## **VII.B. New Housing Operative Builders**

### **VII.B.1. Overview of Industry**

The New Housing Operative Builders industry comprises establishments primarily engaged in building new homes on land that is owned or controlled by the builder rather than the homebuyer or investor. The land is included with the sale of the home. Establishments in this industry build single and/or multifamily homes. These establishments are often referred to as merchant builders, but are also known as production or for-sale builders.

### **VII.B.2. Description of Economic Data**

#### **VII.B.2.a. Census Bureau Data**

Census Bureau data from the year 2004 indicate that the New Housing Operative Builders industry employed 158,231 people at 10,774 establishments<sup>192</sup>. These establishments had estimated annual revenue of \$9.9 billion. Thus, in 2004 the New Housing Operative Builders industry averaged 14.7 employees per establishment and had estimated annual revenue

<sup>191</sup> These firms also accounted for 8.1% of the industry's multi-family housing starts, which includes condos as well as rental apartments. However, because Census does not report the number of condo versus rental apartment starts, the multi-family numbers are not presented.

<sup>192</sup> Census Data for the New Housing Operative Builders industry is reported only for establishments. No firm data is released.

per establishment of \$12.5 million. Within the New Housing Operative Builders industry, 47.9% of the employees worked at establishments employing fewer than 100; 24.3% worked at establishments employing fewer than 20. In addition to the 10,774 establishments from the New Housing Operative Builders industry offices that had employees in 2004, the Census reports that there were 66,033 nonemployer establishments in the New Housing Operative Builders industry. While the data do not provide many details about these non-employer establishments, it seems likely they would meet any reasonable definition of small.

Data from the 2002 Economic Census provide information on revenue. Employer establishments of the New Housing Operative Builders industry numbered 26,043, employed a total of 240,292 employees, earned an aggregate revenue of \$140 billion (\$147 billion in 2004 dollars),<sup>193</sup> and had a payroll amounting to \$10.5 billion (\$11.0 billion in 2004 dollars). In addition to the 26,043 from the New Housing Operative Builders industry that had employees, there were 52,762 nonemployer establishments in 2002 earning an aggregate revenue of \$9.9 billion (\$10.4 billion in 2004 dollars).

#### **VII.B.2.b. Census Bureau Data for Small Businesses: New Housing Operative Builders**

The greater financial detail provided in the 2002 data makes the 2002 data better suited for the task of determining how many establishments meet the SBA's definition of small. Although the SBA size standard is \$28.5 million in revenue, we use a standard of \$10.0 million because it is consistent with the manner in which the 2002 Economic Census presents its data<sup>194</sup>. This will have the effect of slightly underestimating the proportion of businesses that are small. The need for the more detailed data is negated by the fact that the data shows that over 99 percent of the industry's establishments are small using the \$10 million threshold. It is estimated that in 2002, at least 97.4% of New Housing Operative Builders were small businesses.<sup>195</sup> These small businesses account for 31.9% of the revenue earned by real estate agents and brokers and 55.8% of its workers.<sup>196</sup>

**An Alternative Definition of Small.** An alternative method of characterizing a small business is by the number of employees. Although this is not the Small Business Administration's method of defining a small business, Census data on establishments with less

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<sup>193</sup> See the technical appendix for information on the price deflator used to convert 2002 to 2004 dollars.

<sup>194</sup> The Small Business Administration (SBA) published special tabulations of the 2002 economic census which provides more detailed revenue data, specifically firms earning between \$10 million and \$50 million in revenue. This data, however, is reported using the obsolete 1997 NAICS industrial classification, which defined the New Housing Operative Builders within a broader industry titled Single Family Housing Construction, which included general contractors, operative builders and remodeling contractors. Estimates of 2002 nonemployer firms and the 2002 Economic Census are not available using these definitions. However, the data shows that over 97 percent of the industry's establishments are classified as small, negating the need for the more detailed data.

<sup>195</sup> The numerator (76,794) is derived by adding the number of employer establishments earning less than \$10 million (24,032) to the number of nonemployer establishments (52,762). The denominator (78,805) is derived by adding the number of employer establishments (26,043) to the number of nonemployer establishments.

<sup>196</sup> The revenue share of small firms is calculated in the same way as the share of firms. The number of people working at a nonemployer firm is assumed to be one.

than twenty employees reveals the characteristics of those establishments that are “very small.” In 2004, employer establishments, employing less than twenty employees, accounted for 84.1% of all employer establishments in the New Housing Operative Builders industry, employed 24.3% of its employees, and received 17.7% of its (estimated) revenue. The average number of employees per establishments was 4.2, which is less than the average number (4.6) of employees who worked for establishments earning less than \$10 million in 2002, our approximation of the SBA’s definition of small. Including nonemployer establishments would yield that “very small” establishments constitute 97.8% of all New Housing Operative Builders establishments in 2004, earn 46.6% of the industry’s (estimated) revenue, and employ 38.4% of its employees.<sup>197</sup>

Alternatively, it may be appropriate to classify New Housing Operative Builders by the number of housing starts per establishment, rather than revenue or employment size. Using housing starts to define small new housing operative builders avoids inherent differences between establishments within the industry, such as worker productivity and sales price which then affects how many workers an establishment hires or how much revenue it generates. Instead, it provides a real measure of an establishment’s output.

Table 5-21 shows New Housing Operative Builder establishments by housing start size. In 2002, establishments with less than 25 housing starts accounted for 88.6% of all establishments in the New Single-Family General Contractors industry. These establishments accounted for 14.1% of all single-family housing starts.<sup>198</sup>

**Table 5-21. Establishments by Housing Starts Size: New Housing Operative Builders, 2002**

	Establishments	Share of Establishments	Total Single-Family Starts	Share of Single-Family Starts
All Housing Starts	26,079	100.0%	523,067	100.0%
Establishments with <25 Starts	23,098	88.6%	73,494	14.1%
Establishments with 25-99 Starts	1,955	7.5%	81,570	15.6%
Establishments with 100-499 Starts	805	3.1%	149,717	28.6%
Establishments with <500 Starts	221	0.8%	218,286	41.7%

<sup>197</sup> These proportions are derived by defining the amount “small” as equal to the sum of employer firms with less than twenty firms and plus nonemployer firms.

<sup>198</sup> These firms also accounted for 6.4% of the industry’s multi-family housing starts, which includes condos as well as rental apartments. However, because Census does not report the number of condo versus rental apartment starts, the multi-family numbers are not presented.

# Technical and Data Appendix for Chapter 5

## I. Description of Data Sets

### I.A. Employer Firms

Throughout the chapter, data on employer firms are presented for both 2002 and 2004. The 2002 data are from the 2002 Economic Census and the 2004 data are from Statistics of U.S. Businesses, an annual series. The primary difference between the two series is that revenue data are available for 2002, but not for 2004.

#### I.A.1. Statistics of U.S. Businesses

The 2004 data on employer firms are from Statistics of U.S. Businesses (SUSB), an annual series that provides national and subnational data on the distribution of economic data by size and industry.<sup>199</sup> Statistics of U.S. Businesses covers most of the country's economic activity. The series excludes data on self-employed individuals, employees of private households, railroad employees, agricultural production employees, and most government employees.

Basic data items from the Statistics of U.S. Businesses are extracted from the Standard Statistical Establishment List, a file of all known single and multi-establishment employer companies maintained and updated by the U.S. Census Bureau. The annual Company Organization Survey provides individual establishment data for multi-establishment companies. Data for single-establishment companies are obtained from various Census Bureau programs, such as the Annual Survey of Manufactures and Current Business Surveys, as well as from administrative records of the Internal Revenue Service, the Social Security Administration, and the Bureau of Labor Statistics. These data were developed in cooperation with, and partially funded by, the Office of Advocacy of the U.S. Small Business Administration (SBA). The variables included in the annual series of the Statistics of U.S. Businesses include the number of firms, establishments, employees, and payroll of an industry. The data are classified by the employment size of enterprises.

#### I.A.2. Classification by Employment Size

An establishment is a single physical location at which business is conducted or where services or industrial operations are performed. An enterprise is a business organization consisting of one or more domestic establishments under common ownership or control. For companies with only one establishment, the enterprise and the establishment are the same. The

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<sup>199</sup> The description of Statistics of U.S. Businesses is taken from the Census Bureau's web site: <http://www.census.gov/csd/susb/susb.htm>

employment of a multi-establishment enterprise is determined by summing the employment of all associated establishments.

The size of an enterprise is determined by the summed employment of all associated establishments. The enterprise size group of zero includes enterprises for which no associated establishments reported paid employees in the mid-March pay period, but paid employees at some time during the year.

A firm is defined as that part of an enterprise tabulated within a particular industry. For example, an enterprise with establishments in more than one industry is counted as a firm in each industry in which it operates an establishment, but is also counted as only one firm in all-industry tabulations. Thus, summing the firms across industries would overstate the number of unique firms.

Employment size is determined only for the *entire* enterprise. Hence, counterintuitive results are possible. For example, it would be possible that enterprises classified as having more than one hundred employees have an average of less than one hundred employees in a particular industry. However, for 2004, the averages for the industries described in our analysis are consistent with the size classification.

**Economic Census.** The quinquennial<sup>200</sup> Economic Census is the major source of facts about the structure and functioning of the Nation's economy. It reports statistics on the number of establishments; employment; payroll; and value of sales, receipts, revenue, or shipments for establishments with paid employees.<sup>201</sup>

The Economic Census is conducted on an establishment basis.<sup>202</sup> A company operating at more than one location is required to file a separate report for each store, factory, shop, or other location. Each establishment is assigned a separate industry classification based on its primary activity and not that of its parent company.

### **I.A.3. Comparison of 2002 Economic Census with SUSB**

For the covered sectors and their industries, the firm size reports of the 2002 Economic Census provide aggregate revenue in all displays, classification by receipt size of firm, and more detailed classification of employment size than is shown in SUSB.

Data are classified by the employment size of the firm, that is, that part of the enterprise within the industry category shown and not on the employment size of the entire enterprise as

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<sup>200</sup> The Economic Census is taken every five years, covering years ending in 2 and 7.

<sup>201</sup> For 2002 Economic Census data, see <http://www.census.gov/econ/census02/>

<sup>202</sup> For a detailed description of the methodology, see <http://www.census.gov/econ/census02/guide/index.html>

shown in Statistics of U.S. Businesses. In both programs, industry is determined on an establishment-by-establishment basis.<sup>203</sup>

The 2002 Economic Census summarizes data for many service industries separately depending on whether the firm is subject to Federal income tax or is tax-exempt. Statistics of U.S. Businesses combines both types of firms within the same industry.

The 2002 Economic Census generally uses respondent-reported data. The Statistics of U.S. Businesses uses administrative record data. Although efforts are made to resolve significant differences in the data, differences are known to exist.

## **I.B. Description of Basic Terms**

### **I.B.1. Establishments**

An establishment is a single physical location at which business is conducted or services or industrial operations are performed. It is not necessarily identical with a company or enterprise, which may consist of one or more establishments. When two or more activities are carried on at a single location under a single ownership, all activities generally are grouped together as a single establishment. The entire establishment is classified on the basis of its major activity and all data are included in that classification.

An establishment with zero employment is an establishment reporting no paid employees in the mid-March pay period, but paid employees at some time during the year. Establishment counts represent the number of locations with paid employees any time during the year.

### **I.B.2. Annual Payroll**

Payroll includes all forms of compensation, such as salaries, wages, commissions, dismissal pay, bonuses, vacation allowances, sick-leave pay, and employee contributions, to qualified pension plans paid during the year to all employees. For corporations, payroll includes amounts paid to officers and executives; for unincorporated businesses, it does not include profit or other compensation of proprietors or partners. Payroll is reported before deductions for social security, income tax, insurance, union dues, etc. This definition of payroll is the same as that used by the Internal Revenue Service (IRS) on Form 941. For Finance, Insurance, and Real Estate, payroll excludes commissions paid to independent (nonemployee) agents, such as insurance and real estate agents.

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<sup>203</sup> Statistics of U.S. Businesses is developed from the same database that is used to produce County Business Patterns (CBP); nonetheless, CBP classifies establishments by the employment size of the establishment rather than the employment size of the entire enterprise.

### **I.B.3. Number of Employees**

Paid employees consists of full-time and part-time employees, including salaried officers and executives of corporations, who (for all sectors except Construction and Manufacturing) were on the payroll during the pay period including March 12. Included are employees on paid sick leave, paid holidays, and paid vacations; not included are proprietors and partners of unincorporated businesses. The definition of paid employees is the same as that used on IRS Form 941. For Finance, Insurance, and Real Estate, the number of employees excludes independent (nonemployee) agents.

### **I.B.4. Sales, Receipts, or Revenues**

The total sales, shipments, receipts, revenue, or business done by establishments are counted by the Economic Census. For Finance, Insurance, and Real Estate, this includes revenue from all business activities whether or not payment was received in the Census year, including commissions and fees from all sources, rents, net investment income, interest, dividends, royalties, and net insurance premiums earned. Revenue from leasing property marketed under operating leases is included, as well as interest earned from property marketed in the Census year under capital, finance, or full payout leases. Revenue also includes the total value of service contracts, amounts received for work subcontracted to others, and rents from real property sublet to others.

### **I.B.5. Nonemployer Firms**

A nonemployer business is one that has no paid employees, has annual business receipts of \$1,000 or more (\$1 or more in the construction industries), and is subject to federal income taxes.<sup>204</sup> Nonemployers are typically self-employed individuals or partnerships operating businesses that they have not chosen to incorporate. Self-employed owners of incorporated businesses typically pay themselves wages or salary, so that the business is an employer. Note that many businesses use leased or contract employees. In cases where all employees are leased or contracted, the payroll for the business is zero, placing it in the potential nonemployer universe. If the establishment's receipts are large, it may be dropped from nonemployer tabulations because its receipts exceed the cutoffs to be considered a nonemployer.

In terms of sales or receipts, nonemployers account for roughly 3% of business activity. At the same time, nonemployers account for nearly three quarters of all businesses. Most nonemployer businesses are very small, and many are not the primary source of income for their owners.

The Bureau of the Census releases tabulations of nonemployers. Since the reference year of 1998, the nonemployer statistics tabulations have been released as an annual data series. Data include the number of establishments and the aggregate revenue of the industry. Nonemployer

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<sup>204</sup> The description of the Nonemployer series is taken from the Census Bureau's web site: <http://www.census.gov/epcd/nonemployer/view/define.html>

statistics data originate chiefly from administrative records of the Internal Revenue Service (IRS). Data are primarily comprised of sole proprietorship businesses filing IRS Form 1040, Schedule C, although a small percentage of the data is derived from filers of partnership and corporation tax returns that report no paid employees.

### **I.C. Size Standards**

SBA's size standards define whether a business entity is small and, thus, eligible for Government programs and preferences reserved for “small business” concerns. Size standards have been established for types of economic activity, or industry, generally under the North American Industry Classification System (NAICS). For most of the industries considered, a “small” business is defined by revenue (see table below).

For the purposes of estimating the economic impact of the RESPA rule on small businesses, the share of revenue earned by small businesses is required. Data on the distribution of revenues is only available from the Economic Census, the most recent of which reports data for 2002. The most common size standard for 2002 for the industries under consideration was revenue less than six million dollars. Unfortunately, it is not possible to know the exact number of firms earning less than six million dollars of revenue from the 2002 Economic Census data. The data are not presented in a detailed enough breakdown. This is also the case for other revenue size standards, such as \$1.5 and \$4 million.

To estimate the total revenue for employer firms in 2002 earning below \$6 million in revenue, we add the revenue of firms earning less than \$5 million (given by the Economic Census) to an estimate of the aggregate revenue of those earning between \$5 million and \$6 million. To estimate the revenue between \$5 million and \$6 million, we assume that the distribution is linear implying that the number of firms in this range is one fifth of the number of firms earning between \$5 million and \$10 million. A further assumption that the firms in the \$5 million to \$6 million range earn the maximum of \$6 million yields the aggregate revenue. Our estimate of the proportion of employer firms that are small is achieved by dividing by the total number of firms operating the entire year in 2002. The number of employees in this range is estimated by dividing the aggregate revenue by the revenue per employee ratio for firms with revenue between \$5 million and \$10 million.

For other revenue size standards, such as \$1.5 and \$4 million, generous estimates are taken directly from the Economic Census (below \$2.5 and \$5 million respectively). This was not done for the \$6 million dollar standard because the next boundary is \$10 million dollars, which is significantly higher. For 2004, it is not possible to calculate the size distribution by revenue because those data are not provided.

For three of the industries considered in this analysis (Commercial Banks, Savings Institutions, and Credit Unions), the SBA definition of small is by the dollar amount of assets (\$150 million in 2002). However, data on assets are not collected by the Census as part of the Economic Census or the Statistics of U.S. Businesses. Instead, asset data collected by the Federal Deposit Insurance Corporation (FDIC) for Commercial Banks and Savings Institutions is used. Asset data for Credit Unions comes from the National Credit Union Administration.

## **II. Description of Methodology**

In some cases, data were not available. However, fairly straightforward methods for estimating the missing data were possible.

### **II.A. Estimating Nonemployer Statistics for Sub-industries**

For disclosure purposes, sub-industry (six-digit NAICS industry) data are not provided in the Nonemployer Statistics for the following industries: Real Estate Credit (522292), Mortgage and Non-mortgage Loan Brokers (522310), Commercial Banking (522110), Savings Institutions (522120), Credit Unions (522130), Direct Title insurance carriers (524127), Offices of Lawyers (541110), and Title Abstract and Settlement Offices (541191). An estimate of the number of nonemployer firms in each six-digit sub-industry can be calculated by multiplying the number of nonemployer firms in the corresponding four-digit industry (Nondepository credit Intermediation (5222), Activities Related to Credit Intermediation (5223), Insurance Carriers (5241), and Legal Services (5411)) by a ratio calculated from employer data. The ratio is the share of small employer firms (1-4 employees) of a six-digit sub-industry in the four-digit industry. To calculate the share of revenue of nonemployer firms, employer revenue data are used for 2002 and employer payroll data are used for 2004.

Consider the loan brokerage industry. The nonemployer statistics do not provide data for the six-digit sub-industry of Mortgage and Non-mortgage Loan Brokers (NAICS 522310), but they are provided for the four-digit industry of Activities Related to Credit Intermediation (5223). Thus, an estimate of the proportion of nonemployer firms in Activities Related to Credit Intermediation that are Mortgage and Non-mortgage Loan Brokers can be obtained by examining the proportion of small employer firms in Activities Related to Credit Intermediation that are Mortgage and Non-mortgage Loan Brokers.

In 2004, 68.3% of the firms with 1-4 employees in Activities Related to Credit Intermediation are Mortgage and Non-mortgage Loan Brokers. Applying this ratio to the number of Nonemployers in Activities Related to Credit Intermediation (45,392) yields an estimate of 31,014 nonemployer firms in the brokerage industry. Estimating the revenue of nonemployer firms in 2004 is not as straightforward because revenue data are not available that year for employer firms. Instead, the share of payroll of brokers is used as an approximation of the share of revenue. In 2004, Mortgage and Non-mortgage Loan Brokers accounted for 71.0% of the payroll of firms with 1-4 employees in Activities Related to Credit Intermediation. Multiplying the estimated total revenue of Activities Related to Credit Intermediation (\$2.1 billion) by the above percentage of 71.0% yields an estimate of \$1.5 billion of the revenue of nonemployer Loan Brokers.

## **II.B. Estimating Revenue of Employer Firms for 2004**

Revenue statistics for employer firms are available from the Economic Census of 2002, but are not available for more recent years. To estimate revenue for 2004, payroll statistics for 2004 are multiplied by a revenue-payroll ratio for the relevant firm size calculated from 2002 data. Consider the loan broker industry.

For firms with less than 20 employees, the ratio of revenue to payroll for 2002 is 2.92; for firms with between 20 and 99 employees, it is 2.34; and for firms with 100 or more, the ratio is 2.42. These ratios are used to estimate the revenues for the different categories of firms. For example, firms with less than twenty employees are estimated to have earned \$8.75 billion (2.92 times \$2.99 billion). The estimated revenue of the different firm sizes are aggregated to arrive at an estimate of total revenues (\$18.4 billion). The most direct method of estimating revenue for the entire industry would be to multiply the revenue-payroll ratio of the entire industry (2.68) in 2002 by the total payroll in 2004. This would yield an estimate of \$18.9 billion. This is slightly lower than the sum of the parts because payroll and revenue are not distributed identically across firm sizes. Since this analysis focuses on the size distribution, a method is chosen such that the estimate of the whole is consistent with the estimates of the parts.

## **II.C. Miscellaneous**

### **II.C.1. Calculating the Percentage of Small Businesses**

For 2002, the sum of small businesses is calculated by adding the number of employer firms, operating for the entire year, under the appropriate revenue size standard to the number of nonemployer firms. Doing so implicitly assumes that all nonemployer firms have operated for the entire year, are below the revenue size standard, and have exactly one person working full-time at the firm.

### **II.C.2. Dollar Values**

All dollar values presented are expressed in current dollars; i.e., 2002 data are expressed in 2002 dollars, and 2004 data, in 2004 dollars. Consequently, when making comparisons with prior years, users of the data should consider the changes in the price level that has occurred. In order to inflate 2002 dollars to 2004 dollars multiply by 188.9/179.9, or 1.05. The price deflator is based on price levels as measured by the U.S. Consumer Price Index (not seasonally adjusted, the U.S. city average for all items, and base period of 1982-84).

### **III. Description of NAICS (North American Industry Classification System) Industries**

#### **III.A. Mortgage Lending**

##### **522110 Commercial Banking**

This industry comprises establishments primarily engaged in accepting demand and other deposits and making commercial, industrial, and consumer loans. Commercial banks and branches of foreign banks are included.

##### **522120 Savings Institutions**

This industry comprises establishments primarily engaged in accepting time deposits, making mortgage and real estate loans, and investing in high-grade securities. Savings and loan associations and savings banks are included in this industry.

##### **522130 Credit Unions**

This industry comprises establishments primarily engaged in accepting members' share deposits in cooperatives that are organized to offer consumer loans to their members.

##### **522310 Mortgage and Nonmortgage Loan Brokers**

This industry comprises establishments primarily engaged in arranging loans by bringing borrowers and lenders together on a commission or fee basis.

##### **522292 Real Estate Credit**

This U.S. industry comprises establishments primarily engaged in lending funds with real estate as collateral. This includes: construction lending, farm mortgage lending, Federal Land Banks, home equity credit lending, loan correspondents (i.e., lending funds with real estate as collateral), mortgage banking (i.e., nondepository mortgage lending), and mortgage companies.

#### **III.B. Settlement Services**

##### **524127 Direct Title Insurance Carriers**

This U.S. industry comprises establishments primarily engaged in initially underwriting insurance policies to protect the owners of real estate or real estate creditors against loss sustained by reason of any title defect to real property (i.e., assuming the risk and assigning premiums).

##### **531210 Offices of Real Estate Agents and Brokers**

This industry comprises establishments primarily engaged in acting as agents and/or brokers in one or more of the following: (1) selling real estate for others; (2) buying real estate for others; and (3) renting real estate for others.

### **531320 Offices of Real Estate Appraisers**

This industry comprises establishments primarily engaged in estimating the fair market value of real estate.

### **531390 Other Activities Related to Real Estate**

This industry comprises establishments primarily engaged in performing real estate related services (except lessors of real estate, offices of real estate agents and brokers, real estate property managers, and offices of real estate appraisers). Examples of establishments in this industry are: real estate escrow agencies, real estate fiduciaries offices, and real estate listing services.

### **541110 Offices of Lawyers**

This industry comprises offices of legal practitioners known as lawyers or attorneys (i.e., counselors-at-law) primarily engaged in the practice of law. Establishments in this industry may provide expertise in a range or in specific areas of law, such as criminal law, corporate law, family and estate law, patent law, real estate law, or tax law.

### **541191 Title Abstract and Settlement Offices**

This U.S. industry comprises establishments (except offices of lawyers and attorneys) primarily engaged in one or more of the following activities: (1) researching public land records to gather information relating to real estate titles; (2) preparing documents necessary for the transfer of the title, financing, and settlement; (3) conducting final real estate settlements and closings; and (4) filing legal and other documents relating to the sale of real estate. Real estate settlement offices, title abstract companies, and title search companies are included in this industry.

### **541370 Surveying and Mapping (Except Geophysical) Services**

This industry comprises establishments primarily engaged in performing surveying and mapping services of the surface of the earth, including the sea floor. These services may include surveying and mapping of areas above or below the surface of the earth, such as the creation of view easements or segregating rights in parcels of land by creating underground utility easements.

### **561450 Credit Bureaus**

This industry comprises establishments primarily engaged in compiling information, such as credit and employment histories on individuals and credit histories on businesses, and providing the information to financial institutions, retailers, and others who have a need to evaluate the credit worthiness of these persons and businesses. Examples of industries in this classification include: Consumer credit reporting bureaus, Credit agencies, Credit bureaus, Credit investigation services, Credit rating services, Credit reporting bureaus; Credit investigation services, and Mercantile credit reporting bureaus.

### **561710 Exterminating and Pest Control Services**

This industry comprises establishments primarily engaged in exterminating and controlling birds, mosquitoes, rodents, termites, and other insects and pests (except for crop production and forestry production). Establishments providing fumigation services are included in this industry. Examples of industries include: Exterminating services, Fumigating services, Mosquito eradication services, and Termite control services.

## **III.C. Miscellaneous Services**

### **236115 New Single-Family General Contractors**

This U.S. industry comprises general contractor establishments primarily responsible for the entire construction of new single-family housing, such as single-family detached houses and town houses or row houses where each housing unit (1) is separated from its neighbors by a ground-to-roof wall and (2) has no housing units constructed above or below. This industry includes general contractors responsible for the on-site assembly of modular and prefabricated houses. Single-family housing design-build firms and single-family construction management firms acting as general contractors are included in this industry.

### **236117 New Housing Operative Builders**

This U.S. industry comprises establishments primarily engaged in building new homes on land that is owned or controlled by the builder rather than the homebuyer or investor. The land is included with the sale of the home. Establishments in this industry build single and/or multifamily homes. These establishments are often referred to as merchant builders, but are also known as production or for-sale builders.

## IV. Data Appendix

### IV.A. Mortgage Brokers

**Table 5-22. Mortgage and Non-mortgage Loan Brokers: 2004 Industry Characteristics (employers)**

Data	Total	Distribution by Number of Employees		
		<20	20-99	100+
Total Firms	19,138	17,802	1,093	243
Total Establishments	20,838	18,067	1,619	1,152
Total Employment	138,328	61,481	39,697	37,150
Total Payroll (\$1,000)	\$7,052,212	\$2,992,813	\$1,864,679	\$2,194,720
Estimated Revenue (\$1,000)	\$18,422,897	\$8,748,057	\$4,363,163	\$5,311,677
Share of Firms	100.0%	93.0%	5.7%	1.3%
Share of Establishments	100.0%	86.7%	7.8%	5.5%
Share of Employment	100.0%	44.4%	28.7%	26.9%
Share of Payroll	100.0%	42.4%	26.4%	31.1%
Share of Estimated Revenue	100.0%	47.5%	23.7%	28.8%
Employees per Firm	7.2	3.5	36.3	152.9
Payroll per Firm	\$368,493	\$168,117	\$1,706,019	\$9,031,770
Payroll per Employee	\$50,982	\$48,679	\$46,973	\$59,077
Estimated Revenue per Firm	\$962,634	\$491,409	\$3,991,915	\$21,858,752
Estimated Revenue per Employee	\$133,183	\$142,289	\$109,912	\$142,979

1. Revenue is estimated for employer firms by multiplying 2004 payroll data by 2002 revenue-payroll ratios.
2. In the Statistics of U.S. Businesses, a firm is defined as that part of an enterprise tabulated within a particular industry. Employment size is determined only for the *entire* enterprise. This result makes sense only when one is aware that an enterprise can participate in more than one industry.

**Table 5-23. Mortgage and Non-mortgage Loan Brokers: 2004 Firm Totals**

Firm Type	Number of Firms	Revenue (\$1,000)	Revenue per Firm
All Employer Firms <sup>1</sup>	19,138	\$18,422,897	\$962,634
Firms with less than 100 Employees	18,895	\$13,111,220	\$693,899
Nonemployer Firms (estimated) <sup>2</sup>	31,014	\$1,497,546	\$48,285
Total (All Firms)	50,152	19,920,442	\$397,198
Total "Small" (nonemp. + Firms < 100emp.)	49,909	14,608,766	\$292,705
Percentage Firms "Small"	99.5%	73.3%	73.7%

1. Revenue is estimated for employer firms by multiplying 2004 payroll data by 2002 revenue-payroll ratios.
2. Data for Nonemployer firms of the sub-industry Mortgage and non-mortgage loan brokers were estimated from employer data on Activities related to credit intermediation.

**Table 5-24. Mortgage and Non-mortgage Loan Brokers: 2002 Industry Characteristics (employers)**

Data Type	All Firms	Firms Operating		Share of Firms		
		for the Entire Year	entire Year, earning less than \$5 million in revenue	Operating Entire Year, earning less than \$5 million in revenue	Firms Operating Entire Year, earning \$5-10 million in revenue	Operating Entire Year, earning \$5-10 million in revenue
Total Number of Firms	15,590	12,365	11,980	96.9%	244	2.0%
Number of Establishments	17,041	13,810	12,614	91.3%	478	3.5%
Revenue (\$1,000)	\$14,123,022	\$13,386,940	\$8,303,854	62.0%	\$1,660,112	12.4%
Annual Payroll (\$1,000)	\$5,261,535	\$5,060,845	\$3,211,839	63.5%	\$648,839	12.8%
Number of Employees	105,147	101,318	72,734	71.8%	10,911	10.8%
Employees per Firm	6.7	8.2	6.1		44.7	
Payroll per Firm	\$337,494	\$409,288	\$268,100		\$2,659,176	
Payroll per Employee	\$50,040	\$49,950	\$44,159		\$59,467	
Revenue per Firm	\$905,903	\$1,082,648	\$693,143		\$6,803,738	
Revenue per Employee	\$134,317	\$132,128	\$114,167		\$152,150	

**Table 5-25. Mortgage and Non-mortgage Loan Brokers: 2002 Firm Totals**

Firm Type	Number of Firms	Revenue (\$1,000)	Revenue per Firm
All Employer Firms	15,590	\$14,123,022	\$905,903
Firms Operating Entire Year	12,365	\$13,386,940	\$1,082,648
Firms Operating Entire Year, earning <\$5 mill.	11,980	\$8,303,854	\$693,143
Share earning <\$5 million	96.9%	62.0%	
Firms Operating Entire Year, earning <\$6 mill.	12,029	\$8,596,654	\$714,673
Share earning <\$6 million (Estimate)	97.3%	64.2%	
Nonemployer Firms (estimated)	25,105	\$1,226,911	\$48,871
Total (All Firms)	40,695	\$15,349,933	
Total (Nonemp. + Employers entire year)	37,470	\$14,613,851	
Share of "Small Firms", firms earning <\$5 mill.	99.0%	65.2%	
Share of "Small Firms", firms earning <\$6 mill.	99.1%	67.2%	

\* Data for Nonemployer firms of the sub-industry Mortgage and non-mortgage loan brokers were estimated from employer data on Activities related to credit intermediation.

## IV.B. Real Estate Credit

**Table 5-26. Real Estate Credit: 2004 Industry Characteristics of Industry (employers)**

Data	Total	Distribution by Number of Employees		
		<20	20-99	100+
Total Firms	9,502	8,042	895	565
Total Establishments	24,863	8,164	1,356	15,343
Total Employment	360,951	27,031	35,742	298,178
Total Payroll (\$1,000)	\$24,479,460	\$1,446,960	\$1,997,964	\$21,034,536
Estimated Revenue (\$1,000)	\$105,703,258	\$5,700,852	\$6,275,938	\$93,726,468
Share of Firms	100.0%	84.6%	9.4%	5.9%
Share of Establishments	100.0%	32.8%	5.5%	61.7%
Share of Employment	100.0%	7.5%	9.9%	82.6%
Share of Payroll	100.0%	5.9%	8.2%	85.9%
Share of Estimated Revenue	100.0%	5.4%	5.9%	88.7%
Employees per Firm	38.0	3.4	39.9	527.7
Payroll per Firm	\$2,576,243	\$179,925	\$2,232,362	\$37,229,267
Payroll per Employee	\$67,819	\$53,530	\$55,900	\$70,544
Estimated Revenue per Firm	\$11,124,317	\$708,885	\$7,012,221	\$165,887,554
Estimated Revenue per Employee	\$292,847	\$210,901	\$175,590	\$314,331

\* Revenue is estimated for employer firms by multiplying 2004 payroll data by 2002 revenue-payroll ratios.

**Table 5-27. Real estate credit 2004 Firm Totals**

Firm Type	Number of Firms	Revenue (\$1,000)	Revenue per Firm
All Employer Firms <sup>1</sup>	9,502	\$105,703,258	\$11,124,317
Firms with less than 100 Employees	8,937	\$11,976,790	\$1,340,135
Nonemployer Firms (estimated) <sup>2</sup>	6,830	\$599,306	\$87,744
Total (All Firms)	16,332	106,302,563	\$6,508,774
Total "Small" (nonemp. + Firms < 100emp.)	15,767	12,576,095	\$797,611
Percentage Firms "Small"	96.5%	11.8%	12.3%

2. Data for Nonemployer firms of the sub-industry Real estate credit were estimated from employer data on Nondepository credit intermediation.

**Table 5-28. Real estate credit 2002 Industry Characteristics (employers)**

Data Type	All Firms	Firms Operating for the Entire Year				
		Firms Operating for the Entire Year	Firms earning less than \$5 million in revenue	Share of Firms earning less than \$5 million in revenue	Firms earning \$5-10 million in revenue	Share of Firms, earning \$5-10 million in revenue
Total Number of Firms	15,590	12,365	11,980	96.9%	244	2.0%
Number of Establishments	17,041	13,810	12,614	91.3%	478	3.5%
Revenue (\$1,000)	\$14,123,022	\$13,386,940	\$8,303,854	62.0%	\$1,660,112	12.4%
Annual Payroll (\$1,000)	\$5,261,535	\$5,060,845	\$3,211,839	63.5%	\$648,839	12.8%
Number of Employees	105,147	101,318	72,734	71.8%	10,911	10.8%
Employees per Firm	6.7	8.2	6.1		44.7	
Payroll per Firm	\$337,494	\$409,288	\$268,100		\$2,659,176	
Payroll per Employee	\$50,040	\$49,950	\$44,159		\$59,467	
Revenue per Firm	\$905,903	\$1,082,648	\$693,143		\$6,803,738	

**Table 5-29. Real estate credit 2002 Firm Totals**

Firm Type	Number of Firms	Revenue (\$1,000)	Revenue per Firm
All Employer Firms	15,590	\$14,123,022	\$905,903
Firms Operating Entire Year	12,365	\$13,386,940	\$1,082,648
Firms Operating Entire Year, earning <\$5 mill.	11,980	\$8,303,854	\$693,143
Share earning <\$5 million	96.9%	62.0%	
Firms Operating Entire Year, earning <\$6 mill.	12,029	\$8,596,654	\$714,673
Share earning <\$6 million (Estimate)	97.3%	64.2%	
Nonemployer Firms (estimated)	25,105	\$1,226,911	\$48,871
Total (All Firms)	40,695	\$15,349,933	
Total (Nonemp. + Employers entire year)	37,470	\$14,613,851	
Share of "Small Firms", firms earning <\$5 mill.	99.0%	65.2%	
Share of "Small Firms", firms earning <\$6 mill.	99.1%	67.2%	

\* Data for Nonemployer firms of the sub-industry Real estate credit were estimated from employer data on Nondepository credit intermediation.

## IV.C. Commercial Banks

**Table 5-30. Commercial Banking: 2004 Industry Characteristics (employers)**

Data	Total	Distribution by Number of Employees		
		<20	20-99	100+
Total Firms	6,978	1,962	3,602	1,414
Total Establishments	83,030	2,328	9,980	70,722
Total Employment	1,631,328	21,153	159,827	1,450,348
Total Payroll (\$1,000)	\$80,733,881	\$1,074,683	\$5,889,268	\$73,769,930
Estimated Revenue (\$1,000)	\$496,855,046	\$5,980,167	\$33,389,841	\$457,485,038
Share of Firms	100.0%	28.1%	51.6%	20.3%
Share of Establishments	100.0%	2.8%	12.0%	85.2%
Share of Employment	100.0%	1.3%	9.8%	88.9%
Share of Payroll	100.0%	1.3%	7.3%	91.4%
Share of Estimated Revenue	100.0%	1.2%	6.7%	92.1%
Employees per Firm	233.8	10.8	44.4	1025.7
Payroll per Firm	\$11,569,774	\$547,749	\$1,634,999	\$52,171,096
Payroll per Employee	\$49,490	\$50,805	\$36,848	\$50,864
Estimated Revenue per Firm	\$71,203,073	\$3,047,995	\$9,269,806	\$323,539,631
Estimated Revenue per Employee	\$304,571	\$282,710	\$208,912	\$315,431

\* Revenue is estimated for employer firms by multiplying 2004 payroll data by 2002 revenue-payroll ratios.

**Table 5-31. Commercial Banking: 2004 Firm Totals**

Firm Type	Number of Firms	Revenue (\$1,000)	Revenue per Firm
All Employer Firms <sup>1</sup>	6,978	\$496,855,046	\$71,203,073
Firms with less than 100 Employees	5,564	\$39,370,008	\$7,075,846
Nonemployer Firms (estimated) <sup>2</sup>	285	\$37,520	\$131,692
Total (All Firms)	7,263	496,892,566	\$68,415,128
Total "Small" (nonemp. + Firms < 100emp.)	5,849	39,407,528	\$6,737,591
Percentage Firms "Small"	80.5%	7.9%	9.8%

1. Revenue is estimated for employer firms by multiplying 2004 payroll data by 2002 revenue-payroll ratios.

2. Data for Nonemployer firms of the sub-industry Commercial Banks were estimated from employer data on Firm counts from 2004 and revenue data from 2004 were used.

**Table 5-32. Commercial Banking: 2002 Industry Characteristics (employers)**

Data Type	All Firms	Firms Operating for the Entire Year	Firms Operating Entire Year, earning less than \$5 million in revenue	Share of Firms Operating Entire Year, earning less than \$5 million in revenue	Firms Operating Entire Year, earning \$5-10 million in revenue	Share of Firms Operating Entire Year, earning \$5- 10 million in revenue
Total Number of Firms	7,285	6,979	3,080	44.1%	1,616	23.2%
Number of Establishments	81,357	81,042	4,711	5.8%	4,571	5.6%
Revenue (\$1,000)	\$488,659,993	\$485,926,987	\$7,890,497	1.6%	\$11,471,472	2.4%
Annual Payroll (\$1,000)	\$79,150,729	\$78,941,851	\$1,752,168	2.2%	\$2,281,276	2.9%
Number of Employees	1,737,056	1,733,793	54,770	3.2%	68,635	4.0%
Employees per Firm	238.4	248.4	17.8		42.5	
Payroll per Firm	\$10,864,891	\$11,311,341	\$568,886		\$1,411,681	
Payroll per Employee	\$45,566	\$45,531	\$31,991		\$33,238	
Revenue per Firm	\$67,077,556	\$69,627,022	\$2,561,850		\$7,098,683	
Revenue per Employee	\$281,315	\$280,268	\$144,066		\$167,137	

**Table 5-33. Commercial Banking: 2002 Firm Totals**

Firm Type	Number of Firms	Revenue (\$1,000)	Revenue per Firm
All Employer Firms	7,285	\$488,659,993	\$67,077,556
Firms Operating Entire Year	6,979	\$485,926,987	\$69,627,022
Firms Operating Entire Year, earning <\$5 mill. Share earning <\$5 million	3,080	\$7,890,497	\$2,561,850
Firms Operating Entire Year, earning <\$6 mill. Share earning <\$6 million (Estimate)	44.1%	1.6%	
Firms Operating Entire Year, earning <\$6 mill. Share earning <\$6 million (Estimate)	3,403	\$9,829,697	\$2,888,369
Share earning <\$6 million (Estimate)	48.8%	2.0%	
Nonemployer Firms (estimated)	237	\$33,778	\$142,381
Total (All Firms)	7,522	\$488,693,771	
Total (Nonemp. + Employers entire year)	7,216	\$485,960,765	
Share of "Small Firms", firms earning <\$5 mill.	46.0%	1.6%	
Share of "Small Firms", firms earning <\$6 mill.	50.4%	2.0%	

#### IV.D. Savings Institutions

**Table 5-34. Savings Institutions: 2004 Characteristics of Industry (employers)**

Data	Total	Distribution by Number of Employees		
		<20	20-99	100+
Total Firms	1,390	327	616	447
Total Establishments	16,399	400	2,023	13,976
Total Employment	248,962	3,143	29,959	215,860
Total Payroll (\$1,000)	\$12,006,662	\$139,996	\$1,173,505	\$10,693,161
Estimated Revenue (\$1,000)	\$92,507,359	\$953,408	\$7,716,917	\$83,837,034
Share of Firms	100.0%	23.5%	44.3%	32.2%
Share of Establishments	100.0%	2.4%	12.3%	85.2%
Share of Employment	100.0%	1.3%	12.0%	86.7%
Share of Payroll	100.0%	1.2%	9.8%	89.1%
Share of Estimated Revenue	100.0%	1.0%	8.3%	90.6%
Employees per Firm	179.1	9.6	48.6	482.9
Payroll per Firm	\$8,637,886	\$428,122	\$1,905,041	\$23,922,060
Payroll per Employee	\$48,227	\$44,542	\$39,170	\$49,537
Estimated Revenue per Firm	\$66,552,057	\$2,915,622	\$12,527,463	\$187,554,886
Estimated Revenue per Employee	\$371,572	\$303,343	\$257,583	\$388,386

\* Revenue is estimated for employer firms by multiplying 2004 payroll data by 2002 revenue-payroll ratios.

**Table 5-35. Savings Institutions: 2004 Firm Totals**

Firm Type	Number of Firms	Revenue (\$1,000)	Revenue per Firm
All Employer Firms <sup>1</sup>	1,390	\$92,507,359	\$66,552,057
Firms with less than 100 Employees	943	\$8,670,325	\$9,194,406
Nonemployer Firms (estimated) <sup>2</sup>	111	\$7,781	\$70,011
Total (All Firms)	1,501	92,515,140	\$61,630,204
Total "Small" (nonemp. + Firms < 100emp.)	1,054	8,678,106	\$8,232,457
Percentage Firms "Small"	70.2%	9.4%	13.4%

1. Revenue is estimated for employer firms by multiplying 2004 payroll data by 2002 revenue-payroll ratios.

2. Data for Nonemployer firms of the sub-industry Savings Institutions were estimated from employer data on Depository credit inter-mediation. Firm counts from 2004 and revenue data from 2004 were used.

**Table 5-36. Savings Institutions: 2002 Industry Characteristics (employers)**

Data Type	All Firms	Firms Operating for the Entire Year	Firms Operating Entire Year, earning less than \$5 million in revenue	Firms Operating Entire Year, earning less than \$5 million in revenue	Firms Operating Entire Year, earning \$5-10 million in revenue	Share of Firms Operating Entire Year, earning \$5-10 million in revenue
Total Number of Firms	1,480	1,431	444	31.0%	290	20.3%
Number of Establishments	16,744	16,692	684	4.1%	801	4.8%
Revenue (\$1,000)	\$77,459,937	\$77,323,272	\$1,107,439	1.4%	\$2,119,990	2.7%
Annual Payroll (\$1,000)	\$10,109,162	\$10,084,055	\$211,018	2.1%	\$363,499	3.6%
Number of Employees	246,426	245,806	6,576	2.7%	10,513	4.3%
Employees per Firm	166.5	171.8	14.8		36.3	
Payroll per Firm	\$6,830,515	\$7,046,859	\$475,266		\$1,253,445	
Payroll per Employee	\$41,023	\$41,024	\$32,089		\$34,576	
Revenue per Firm	\$52,337,795	\$54,034,432	\$2,494,232		\$7,310,310	
Revenue per Employee	\$314,333	\$314,570	\$168,406		\$201,654	

**Table 5-37. Savings Institutions: 2002 Firm Totals**

Firm Type	Number of Firms	Revenue (\$1,000)	Revenue per Firm
All Employer Firms	1,480	\$77,459,937	\$52,337,795
Firms Operating Entire Year	1,431	\$77,323,272	\$54,034,432
Firms Operating Entire Year, earning <\$5 mill.	444	\$1,107,439	\$2,494,232
Share earning <\$5 million	31.0%	1.4%	
Firms Operating Entire Year, earning <\$6 mill.	502	\$1,455,439	\$2,899,281
Share earning <\$6 million (Estimate)	35.1%	1.9%	
Nonemployer Firms (estimated)	93	\$7,005	\$75,694
Total (All Firms)	1,573	\$77,466,942	
Total (Nonemp. + Employers entire year)	1,524	\$77,330,277	
Share of "Small Firms", firms earning <\$5 mill.	35.2%	1.4%	
Share of "Small Firms", firms earning <\$6 mill.	39.0%	1.9%	

## IV.E. Credit Union Industry

**Table 5-38. Credit Unions: 2004 Industry Characteristics (employers)**

Data	Total	Distribution by Number of Employees		
		<20	20-99	100+
Total Firms	8,358	6,220	1,602	536
Total Establishments	16,043	6,701	4,234	5,108
Total Employment	229,213	35,572	70,063	123,578
Total Payroll (\$1,000)	\$7,711,752	\$981,656	\$2,194,368	\$4,535,728
Estimated Revenue (\$1,000)	\$44,636,510	\$4,871,891	\$11,362,337	\$28,402,282
Share of Firms	100.0%	74.4%	19.2%	6.4%
Share of Establishments	100.0%	41.8%	26.4%	31.8%
Share of Employment	100.0%	15.5%	30.6%	53.9%
Share of Payroll	100.0%	12.7%	28.5%	58.8%
Share of Estimated Revenue	100.0%	10.9%	25.5%	63.6%
Employees per Firm	27.4	5.7	43.7	230.6
Payroll per Firm	\$922,679	\$157,823	\$1,369,768	\$8,462,179
Payroll per Employee	\$33,644	\$27,596	\$31,320	\$36,703
Estimated Revenue per Firm	\$5,340,573	\$783,262	\$7,092,595	\$52,989,332
Estimated Revenue per Employee	\$194,738	\$136,959	\$162,173	\$229,833

\* Revenue is estimated for employer firms by multiplying 2004 payroll data by 2002 revenue-payroll ratios.

**Table 5-39. Credit Union Industry: 2004 Firm Totals**

Firm Type	Number of Firms	Revenue (\$1,000)	Revenue per Firm
All Employer Firms <sup>1</sup>	8,358	\$44,636,510	\$5,340,573
Firms with less than 100 Employees	7,822	\$16,234,228	\$2,075,457
Nonemployer Firms (estimated) <sup>2</sup>	7,226	\$203,128	\$28,112
Total (All Firms)	15,584	44,839,638	\$2,877,347
Total "Small" (nonemp. + Firms < 100emp.)	15,048	16,437,356	\$1,092,352
Percentage Firms "Small"	96.6%	36.7%	38.0%

1. Revenue is estimated for employer firms by multiplying 2004 payroll data by 2002 revenue-payroll ratios.

2. Data for Nonemployer firms of the sub-industry Credit Unions were estimated from employer data on Firm counts from 2004 and revenue data from 2004 were used.

**Table 5-40. Credit Unions: 2002 Industry Characteristics (employers)**

Data Type	All Firms	Firms Operating for the Entire Year	Firms Operating Entire Year, earning less than \$5 million in revenue	Firms Operating Entire Year, earning less than \$5 million in revenue	Firms Operating Entire Year, earning \$5-10 million in revenue	Share of Firms Operating Entire Year, earning \$5-10 million in revenue
Total Number of Firms	8,836	8,617	7,345	85.2%	544	6.3%
Number of Establishments	16,295	16,074	8,867	55.2%	1,784	11.1%
Revenue (\$1,000)	\$37,050,065	\$36,994,154	\$7,256,066	19.6%	\$3,891,443	10.5%
Annual Payroll (\$1,000)	\$6,466,086	\$6,456,010	\$1,561,336	24.2%	\$796,462	12.3%
Number of Employees	208,038	207,411	60,064	29.0%	26,926	13.0%
Employees per Firm	23.5	24.1	8.2		49.5	
Payroll per Firm	\$731,789	\$749,218	\$212,571		\$1,464,085	
Payroll per Employee	\$31,081	\$31,127	\$25,995		\$29,580	
Revenue per Firm	\$4,193,081	\$4,293,159	\$987,892		\$7,153,388	
Revenue per Employee	\$178,093	\$178,362	\$120,806		\$144,524	

**Table 5-41. Credit Unions: 2002 Firm Totals**

Firm Type	Number of Firms	Revenue (\$1,000)	Revenue per Firm
All Employer Firms	8,836	\$37,050,065	\$4,193,081
Firms Operating Entire Year	8,617	\$36,994,154	\$4,293,159
Firms Operating Entire Year, earning <\$5 mill.	7,345	\$7,256,066	\$987,892
Share earning <\$5 million	85.2%	19.6%	
Firms Operating Entire Year, earning <\$6 mill.	7,454	\$7,908,866	\$1,061,052
Share earning <\$6 million (Estimate)	86.5%	21.4%	
Nonemployer Firms (estimated)	6,017	\$182,868	\$30,394
Total (All Firms)	14,853	\$37,232,933	
Total (Nonemp. + Employers entire year)	14,634	\$37,177,022	
Share of "Small Firms", firms earning <\$5 mill.	91.3%	20.0%	
Share of "Small Firms", firms earning <\$6 mill.	92.1%	21.8%	

#### IV.F. Title Abstract and Settlement Offices

**Table 5-42. Title abstract & settlement offices: 2004 Industry Characteristics (employers)**

Data	Total	Distribution by Number of Employees		
		<20	20-99	100+
Total Firms	8,008	7,248	631	129
Total Establishments	9,769	7,349	1,044	1,376
Total Employment	79,819	31,303	21,749	26,767
Total Payroll (\$1,000)	\$3,292,848	\$1,123,652	\$851,836	\$1,317,360
Estimated Revenue (\$1,000)	\$8,915,858	\$3,125,697	\$2,106,527	\$3,683,635
Share of Firms	100.0%	90.5%	7.9%	1.6%
Share of Establishments	100.0%	75.2%	10.7%	14.1%
Share of Employment	100.0%	39.2%	27.2%	33.5%
Share of Payroll	100.0%	34.1%	25.9%	40.0%
Share of Estimated Revenue	100.0%	35.1%	23.6%	41.3%
Employees per Firm	10.0	4.3	34.5	207.5
Payroll per Firm	\$411,195	\$155,029	\$1,349,978	\$10,212,093
Payroll per Employee	\$41,254	\$35,896	\$39,167	\$49,216
Estimated Revenue per Firm	\$1,113,369	\$431,250	\$3,338,394	\$28,555,308
Estimated Revenue per Employee	\$111,701	\$99,853	\$96,856	\$137,619

\* Revenue is estimated for employer firms by multiplying 2004 payroll data by 2002 revenue-payroll ratios.

**Table 5-43. Title abstract and settlement offices: 2004 Firm Totals**

Firm Type	Number of Firms	Revenue (\$1,000)	Revenue per Firm
All Employer Firms <sup>1</sup>	8,008	\$8,915,858	\$1,113,369
Firms with less than 100 Employees	7,879	\$5,232,224	\$664,072
Nonemployer Firms (estimated) <sup>2</sup>	6,203	\$333,770	\$53,809
Total (All Firms)	14,211	9,249,628	\$650,884
Total "Small" (nonemp. + Firms < 100emp.)	14,082	5,565,993	\$395,259
Percentage Firms "Small"	99.1%	60.2%	60.7%

<sup>8</sup> Revenue is estimated for employer firms using revenue-payroll ratios calculating from 2002 data.

**Table 5-44. Title abstract and settlement offices: 2002 Industry Characteristics (employers)**

Data Type	All Firms	Firms Operating for the Entire Year	Firms Operating Entire Year, earning less than \$5 million in revenue	Firms Operating Entire Year, earning less than \$5 million in revenue	Firms Operating Entire Year, earning \$5-10 million in revenue	Share of Firms Operating Entire Year, earning \$5-10 million in revenue
Total Number of Firms	6,252	5,258	5,073	96.5%	107	2.0%
Number of Establishments	8,013	7,014	5,533	78.9%	349	5.0%
Revenue (\$1,000)	\$7,600,419	\$7,433,115	\$3,423,742	46.1%	\$726,668	9.8%
Annual Payroll (\$1,000)	\$2,608,123	\$2,559,153	\$1,320,401	51.6%	\$278,786	10.9%
Number of Employees	65,833	64,807	37,643	58.1%	6,295	9.7%
Employees per Firm	10.5	12.3	7.4		58.8	
Payroll per Firm	\$417,166	\$486,716	\$260,280		\$2,605,477	
Payroll per Employee	\$39,617	\$39,489	\$35,077		\$44,287	
Revenue per Firm	\$1,215,678	\$1,413,677	\$674,895		\$6,791,290	
Revenue per Employee	\$115,450	\$114,696	\$90,953		\$115,436	

**Table 5-45. Title abstract and settlement offices: 2002 Firm Totals**

Firm Type	Number of Firms	Revenue (\$1,000)	Revenue per Firm
All Employer Firms	6,252	\$7,600,419	\$1,215,678
Firms Operating Entire Year	5,258	\$7,433,115	\$1,413,677
Firms Operating Entire Year, earning <\$5 mill.	5,073	\$3,423,742	\$674,895
Share earning <\$5 million	96.5%	46.1%	
Firms Operating Entire Year, earning <\$6 mill.	5,094	\$3,552,142	\$697,264
Share earning <\$6 million (Estimate)	96.9%	47.8%	
Nonemployer Firms (estimated)	5,778	\$297,785	\$51,534
Total (All Firms)	12,030	\$7,898,204	
Total (Nonemp. + Employers entire year)	11,036	\$7,730,900	
Share of "Small Firms", firms earning <\$5 mill.	98.3%	48.1%	
Share of "Small Firms", firms earning <\$6 mill.	98.5%	49.8%	

## IV.G. Offices of Lawyers

**Table 5-46. Offices of Lawyers: 2004 Characteristics of Industry (employers)**

Data	Total	Distribution by Number of Employees		
		<20	20-99	100+
Total Firms	166,704	158,661	6,933	1,110
Total Establishments	173,044	159,551	9,139	4,354
Total Employment	1,122,723	516,890	257,392	348,441
Total Payroll (\$1,000)	\$74,131,522	\$24,855,287	\$18,305,726	\$30,970,509
Estimated Revenue (\$1,000)	\$189,579,592	\$73,151,313	\$39,060,403	\$77,367,876
Share of Firms	100.0%	95.2%	4.2%	0.7%
Share of Establishments	100.0%	92.2%	5.3%	2.5%
Share of Employment	100.0%	46.0%	22.9%	31.0%
Share of Payroll	100.0%	33.5%	24.7%	41.8%
Share of Estimated Revenue	100.0%	38.6%	20.6%	40.8%
Employees per Firm	6.7	3.3	37.1	313.9
Payroll per Firm	\$444,690	\$156,657	\$2,640,376	\$27,901,359
Payroll per Employee	\$66,028	\$48,086	\$71,120	\$88,883
Estimated Revenue per Firm	\$1,137,223	\$461,054	\$5,633,983	\$69,700,790
Estimated Revenue per Employee	\$168,857	\$141,522	\$151,755	\$222,040

\* Revenue is estimated for employer firms by multiplying 2004 payroll data by 2002 revenue-payroll ratios.

**Table 5-47. Offices of Lawyers 2004 Firm Totals**

Firm Type	Number of Firms	Revenue (\$1,000)	Revenue per Firm
All Employer Firms <sup>1</sup>	166,704	\$189,579,592	\$1,137,223
Firms with less than 100 Employees	165,594	\$112,211,715	\$677,632
Nonemployer Firms (estimated) <sup>2</sup>	234,849	\$13,985,539	\$59,551
Total (All Firms)	401,553	203,565,131	\$506,945
Total "Small" (nonemp. + Firms < 100emp.)	400,443	126,197,254	\$315,144
Percentage Firms "Small"	99.7%	62.0%	62.2%

\* Revenue is estimated for employer firms using revenue-payroll ratios calculating from 2002 data.

**Table 5-48. Offices of Lawyers: 2002 Industry Characteristics (employers)**

Data Type	All Firms	Firms Operating for the Entire Year	Firms Operating Entire Year, earning less than \$5 million in revenue	Share of Firms Operating Entire Year, earning less than \$5 million in revenue	Firms Operating Entire Year, earning \$5-10 million in revenue	Share of Firms Operating Entire Year, earning \$5-10 million in revenue
Total Number of Firms	162,593	136,934	133,148	97.2%	2,108	1.5%
Number of Establishments	169,120	143,438	135,327	94.3%	3,156	2.2%
Revenue (\$1,000)	\$172,863,871	\$168,013,231	\$71,269,426	42.4%	\$14,406,204	8.6%
Annual Payroll (\$1,000)	\$66,761,394	\$65,084,824	\$26,780,420	41.1%	\$6,564,815	10.1%
Number of Employees	1,080,428	1,045,862	594,558	56.8%	90,810	8.7%
Employees per Firm	6.6	7.6	4.5		43.1	
Payroll per Firm	\$410,604	\$475,301	\$201,133		\$3,114,239	
Payroll per Employee	\$61,792	\$62,231	\$45,043		\$72,292	
Revenue per Firm	\$1,063,169	\$1,226,965	\$535,265		\$6,834,063	
Revenue per Employee	\$159,996	\$160,646	\$119,870		\$158,641	

**Table 5-49. Offices of Lawyers: 2002 Firm Totals**

Firm Type	Number of Firms	Revenue (\$1,000)	Revenue per Firm
All Employer Firms	162,593	\$172,863,871	\$1,063,169
Firms Operating Entire Year	136,934	\$168,013,231	\$1,226,965
Firms Operating Entire Year, earning <\$5 mill.	133,148	\$71,269,426	\$535,265
Share earning <\$5 million	97.2%	42.4%	
Firms Operating Entire Year, earning <\$6 mill.	133,570	\$73,799,026	\$552,514
Share earning <\$6 million (Estimate)	97.5%	43.9%	
Nonemployer Firms (estimated)	218,777	\$12,477,720	\$57,034
Total (All Firms)	381,370	\$185,341,591	
Total (Nonemp. + Employers entire year)	355,711	\$180,490,951	
Share of "Small Firms", firms earning <\$5 mill.	98.9%	46.4%	
Share of "Small Firms", firms earning <\$6 mill.	99.1%	47.8%	

## IV.H. Direct Title Insurance Carriers

**Table 5-50. Direct Title Insurance Carriers: 2004 Industry Characteristics (employers)**

Data	Total	Distribution by Number of Employees		
		<20	20-99	100+
Total Firms	1,959	1,778	124	57
Total Establishments	6,229	1,781	210	4,238
Total Employment	75,702	6,366	4,177	65,159
Total Payroll (\$1,000)	\$4,754,017	\$237,687	\$182,352	\$4,333,978
Estimated Revenue (\$1,000)	\$18,087,340	\$796,541	\$558,079	\$16,732,720
Share of Firms	100.0%	90.8%	6.3%	2.9%
Share of Establishments	100.0%	28.6%	3.4%	68.0%
Share of Employment	100.0%	8.4%	5.5%	86.1%
Share of Payroll	100.0%	5.0%	3.8%	91.2%
Share of Estimated Revenue	100.0%	4.4%	3.1%	92.5%
Employees per Firm	38.6	3.6	33.7	1143.1
Payroll per Firm	\$2,426,757	\$133,682	\$1,470,581	\$76,034,702
Payroll per Employee	\$62,799	\$37,337	\$43,656	\$66,514
Estimated Revenue per Firm	\$9,232,945	\$447,998	\$4,500,634	\$293,556,493
Estimated Revenue per Employee	\$238,928	\$125,124	\$133,608	\$256,798

\* Revenue is estimated for employer firms by multiplying 2004 payroll data by 2002 revenue-payroll ratios.

**Table 5-51. Direct Title Insurance Carriers: 2004 Firm Totals**

Firm Type	Number of Firms	Revenue (\$1,000)	Revenue per Firm
All Employer Firms <sup>1</sup>	1,959	\$18,087,340	\$9,232,945
Firms with less than 100 Employees	1,902	\$1,354,620	\$712,208
Nonemployer Firms (estimated) <sup>2</sup>	135	\$2,731	\$20,190
Total (All Firms)	2,094	18,090,070	\$8,637,972
Total "Small" (nonemp. + Firms < 100emp.)	2,037	1,357,350	\$666,266
Percentage Firms "Small"	97.3%	7.5%	7.7%

<sup>1</sup> Revenue is estimated for employer firms using revenue-payroll ratios calculating from 2002 data.

<sup>2</sup> Detailed Nonemployer firms are estimated using ratios computed from 2004 employer data.

**Table 5-52. Direct Title Insurance Carriers: 2002 Industry Characteristics (employers)**

Data Type	All Firms	Firms Operating for the Entire Year	Firms Operating Entire Year, earning less than \$5 million in revenue	Firms Operating Entire Year, earning less than \$5 million in revenue	Firms Operating Entire Year, earning \$5-10 million in revenue	Share of Firms Operating Entire Year, earning \$5-10 million in revenue
Total Number of Firms	1,201	943	887	94.1%	23	2.4%
Number of Establishments	4,375	4,117	944	22.9%	75	1.8%
Revenue (\$1,000)	\$12,805,302	\$12,763,346	\$576,661	4.5%	\$159,633	1.3%
Annual Payroll (\$1,000)	\$3,431,301	\$3,419,262	\$196,235	5.7%	\$49,399	1.4%
Number of Employees	63,278	63,144	5,702	9.0%	1,286	2.0%
Employees per Firm	52.7	67.0	6.4		55.9	
Payroll per Firm	\$2,857,037	\$3,625,941	\$221,234		\$2,147,783	
Payroll per Employee	\$54,226	\$54,150	\$34,415		\$38,413	
Revenue per Firm	\$10,662,200	\$13,534,831	\$650,125		\$6,940,565	
Revenue per Employee	\$202,366	\$202,131	\$101,133		\$124,131	

**Table 5-53. Direct Title Insurance Carriers: 2002 Firm Totals**

Firm Type	Number of Firms	Revenue (\$1,000)	Revenue per Firm
All Employer Firms	68,649	\$63,381,021	\$923,262
Firms Operating Entire Year	49,089	\$59,376,212	\$1,209,562
Firms Operating Entire Year, earning <\$5 mill.	47,510	\$26,503,169	\$557,844
Share earning <\$5 million	96.8%	44.6%	
Firms Operating Entire Year, earning <\$2.5 mill.	45,694	\$20,215,859	\$442,418
Share earning <\$2.5 million	93.1%	34.0%	
Nonemployer Firms	569,949	\$26,007,073	\$45,631
Total (All Firms)	638,598	\$89,388,094	
Total (Nonemp. + Employers entire year)	619,038	\$85,383,285	
Share of "Small Firms", firms earning <\$5 mill.	99.7%	61.5%	
Share of "Small Firms", firms earning <\$2.5 mill.	99.5%	54.1%	

<sup>1</sup> use 2004 data to create ratio for estimating revenue

## IV.I. Office of Real Estate Appraisers

**Table 5-54. Real Estate Appraisers: 2004 Industry Characteristics (Employer Firms)**

Data	Total	Distribution by Number of Employees		
		<20	20-99	100+
Total Firms	15,689	15,494	150	45
Total Establishments	15,922	15,549	235	138
Total Employment	45,021	37,024	4,514	3,483
Total Payroll (\$1,000)	\$1,721,397	\$1,380,663	\$205,799	\$134,935
Estimated Revenue (\$1,000)	\$4,958,984	\$3,996,071	\$436,683	\$526,230
Share of Firms	100.0%	98.8%	1.0%	0.3%
Share of Establishments	100.0%	97.7%	1.5%	0.9%
Share of Employment	100.0%	82.2%	10.0%	7.7%
Share of Payroll	100.0%	80.2%	12.0%	7.8%
Share of Estimated Revenue	100.0%	80.6%	8.8%	10.6%
Employees per Firm	2.9	2.4	30.1	77.4
Payroll per Firm	\$109,720	\$89,110	\$1,371,993	\$2,998,556
Payroll per Employee	\$38,235	\$37,291	\$45,591	\$38,741
Estimated Revenue per Firm	\$316,080	\$257,911	\$2,911,218	\$11,693,998
Estimated Revenue per Employee	\$110,148	\$107,932	\$96,740	\$151,085

\* Revenue is estimated for employer firms by multiplying 2004 payroll data by 2002 revenue-payroll ratios.

**Table 5-55. Real Estate Appraisers: 2004 Firm Totals**

Firm Type	Number of Firms	Revenue (\$1,000)	Revenue per Firm
All Employer Firms <sup>1</sup>	15,689	\$4,958,984	\$316,080
Firms with less than 100 Employees	15,644	\$4,432,754	\$283,352
Nonemployer Firms	49,802	\$2,334,356	\$46,873
Total (All Firms)	65,491	7,293,340	\$111,364
Total "Small" (nonemp. + Firms < 100emp.)	65,446	6,767,110	\$103,400
Percentage Firms "Small"	99.9%	92.8%	92.8%

\* Revenue is estimated for employer firms by multiplying 2004 payroll data by 2002 revenue-payroll ratios.

**Table 5-56. Real Estate Appraisers: 2002 Industry Characteristics (employers)**

Data Type	All Firms	Firms Operating for the Entire Year	Firms Operating Entire Year, earning less than \$5 million in revenue	Firms Operating Entire Year, earning less than \$5 million in revenue	Firms Operating Entire Year, earning less than \$2.5 million in revenue	Firms Operating Entire Year, earning less than \$2.5 million in revenue
Total Number of Firms	13,579	10,791	10,755	99.7%	10,685	99.0%
Number of Establishments	13,770	10,981	10,869	99.0%	10,770	98.1%
Revenue (\$1,000)	\$4,611,696	\$4,284,001	\$3,438,765	80.3%	\$3,218,492	75.1%
Annual Payroll (\$1,000)	\$1,557,043	\$1,479,479	\$1,262,538	85.3%	\$1,160,325	78.4%
Number of Employees	42,040	40,191	35,303	87.8%	33,298	82.8%
Employees per Firm	3.1	3.7	3.3		3.1	
Payroll per Firm	\$114,666	\$137,103	\$117,391		\$108,594	
Payroll per Employee	\$37,037	\$36,811	\$35,763		\$34,847	
Revenue per Firm	\$339,620	\$396,998	\$319,736		\$301,216	
Revenue per Employee	\$109,698	\$106,591	\$97,407		\$96,657	

**Table 5-57. Real Estate Appraisers: 2002 Firm Totals**

Firm Type	Number of Firms	Revenue (\$1,000)	Revenue per Firm
All Employer Firms	13,579	\$4,611,696	\$339,620
Firms Operating Entire Year	10,791	\$4,284,001	\$396,998
Firms Operating Entire Year, earning <\$5 mill.	10,755	\$3,438,765	\$319,736
Share earning <\$5 million	99.7%	80.3%	
Firms Operating Entire Year, earning <\$2.5 mill	10,685	\$3,218,492	\$301,216
Share earning <\$2.5 million	99.0%	75.1%	
Nonemployer Firms	39,727	\$2,021,004	\$50,872
Total (All Firms)	53,306	\$6,632,700	
Total (Nonemp. + Employers entire year)	50,518	\$6,305,005	
Share of "Small Firms", firms earning <\$5 mill.	99.9%	86.6%	
Share of "Small Firms", firms earning <\$2.5 mil	99.8%	83.1%	

## IV.J. Extermination & Pest Control Services

**Table 5-58. Exterminating & Pest Control Services: 2004 Industry Characteristics (employers)**

Data	Total	Distribution by Number of Employees		
		<20	20-99	100+
Total Firms	10,065	9,432	556	77
Total Establishments	11,821	9,486	754	1,581
Total Employment	95,437	38,800	19,212	37,425
Total Payroll (\$1,000)	\$2,963,040	\$1,045,591	\$603,123	\$1,314,326
Estimated Revenue (\$1,000)	\$7,397,076	\$2,758,330	\$1,337,594	\$3,301,153
Share of Firms	100.0%	93.7%	5.5%	0.8%
Share of Establishments	100.0%	80.2%	6.4%	13.4%
Share of Employment	100.0%	40.7%	20.1%	39.2%
Share of Payroll	100.0%	35.3%	20.4%	44.4%
Share of Estimated Revenue	100.0%	37.3%	18.1%	44.6%
Employees per Firm	9.5	4.1	34.6	486.0
Payroll per Firm	\$294,390	\$110,856	\$1,084,754	\$17,069,169
Payroll per Employee	\$31,047	\$26,948	\$31,393	\$35,119
Estimated Revenue per Firm	\$734,931	\$292,444	\$2,405,744	\$42,872,112
Estimated Revenue per Employee	\$77,507	\$71,091	\$69,623	\$88,207

\* Revenue is estimated for employer firms by multiplying 2004 payroll data by 2002 revenue-payroll ratios.

**Table 5-59. Exterminating & Pest Control Services: 2004 Firm Totals**

Firm Type	Number of Firms	Revenue (\$1,000)	Revenue per Firm
All Employer Firms <sup>1</sup>	10,065	\$7,397,076	\$734,931
Firms with less than 100 Employees	9,988	\$4,095,924	\$410,084
Nonemployer Firms	7,935	\$371,389	\$46,804
Total (All Firms)	18,000	7,768,465	\$431,581
Total "Small" (nonemp. + Firms < 100emp.)	17,923	4,467,313	\$249,250
Percentage Firms "Small"	99.6%	57.5%	57.8%

\* Revenue is estimated for employer firms by multiplying 2004 payroll data by 2002 revenue-payroll ratios.

**Table 5-60. Exterminating & Pest Control Services: 2002 Industry Characteristics (employers)**

Data Type	All Firms	Firms Operating for the Entire Year	Firms Operating Entire Year, earning less than \$5 million in revenue	Firms Operating Entire Year, earning less than \$5 million in revenue	Firms Operating Entire Year, earning \$5-10 million in revenue	Share of Firms Operating Entire Year, earning \$5-10 million in revenue
Total Number of Firms	9,618	8,052	7,969	99.0%	39	0.5%
Number of Establishments	11,321	9,751	8,195	84.0%	143	1.5%
Revenue (\$1,000)	\$6,597,034	\$6,416,733	\$3,269,753	51.0%	\$260,410	4.1%
Annual Payroll (\$1,000)	\$2,622,362	\$2,570,495	\$1,313,695	51.1%	\$115,228	4.5%
Number of Employees	90,948	89,032	51,157	57.5%	3,393	3.8%
Employees per Firm	9.5	11.1	6.4		87.0	
Payroll per Firm	\$272,651	\$319,237	\$164,851		\$2,954,564	
Payroll per Employee	\$28,834	\$28,872	\$25,680		\$33,961	
Revenue per Firm	\$685,905	\$796,912	\$410,309		\$6,677,179	
Revenue per Employee	\$72,536	\$72,072	\$63,916		\$76,749	

**Table 5-61. Exterminating and Pest Control Services: 2002 Firm Totals**

Firm Type	Number of Firms	Revenue (\$1,000)	Revenue per Firm
All Employer Firms	9,618	\$6,597,034	\$685,905
Firms Operating Entire Year	8,052	\$6,416,733	\$796,912
Firms Operating Entire Year, earning <\$5 mill.	7,969	\$3,269,753	\$410,309
Share earning <\$5 million	99.0%	51.0%	
Firms Operating Entire Year, earning <\$6 mill.	7,977	\$3,316,553	\$415,775
Share earning <\$6 million (Estimate)	99.1%	51.7%	
Nonemployer Firms	7,910	\$314,691	\$39,784
Total (All Firms)	17,528	\$6,911,725	
Total (Nonemp. + Employers entire year)	15,962	\$6,731,424	
Share of "Small Firms", firms earning <\$5 mill.	99.5%	53.2%	
Share of "Small Firms", firms earning <\$6 mill.	99.5%	53.9%	

## IV.K. Surveying & Mapping Services

**Table 5-62. Surveying & Mapping Services: 2004 Industry Characteristics (employers)**

Data	Total	Distribution by Number of Employees		
		<20	20-99	100+
Total Firms	9,028	8,419	535	74
Total Establishments	9,274	8,456	650	168
Total Employment	61,623	37,998	17,179	6,446
Total Payroll (\$1,000)	\$2,332,454	\$1,275,108	\$723,949	\$333,397
Estimated Revenue (\$1,000)	\$4,875,859	\$2,716,783	\$1,413,562	\$745,513
Share of Firms	100.0%	93.3%	5.9%	0.8%
Share of Establishments	100.0%	91.2%	7.0%	1.8%
Share of Employment	100.0%	61.7%	27.9%	10.5%
Share of Payroll	100.0%	54.7%	31.0%	14.3%
Share of Estimated Revenue	100.0%	55.7%	29.0%	15.3%
Employees per Firm	6.8	4.5	32.1	87.1
Payroll per Firm	\$258,358	\$151,456	\$1,353,176	\$4,505,365
Payroll per Employee	\$37,850	\$33,557	\$42,142	\$51,722
Estimated Revenue per Firm	\$540,082	\$322,697	\$2,642,172	\$10,074,505
Estimated Revenue per Employee	\$79,124	\$71,498	\$82,284	\$115,655

\* Revenue is estimated for employer firms by multiplying 2004 payroll data by 2002 revenue-payroll ratios.

**Table 5-63. Surveying & Mapping Services: 2004 Firm Totals**

Firm Type	Number of Firms	Revenue (\$1,000)	Revenue per Firm
All Employer Firms <sup>1</sup>	9,028	\$4,875,859	\$540,082
Firms with less than 100 Employees	8,954	\$4,130,345	\$461,285
Nonemployer Firms	9,196	\$342,605	\$37,256
Total (All Firms)	18,224	5,218,464	\$286,351
Total "Small" (nonemp. + Firms < 100emp.)	18,150	4,472,950	\$246,444
Percentage Firms "Small"	99.6%	85.7%	86.1%

\* Revenue is estimated for employer firms by multiplying 2004 payroll data by 2002 revenue-payroll ratios.

**Table 5-64. Surveying & Mapping Services: 2002 Industry Characteristics (employers)**

Data Type	All Firms	Firms Operating for the Entire Year		
		Firms Operating Entire Year, earning less than \$5 million in revenue	Firms Operating Entire Year, earning less than \$5 million in revenue	Firms Operating Entire Year, earning less than \$5 million in revenue
Total Number of Firms	8,856	7,711	7,642	99.1%
Number of Establishments	9,120	7,972	7,819	98.1%
Revenue (\$1,000)	\$4,277,685	\$4,165,022	\$3,330,021	80.0%
Annual Payroll (\$1,000)	\$2,046,307	\$2,005,619	\$1,639,529	81.7%
Number of Employees	59,174	57,783	50,269	87.0%
Employees per Firm	6.7	7.5	6.6	
Payroll per Firm	\$231,064	\$260,098	\$214,542	
Payroll per Employee	\$34,581	\$34,709	\$32,615	
Revenue per Firm	\$483,027	\$540,140	\$435,753	
Revenue per Employee	\$72,290	\$72,080	\$66,244	

**Table 5-65. Surveying & Mapping Services: 2002 Firm Totals**

Firm Type	Number of Firms	Revenue (\$1,000)	Revenue per Firm
All Employer Firms	8,856	\$4,277,685	\$483,027
Firms Operating Entire Year	7,711	\$4,165,022	\$540,140
Firms Operating Entire Year, earning <\$5 mill.	7,642	\$3,330,021	\$435,753
Share earning <\$5 million	99.1%	80.0%	
Nonemployer Firms	8,651	\$291,561	\$33,703
Total (All Firms)	17,507	\$4,569,246	
Total (Nonemp. + Employers entire year)	16,362	\$4,456,583	
Share of "Small Firms", firms earning <\$5 mill.	99.6%	81.3%	

## IV.L. Credit Bureau Industry

**Table 5-66. Credit Bureau Industry: 2004 Industry Characteristics (employers)**

Data	Total	Distribution by Number of Employees		
		<20	20-99	100+
Total Firms	740	620	84	36
Total Establishments	1,161	624	124	413
Total Employment	25,555	2,937	3,035	19,583
Total Payroll (\$1,000)	\$1,496,078	\$98,616	\$133,933	\$1,263,529
Estimated Revenue (\$1,000)	\$5,406,573	\$314,056	\$419,160	\$4,673,357
Share of Firms	100.0%	83.8%	11.4%	4.9%
Share of Establishments	100.0%	53.7%	10.7%	35.6%
Share of Employment	100.0%	11.5%	11.9%	76.6%
Share of Payroll	100.0%	6.6%	9.0%	84.5%
Share of Estimated Revenue	100.0%	5.8%	7.8%	86.4%
Employees per Firm	34.5	4.7	36.1	544.0
Payroll per Firm	\$2,021,727	\$159,058	\$1,594,440	\$35,098,028
Payroll per Employee	\$58,543	\$33,577	\$44,129	\$64,522
Estimated Revenue per Firm	\$7,306,179	\$506,542	\$4,990,001	\$129,815,468
Estimated Revenue per Employee	\$211,566	\$106,931	\$138,109	\$238,644

\* Revenue is estimated for employer firms by multiplying 2004 payroll data by 2002 revenue-payroll ratios.

**Table 5-67. Credit Bureau Industry: 2004 Firm Totals**

Firm Type	Number of Firms	Revenue (\$1,000)	Revenue per Firm
All Employer Firms <sup>1</sup>	740	\$5,406,573	\$7,306,179
Firms with less than 100 Employees	704	\$733,216	\$1,041,500
Nonemployer Firms	545	\$18,998	\$34,859
Total (All Firms)	1,285	5,425,571	\$4,222,234
Total "Small" (nonemp. + Firms < 100emp.)	1,249	752,214	\$602,253
Percentage Firms "Small"	97.2%	13.9%	14.3%

\* Revenue is estimated for employer firms by multiplying 2004 payroll data by 2002 revenue-payroll ratios.

**Table 5-68. Credit Bureau Industry: 2002 Industry Characteristics (employers)**

Data Type	All Firms	Firms Operating for the Entire Year	Firms Operating Entire Year, earning less than \$5 million in revenue	Firms Operating Entire Year, earning less than \$5 million in revenue	Firms Operating Entire Year, earning \$5-10 million in revenue	Share of Firms Operating Entire Year, earning \$5-10 million in revenue
Total Number of Firms	741	641	590	92.0%	20	3.1%
Number of Establishments	1,109	1,009	615	61.0%	36	3.6%
Revenue (\$1,000)	\$4,590,612	\$4,571,669	\$437,392	9.6%	\$131,212	2.9%
Annual Payroll (\$1,000)	\$1,253,356	\$1,248,978	\$157,134	12.6%	\$48,056	3.8%
Number of Employees	25,957	25,793	4,922	19.1%	1,307	5.1%
Employees per Firm	35.0	40.2	8.3		65.4	
Payroll per Firm	\$1,691,439	\$1,948,484	\$266,329		\$2,402,800	
Payroll per Employee	\$48,286	\$48,423	\$31,925		\$36,768	
Revenue per Firm	\$6,195,158	\$7,132,089	\$741,342		\$6,560,600	
Revenue per Employee	\$176,854	\$177,245	\$88,865		\$100,392	

**Table 5-69. Credit Bureau Industry: 2002 Firm Totals**

Firm Type	Number of Firms	Revenue (\$1,000)	Revenue per Firm
All Employer Firms	741	\$4,590,612	\$6,195,158
Firms Operating Entire Year	641	\$4,571,669	\$7,132,089
Firms Operating Entire Year, earning <\$5 mill.	590	\$437,392	\$741,342
Share earning <\$5 million	92.0%	9.6%	
Firms Operating Entire Year, earning <\$6 mill.	594	\$461,392	\$776,754
Share earning <\$6 million (Estimate)	92.7%	10.1%	
Nonemployer Firms	520	\$22,072	\$42,446
Total (All Firms)	1,261	\$4,612,684	
Total (Nonemp. + Employers entire year)	1,161	\$4,593,741	
Share of "Small Firms", firms earning <\$5 mill.	95.6%	10.0%	
Share of "Small Firms", firms earning <\$6 mill.	96.0%	10.5%	

#### IV.M. Other Activities Real Estate Related to Real Estate

**Table 5-70. Other Activities Related to Real Estate: 2004 Industry Characteristics (employers)**

Data	Total	Distribution by Number of Employees		
		<20	20-99	100+
Total Firms	15,136	14,477	477	182
Total Establishments	15,814	14,513	618	683
Total Employment	67,274	30,689	15,376	21,209
Total Payroll (\$1,000)	\$4,009,898	\$1,667,289	\$842,504	\$1,500,105
Estimated Revenue (\$1,000)	\$10,460,438	\$5,257,275	\$1,801,777	\$3,401,386
Share of Firms	100.0%	95.6%	3.2%	1.2%
Share of Establishments	100.0%	91.8%	3.9%	4.3%
Share of Employment	100.0%	45.6%	22.9%	31.5%
Share of Payroll	100.0%	41.6%	21.0%	37.4%
Share of Estimated Revenue	100.0%	50.3%	17.2%	32.5%
Employees per Firm	4.4	2.1	32.2	116.5
Payroll per Firm	\$264,925	\$115,168	\$1,766,256	\$8,242,335
Payroll per Employee	\$59,605	\$54,329	\$54,793	\$70,730
Estimated Revenue per Firm	\$691,097	\$363,147	\$3,777,310	\$18,688,936
Estimated Revenue per Employee	\$155,490	\$171,308	\$117,181	\$160,375

\* Revenue is estimated for employer firms by multiplying 2004 payroll data by 2002 revenue-payroll ratios.

**Table 5-71. Other Activities Related to Real Estate: 2004 Firm Totals**

Firm Type	Number of Firms	Revenue (\$1,000)	Revenue per Firm
All Employer Firms <sup>1</sup>	15,136	\$10,460,438	\$691,097
Firms with less than 100 Employees	14,954	\$7,059,052	\$472,051
Nonemployer Firms	448,409	\$29,659,464	\$66,144
Total (All Firms)	463,545	40,119,902	\$86,550
Total "Small" (nonemp. + Firms < 100emp.)	463,363	36,718,516	\$79,244
Percentage Firms "Small"	100.0%	91.5%	91.6%

\* Revenue is estimated for employer firms by multiplying 2004 payroll data by 2002 revenue-payroll ratios.

**Table 5-72. Other activities related to real estate: 2002 Industry Characteristics (employers)**

Data Type	All Firms	Firms Operating for the Entire Year	Firms Operating Entire Year, earning less than \$5 million in revenue	Firms Operating Entire Year, earning less than \$5 million in revenue	Firms Operating Entire Year, earning less than \$2.5 million in revenue	Firms Operating Entire Year, earning less than \$2.5 million in revenue
Total Number of Firms	13,908	8,620	8,460	98.1%	8,225	95.4%
Number of Establishments	14,533	9,244	8,649	93.6%	8,330	90.1%
Revenue (\$1,000)	\$8,238,695	\$7,171,675	\$4,119,093	57.4%	\$3,332,008	46.5%
Annual Payroll (\$1,000)	\$2,853,742	\$2,620,288	\$1,525,429	58.2%	\$1,215,392	46.4%
Number of Employees	57,123	52,476	36,550	69.7%	31,259	59.6%
Employees per Firm	4.1	6.1	4.3		3.8	
Payroll per Firm	\$205,187	\$303,978	\$180,311		\$147,768	
Payroll per Employee	\$49,958	\$49,933	\$41,735		\$38,881	
Revenue per Firm	\$592,371	\$831,981	\$486,890		\$405,107	
Revenue per Employee	\$144,227	\$136,666	\$112,697		\$106,594	

**Table 5-73. Other activities related to real estate: 2002 Firm Totals**

Firm Type	Number of Firms	Revenue (\$1,000)	Revenue per Firm
All Employer Firms	13,908	\$8,238,695	\$592,371
Firms Operating Entire Year	8,620	\$7,171,675	\$831,981
Firms Operating Entire Year, earning <\$5 mill.	8,460	\$4,119,093	\$486,890
Share earning <\$5 million	98.1%	57.4%	
Firms Operating Entire Year, earning <\$2.5 mill	8,225	\$3,332,008	\$405,107
Share earning <\$2.5 million	95.4%	46.5%	
Nonemployer Firms	335,115	\$22,046,758	\$65,789
Total (All Firms)	349,023	\$30,285,453	
Total (Nonemp. + Employers entire year)	343,735	\$29,218,433	
Share of "Small Firms", firms earning <\$5 mill.	100.0%	89.6%	
Share of "Small Firms", firms earning <\$2.5 mil	99.9%	86.9%	

## IV.N. Office of Real Estate Agents and Brokers Industry

**Table 5-74. Real Estate Agents & Brokers Industry: 2004 Industry Characteristics (employers)**

Data	Total	Distribution by Number of Employees		
		<20	20-99	100+
Total Firms	86,258	84,250	1,544	464
Total Establishments	93,920	85,164	3,298	5,458
Total Employment	323,045	174,181	53,071	95,793
Total Payroll (\$1,000)	\$15,210,338	\$6,857,915	\$2,269,946	\$6,082,477
Estimated Revenue (\$1,000)	\$91,691,826	\$47,919,945	\$13,248,281	\$30,523,599
Share of Firms	100.0%	97.7%	1.8%	0.5%
Share of Establishments	100.0%	90.7%	3.5%	5.8%
Share of Employment	100.0%	53.9%	16.4%	29.7%
Share of Payroll	100.0%	45.1%	14.9%	40.0%
Share of Estimated Revenue	100.0%	52.3%	14.4%	33.3%
Employees per Firm	3.7	2.1	34.4	206.5
Payroll per Firm	\$176,335	\$81,400	\$1,470,172	\$13,108,787
Payroll per Employee	\$47,084	\$39,372	\$42,772	\$63,496
Estimated Revenue per Firm	\$1,062,995	\$568,783	\$8,580,493	\$65,783,619
Estimated Revenue per Employee	\$283,836	\$275,116	\$249,633	\$318,641

\* Revenue is estimated for employer firms by multiplying 2004 payroll data by 2002 revenue-payroll ratios.

**Table 5-75. Real Estate Agents and Brokers: 2004 Firm Totals**

Firm Type	Number of Firms	Revenue (\$1,000)	Revenue per Firm
All Employer Firms <sup>1</sup>	86,258	\$91,691,826	\$1,062,995
Firms with less than 100 Employees	85,794	\$61,168,226	\$712,966
Nonemployer Firms	702,898	\$34,288,373	\$48,781
Total (All Firms)	789,156	125,980,199	\$159,639
Total "Small" (nonemp. + Firms < 100emp.)	788,692	95,456,599	\$121,032
Percentage Firms "Small"	99.9%	75.8%	75.8%

\* Revenue is estimated for employer firms by multiplying 2004 payroll data by 2002 revenue-payroll ratios.

**Table 5-76. Real Estate Agents and Brokers: 2002 Industry Characteristics (employers)**

Data Type	All Firms	Firms Operating for the Entire Year	Firms Operating	Share of Firms	Firms Operating	Share of Firms
			entire Year, earning less than \$5 million in revenue	Operating Entire Year, earning less than \$5 million in revenue	entire Year, earning less than \$2.5 million in revenue	Operating Entire Year, earning less than \$2.5 million in revenue
Total Number of Firms	68,649	49,089	47,510	96.8%	45,694	93.1%
Number of Establishments	76,341	56,763	48,674	85.7%	46,240	81.5%
Revenue (\$1,000)	\$63,381,021	\$59,376,212	\$26,503,169	44.6%	\$20,215,859	34.0%
Annual Payroll (\$1,000)	\$10,383,693	\$9,775,163	\$4,685,151	47.9%	\$3,766,418	38.5%
Number of Employees	280,754	263,841	157,830	59.8%	134,196	50.9%
Employees per Firm	4.1	5.4	3.3		2.9	
Payroll per Firm	\$151,258	\$199,131	\$98,614		\$82,427	
Payroll per Employee	\$36,985	\$37,049	\$29,685		\$28,067	
Revenue per Firm	\$923,262	\$1,209,562	\$557,844		\$442,418	
Revenue per Employee	\$225,753	\$225,045	\$167,922		\$150,644	

**Table 5-77. Real Estate Agents and Brokers: 2002 Firm Totals**

Firm Type	Number of		
	Firms	Revenue (\$1,000)	Revenue per Firm
All Employer Firms	68,649	\$63,381,021	\$923,262
Firms Operating Entire Year	49,089	\$59,376,212	\$1,209,562
Firms Operating Entire Year, earning <\$5 mill.	47,510	\$26,503,169	\$557,844
Share earning <\$5 million	96.8%	44.6%	
Firms Operating Entire Year, earning <\$2.5 mill.	45,694	\$20,215,859	\$442,418
Share earning <\$2.5 million	93.1%	34.0%	
Nonemployer Firms	569,949	\$26,007,073	\$45,631
Total (All Firms)	638,598	\$89,388,094	
Total (Nonemp. + Employers entire year)	619,038	\$85,383,285	
Share of "Small Firms", firms earning <\$5 mill.	99.7%	61.5%	
Share of "Small Firms", firms earning <\$2.5 mill.	99.5%	54.1%	

## CHAPTER 6

### REGULATORY FLEXIBILITY ANALYSIS

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#### I. Introduction

This chapter of the Regulatory Impact Analysis is the Final Regulatory Flexibility Analysis (FRFA) of the final rule as described under Section 604 of the Regulatory Flexibility Act. The requirements of the FRFA are listed below along with references to where the requirements are covered in the FRFA and where more detailed discussion can be found in other chapters of the Regulatory Impact Analysis (RIA).

*A description of the reasons why action by the agency is being considered can be found in Section III of this chapter, in Section II of Chapter 1 of the RIA, and in greater detail in the first sections of Chapters 3 and 4 of the RIA.*

*A succinct statement of the objectives of, and legal basis for, the final rule is provided in Section III of this chapter. This is also discussed in Section II of Chapter 1 of the RIA and in greater detail in the first sections of Chapters 3 and 4 of the RIA.*

*A description and an estimate of the number of small entities to which the rule will apply or an explanation of why no such estimate is available. Section V provides data on small businesses that may be affected by the rule. As explained in Section V, Chapter 5 of the RIA also provides extensive documentation of the characteristics of the industries directly affected by the rule, including various estimates of the numbers of small entities, reasons why various data elements are not reliable or unavailable, and descriptions of methodologies used to estimate (if possible) necessary data elements that were not readily available. The industries discussed in Chapter 5 of the RIA included the following (with section reference): mortgage brokers (Section II); lenders including commercial banks, thrifts, mortgage banks, credit unions (Section III); settlement and title services including direct title insurance carriers, title agents, escrow firms, and lawyers (Section IV); and other third-party settlement providers including appraisers, surveyors, pest inspectors, and credit bureaus (Section V); and real estate agents (Section VI). As explained in Section V of this chapter, Appendix A includes estimates of revenue impacts for the new Good Faith Estimate (GFE).*

*A description of the projected reporting, record keeping, and other compliance requirements of the rule, including an estimate of the classes of small entities that will be subject to the requirement and the types of professional skills necessary for preparation of the report or record. Compliance requirements and costs are discussed in Sections VII through IX of this chapter. In no case are any professional skills required for reporting, record keeping, and other compliance requirements of this rule that are not otherwise required in the ordinary course of business of firms affected by the rule. As noted above, Chapter 5 of the RIA includes estimates of the small entities that may be affected by the rule.*

*An identification, to the extent practicable, of all relevant Federal rules which may duplicate, overlap or conflict with the final rule. The final rule provisions describing some loan terms in the new GFE and the HUD-1 are similar to the Truth in Lending Act (TILA) regulations; however the differences in approach between the TILA regulations and HUD's RESPA rule make them more complementary than duplicative. Overlaps are discussed further in this chapter.*

In addition, this Chapter contains (c) *a description of any significant alternatives to the final rule which accomplish the stated objectives of applicable statutes and which minimize any significant impact of the final rule on small entities.* The FRFA also describes comments dealing with compliance and regulatory burden in the 2008 proposed rule. Some of the comments were on provisions of the 2008 proposed rule that have been dropped. Other comments were on impacts that the Department believes will be small or non-existent. Some of the compliance and

regulatory burden comments concerned costs that are only felt during the start-up period and are one-time costs. These are discussed in Section VII.B, while comments on recurring costs of implementing the new GFE form are addressed in Section VII.C. Section VII.D discusses GFE-related changes in the final rule that reduce regulatory burden. Section VII.E discusses compliance issues related to GFE tolerances on settlement party costs, while Section VII.F discusses efficiencies associated with the new GFE.

Before proceeding further, Section II provides a brief summary of the main findings from the Regulatory Impact Analysis that relate to the final rule.

## **II. Summary of the Regulatory Impact Analysis**

There is strong evidence of information asymmetry between mortgage originators and settlement service providers and consumers, allowing loan originators to capture much of the consumer surplus in this market through price discrimination. The RESPA disclosure statute is meant to address this information asymmetry, but the evidence shows that the current RESPA regulations are not effective. The final rule will create a more level-playing field through a more transparent and standard disclosure of loan details and settlement costs; tolerances on settlement charges leading to prices that consumers can rely on; and a comparison page on the HUD-1 that allows the consumer to compare the amounts listed for particular settlement costs on the GFE with the total costs listed for those charges on the HUD-1, and to double check the loan details at settlement. These changes will encourage comparison shopping by informed consumers, which will place a competitive pressure on market prices, and enable consumers to retain more consumer surplus.

### **II.A. Overview of Final Rule**

The Department of Housing and Urban Development has issued a final rule under the Real Estate Settlement Procedures Act (RESPA) to simplify and improve the process of obtaining home mortgages and to reduce settlement costs for consumers. This Regulatory Impact Analysis and Regulatory Flexibility Analysis examine the economic effects of that rule. As this Regulatory Impact Analysis demonstrates, the final rule is expected to improve consumer shopping for mortgages and to reduce the costs of closing a mortgage transaction for the consumer. Consumer savings were estimated under a variety of scenarios about originator and settlement costs. In the base case, the estimated price reduction to borrowers comes to \$8.35 billion or \$668 per loan. This represents the substantial savings that can be achieved with the final rule.

The final RESPA rule includes a new, simplified Good Faith Estimate (GFE) that includes tolerances on final settlement costs and a new method for reporting wholesale lender payments in broker transactions. The final rule allows service providers to use prices based on the average charges for the third-party services they purchase, making their business operations simpler and less costly. Competition among loan originators will put pressure for these cost savings to be passed on to borrowers. The new GFE will produce substantial shopping and price-reduction benefits for both origination and third-party settlement services.

Because the final rule calls for significant changes in the process of originating a mortgage, this Regulatory Impact Analysis identifies a wide range of benefits, costs, efficiencies, transfers, and market impacts. The effects on consumers from improved borrower shopping will be substantial under this rule. Similarly, the use of tolerances will place needed controls on origination and third-party fees. Ensuring that yield spread premiums are credited to borrowers in brokered transactions could cause significant transfers to consumers. The increased competition associated with RESPA reform will reduce settlement service costs and result in transfers to consumers from service providers. Entities that will suffer revenue losses under the final rule are usually those who are charging prices higher than necessary or are benefiting from the current system's market failure.

Note to Reader: A comprehensive summary of the problems with the current mortgage shopping system and the benefits and market impacts of the final rule is provided in Section I of Chapter 3.

## **II.B. Problems with the Mortgage Shopping Process and the Current GFE**

The current system for originating and closing mortgages is highly complex and suffers from several problems that have resulted in high prices for borrowers. Studies indicate that consumers are often charged high fees and can face wide variations in prices, both for origination and third-party settlement services. The main points are as follows:

- There are many barriers to effective shopping for mortgages in today's market. The process can be complex and can involve rather complicated financial trade-offs, which are often not fully and clearly explained to borrowers.
- Consumers often pay non-competitive fees for originating mortgages. Most observers believe that the market breakdown occurs in the relationship between the consumer and the loan originator -- the ability of the loan originator to price discriminate among different types of consumers leads to some consumers paying more than other consumers.<sup>1</sup>
- There is convincing statistical evidence that yield spread premiums are not always used to offset the origination and settlement costs of the consumer. Studies, including a recent HUD-sponsored study of FHA closing costs by the Urban Institute, find that yield spread premiums are often used for the originator's benefit, rather than for the consumer's benefit.<sup>2</sup>

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<sup>1</sup> One could see price discrimination in a competitive market that was the result of different costs associated with originating loans for different applicants. For example, those who required more work by the originator to obtain loan approval might be charged more than those whose applications required little work in order to obtain an approval. The price discrimination we refer to in this paragraph and elsewhere in this analysis is not cost-based. It is the result of market imperfections, such as poor borrower information on alternatives that leads borrowers to accept loans at higher cost than the competitive level.

<sup>2</sup> See Section IV.D of Chapter 2 for a discussion of these studies.

- Borrowers can be confused about the trade-off between interest rates and closing costs. It may be difficult for borrowers (even sophisticated ones but surely unsophisticated ones) to understand the financial trade-offs associated with discount points, yield spread premiums, and upfront settlement costs. While many originators explain this to their borrowers, giving them an array of choices to meet their needs, some originators may only show borrowers a limited number of options.
- There is also evidence that prices paid for third-party services are highly variable, indicating that there is much potential to reduce title, closing, and other settlement costs. For example, a recent analysis of FHA closing costs by the Urban Institute shows wide variation in title and settlement costs. There is not always an incentive in today's market for originators to control these costs. Too often, high third-party costs are simply passed through to the consumer. And consumers may not be the best shoppers for third-party service providers due to their lack of expertise and to the infrequency with which they shop for these services. Consumers often rely on recommendations from the real estate agent (in the case of a home purchase) or from the loan originator (in the case of a refinance as well as a home purchase).

**Today's GFE.** Today's GFE does not help the above situations, as it is not an effective tool for facilitating borrower shopping nor for controlling third-party settlement costs. The current GFE is typically comprised of a long list of charges, as today's rules do not prescribe a standard form or consolidated categories. Such a long list of individual charges can be overwhelming, often confuses consumers, and seems to provide little useful information for consumer shopping. The current GFE certainly does not inform consumers what the major costs are so that they can effectively shop and compare mortgage offers among different loan originators. The current GFE does not explain how the borrower can use the document to shop and compare loans. Also, the GFE fails to make clear the relationship between the closing costs and the interest rate on a loan, notwithstanding that many mortgage loans originated today adjust up-front closing costs due at settlement, either up or down, depending on whether the interest rate on the loan is below or above "par." Finally, current rules do not assure that the "good faith estimate" is a reliable estimate of final settlement costs. As a result, under today's rules, the estimated costs on GFEs may be unreliable or incomplete, and final charges at settlement may include significant increases in items that were estimated on the GFE, as well as additional fees, which can add to the consumer's ultimate closing costs.

Thus, today's GFE is not an effective tool for facilitating borrower shopping or for controlling origination and third-party settlement costs. There is enormous potential for cost reductions in today's market, which is too often characterized by relatively high and highly variable charges for both origination and third-party services.

In addition, today's RESPA rules hold back efficiency and competition by acting as a barrier to innovative cost-reduction arrangements. While today's mortgage market is characterized by increased efficiencies and lower prices due to technological advances and other innovations, that is not the case in the settlement area where aggressive competition among settlement service providers simply does not always take place. Existing RESPA regulations

inhibit average cost pricing,<sup>3</sup> which is an example of a cost reduction technique. Thus, a framework is needed that would encourage competitive negotiations and other arrangements that would lead to lower settlement prices. The new GFE will provide such a framework.

## **II.C. Approach of the Final Rule**

### **II.C.1. Main Components of the New GFE and HUD-1**

The GFE format simplifies the process of originating mortgages by consolidating costs into a few major cost categories.<sup>4</sup> The GFE ensures that in brokered transactions, borrowers receive the full benefit of the higher price paid by wholesale lenders for a loan with a high interest rate; that is, so-called yield spread premiums. On both the GFE and HUD-1, the portion of any wholesale lender payments that arise because a loan has an above-par interest rate is passed through to borrowers as a credit against other costs. Thus, there is assurance that borrowers who take on an above-par loan receive funds to offset their settlement costs. The new GFE also includes a trade-off table that will assist consumers in understanding the relationship between higher interest rates and lower settlement costs.

HUD conducted consumer tests to further improve the GFE form in the 2002 proposed rule. Numerous changes were made to make the GFE more user-friendly. The GFE form in the final rule includes a summary page containing the key information for shopping; during the tests, consumers reported that the summary page was a useful addition to the GFE. The trade-off table, another component of the GFE that consumers found useful, is also included in the final GFE. The final GFE is a form that consumers find to be clear and well written and, according to the tests conducted, one that they can use to determine the least expensive loan. In other words, it is a shopping tool that is a vast improvement over today's GFE with its long list of fees that can change (i.e., increase) at settlement.

The final GFE includes a set of tolerances on originator and third-party costs: originators must adhere to their own origination fees, and give estimates subject to a 10 percent upper limit on the sum of certain third-party fees. The tolerances on originator and third-party costs will encourage originators not only to lower their own costs but also to seek lower costs for third-party services.

The final rule would allow service providers to use pricing based on average charges for third-party services they purchase so long as the average is calculated using a documented method and the charge on the HUD-1 is no greater than the average paid for that service. This will make internal operations for the loan originator simpler and less costly and competition

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<sup>3</sup> The charges reported on the HUD-1 are required to be the specific charge paid in connection with the specific loan for which the HUD-1 is filled out. Pricing based on average charges is the practice of charging all borrowers the same average charge for a group of similar loans. Average cost pricing requires less record keeping and tracking for any individual loan since the numbers reported to the settlement agent need not be transaction specific. Average cost pricing is not permissible under RESPA because loan-specific prices are required.

<sup>4</sup> See the proposed GFE in Exhibit 3-B of Chapter 3.

among lenders will put pressure for these cost savings to be passed on to borrowers as well. The end result of all these changes should be lower third-party fees for consumers.

To increase the value of the new GFE as a shopping document, HUD is proposing revisions to the HUD-1 Settlement Statement form that will make the GFE and HUD-1 easier to compare. The revised HUD-1 uses the same language to describe categories of charges as the GFE, and orders the categories of charges in the same way. This makes it much simpler to compare the two documents and confirm whether the tolerances required in the new GFE have been met or exceeded. In addition, the final rule introduces a comparison in the revised HUD-1 that would: (1) compare the GFE estimates to the HUD-1 charges and advise borrowers whether tolerances have been met or exceeded; (2) verify that the loan terms summarized on the GFE match those in the loan documents, including the mortgage note; and (3) provide additional information on the terms and conditions of the mortgage. These components of the rule are required together to fully realize the consumer saving on mortgage closing cost estimated here.

Given that there has been no significant change in the basic HUD-1 structure and layout, besides the addition of a comparison page, generating this new HUD-1 should not pose any problem for firms closing loans -- in fact, the closing process will be much simpler given that borrowers and closing agents can precisely link the information on the initial GFE to the information on the final HUD-1. The HUD-1 has also been adjusted to ensure that the new GFE (a shopping document issued early in the process) and the HUD-1 (a final settlement document issued at closing) work well together. The layout of the revised HUD-1 has new labeling of some lines so that each entry from the GFE can be found on the revised HUD-1 with the exact wording as on the GFE. This will make it much easier to determine if the fees actually paid at settlement are consistent with the GFE, whether the borrower does it alone or with the assistance of the settlement agent. The reduced number of HUD-1 entries that should result, as well as use of the same terminology on both forms should reduce the time spent by the borrower and settlement agents comparing and checking the numbers.

The significant changes made to the final rule from the March 2008 proposed rule are:

- A GFE form that is a shorter form than had been proposed.
- Allowing originators the option not to fill out the tradeoff table on the GFE form.
- A revised definition of application to eliminate the separate GFE application process.
- Adoption of requirements for the GFE that are similar to recently revised Federal Reserve Board Truth-in-Lending regulations which limit fees charged in connection with early disclosures and defining timely provision of the disclosures.
- Clarification of terminology that describes the process applicable to, and the terms of, an applicant's particular loan.
- Inclusion of a provision to allow lenders a short period of time in which to correct certain violations of the new disclosure requirements.

- A revised HUD-1/1A settlement statement form that includes a summary page of information that provides a comparison of the GFE and HUD-1/1A list of charges and a listing of final loan terms as a substitute for the proposed closing script addition.
- Elimination of the requirement for a closing script to be completed and read by the closing agent.
- A simplified process for utilizing an average charge mechanism.
- No regulatory change in this rulemaking regarding negotiated discounts, including volume based discounts.

## **II.C.2. Estimates and Sources of Consumer Savings from the Final Rule**

**Overall Savings.** Chapter 3 discusses the consumer benefits associated with the new GFE form and provides dollar estimates of consumer savings due to improved shopping for both originator and third-party services. Consumer savings were estimated under a variety of scenarios about originator and settlement costs.<sup>5</sup> In the base case, the estimated price reduction to borrowers comes to \$8.35 billion annually, or 12.5 percent of the \$66.7 billion in total charges (i.e., origination fees, appraisal, credit report, tax service and flood certificate and title insurance and settlement agent charges).<sup>6</sup> Thus, there is an estimated \$8.35 billion in transfers from firms to borrowers from the improved disclosures and tolerances of the new GFE. This would represent savings of \$668 per loan. Sensitivity analysis was conducted with respect to the savings projection in order to provide a range of estimates. Because title fees account for over 70 percent of third-party fees and because there is widespread evidence of lack of competition and overcharging in the title and settlement closing industry, one approach projected third-party savings only in that industry. This approach (called the “title approach”) projected savings of \$200 per loan in title and settlement fees. In this case, the estimated price reduction to borrowers comes to \$8.38 billion (\$670 per loan), or 12.6 percent of the \$66.7 billion in total charges – savings figures that are practically identical to the base case mentioned above.<sup>7</sup> Other projections also showed substantial savings for consumers. As explained in Chapter 3, estimated consumer savings under a more conservative projection totaled \$6.48 billion (\$518 per loan), or 9.7 percent of total settlement charges. Thus, while consumer savings are expected to be \$8.35 billion (or 12.5 percent of total charges) in the base case or \$8.38 billion (12.6 percent of total charges) in the title approach, they were \$6.48 billion (or 9.7 percent of total charges) in a more conservative sensitivity analysis. This \$6.48-\$8.38 billion (\$518 - \$670 per loan) represents the substantial savings that can be achieved with the new GFE.

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<sup>5</sup> Throughout this Economic Analysis, the terms “borrowers” and “consumers” are often used interchangeably.

<sup>6</sup> Government fees and taxes and escrow items are not included in this analysis, as they are not subject to competitive market pressures.

<sup>7</sup> If the savings in title and settlement closing fees due to RESPA reform were only \$150, then the estimated price reduction to borrowers comes to \$7.76 billion, or 11.6 percent of the \$66.7 billion in total charges.

**Industry Breakdown of Savings.** Chapter 3 also disaggregates the sources of consumer savings into the following major categories: originators with a breakdown for brokers and lenders, and third-party providers with a breakdown for the title and settlement industry and other third-party providers.<sup>8</sup> In the base case, originators (brokers and lenders) contribute \$5.88 billion, or 70 percent of the \$8.35 billion in consumer savings. This \$5.88 billion in savings represents 14.0 percent of the total revenue of originators, which is projected to be \$42.0 billion.<sup>9</sup> The \$5.88 billion is divided between brokers, which contribute \$3.53 billion, and lenders (banks, thrifts, and mortgage banks), which contribute the remaining \$2.35 billion. The shares for brokers (60 percent) and lenders (40 percent) represent their respective shares of mortgage originations.

In the base case, third-party settlement service providers contribute \$2.47 billion, or 30 percent of the \$8.35 billion in consumer savings. This \$2.47 billion in savings represents 10.0 percent of the total revenue of third-party providers, which is projected to be \$24.738 billion.<sup>10</sup> The \$2.47 billion is divided between title and settlement agents, which contribute \$1.79 billion, and other third-party providers (appraisers, surveyors, pest inspectors, etc.), which contribute \$0.68 billion. Title and settlement agents contribute a large share because they account for 72.5 percent of the third-party services included in this analysis. In the title approach, title and settlement agents account for all third-party savings, which total \$2.5 billion if per loan savings are \$200 and \$1.88 billion if per loan savings are \$150.

**Table 6-1. Industry Breakdown of Consumer Savings**

Source of Savings	Transfers (billions)	Savings per loan (12.5 million loans)	Percentage of Total Savings
<b>Loan Origination</b>	<b>\$5.88</b>	<b>\$470</b>	<b>70%</b>
Lenders	\$2.35	\$470 <u>or</u>	28%
Brokers	\$3.53	\$470	42%
<b>Third-Party Services</b>	<b>\$2.47</b>	<b>\$198</b>	<b>30%</b>
Title/Settlement	\$1.79	\$143	22%
Other	\$0.68	\$54	8%
<b>Total*</b>	<b>\$8.35</b>	<b>\$668</b>	<b>100%</b>

\*Savings are 12.5% of \$66.7 billion revenue in charges.

Section III.D of this executive summary presents the revenue impacts on small originators and small third-party providers.

**Sources of Savings: Lower Origination and Third-Party Fees.** The Regulatory Impact Analysis presents evidence that some consumers are paying higher prices for origination and third-party services. The new GFE format in the final rule will improve consumer shopping

<sup>8</sup> Readers are referred to Chapter 5 for a more detailed examination of the various component industries (e.g., title services, appraisal, etc.) as well as for the derivations of many of the estimates presented in this chapter.

<sup>9</sup> This assumes a 1.75 percent origination fee for brokers and lenders, which, when applied to projected originations of \$2.4 trillion, yields \$42.0 billion in total revenues from origination fees (both direct and indirect). See Steps (3)-(5) of Section VII.E.1 of Chapter 3 for the explanation of origination costs. Sensitivity analyses are conducted for smaller origination fees of 1.5 percent and larger fees of 2.0 percent; see Step (21) in Section VII.E.4 of Chapter 3.

<sup>10</sup> See Step (7) of Section VII.E.1 of Chapter 3 for the derivation of the \$24.738 billion.

for mortgages, which will result in better mortgage products, lower interest rates, and lower origination and third-party costs for borrowers.

- The final rule simplifies the process of originating mortgages by consolidating costs into a few major cost categories. This is a substantial improvement over today's GFE that is not standardized and can contain a long list of individual charges that encourages fee proliferation. This makes it easier for the consumer to become overwhelmed and confused. The consistent and simpler presentation of the GFE will improve the ability of the consumer to shop.
- A GFE with a summary page, which includes the terms of the loan, will make it clear to the consumer whether they are comparing similar loans.
- A GFE with a summary page will make it simpler for borrowers to shop. The higher reward for shopping, along with the increased ease with which borrowers can compare loans, should lead to more effective shopping, more competition, and lower prices for borrowers.
- The GFE makes cost estimates more reliable by applying tolerances to the figures reported. This will reduce the all too frequent problem of borrowers being surprised by additional costs at settlement. With fees firmer under the GFE, shopping is more likely to result in borrowers saving money when they shop.
- The new GFE will disclose yield spread premiums and discount points in brokered loans prominently, accurately, and in a way that should inform borrowers how they may be used to their advantage. Both values will have to be calculated as the difference between the wholesale price of the loan and its par value. Their placement in the calculations that lead to net settlement costs will make them very difficult to miss. That placement should also enhance borrower comprehension of how yield spread premiums can be used to reduce up-front settlement costs. Tests of the form indicate that consumers can determine the cheaper loan when comparing a broker loan with a lender loan.
- The new GFE will better inform consumers about their financing choices by including a tradeoff table on page 3 where originators can present the different interest rate and closing cost options available to borrowers. For example, consumers will better understand the trade-offs between reducing their closing costs and increasing the interest rate on the mortgage.
- The final rule allows settlement service providers to use prices based on average charges for the third-party services they purchase.
- The above changes and the imposition of tolerances on fees will encourage originators to seek lower settlement service prices. The tolerances will lead to well-informed market professionals either arranging for the purchase of the settlement services or at least establishing a benchmark that borrowers can use to start their own search. Under either set of circumstances, this should lead to lower prices for borrowers than if the borrowers

shopped on their own, since the typical borrower's knowledge of the settlement service market is limited, at best.

### **II.C.3. Savings and Transfers, Efficiencies, and Costs**

As explained above, it is estimated that borrowers would save \$8.35 billion in origination and settlement charges. This \$8.35 billion represents transfers to borrowers from high priced producers, with \$5.88 billion coming from originators and \$2.47 billion from third-party settlement service providers. In addition to the transfers, there are efficiencies associated with the rule as well as costs.

Mortgage applicants and borrowers realize \$1,169 million savings in time spent shopping for loans and third-party services. Loan originators save \$975 million in time spent with shoppers and from average cost pricing. Third-party settlement service providers save \$191 million in time spent with shoppers. Some or all of industry's total of \$1,166 million in efficiency gains have the potential to be passed through to borrowers through competition. There are additional social efficiencies such as the reduction of non-productive behavior and positive externalities of preventing foreclosures (see Section X.D.).

The total one-time compliance costs to the lending and settlement industry of the GFE and HUD-1 are estimated to be \$571 million, \$407 million of which is borne by small business. These costs are summarized below. Total recurring costs are estimated to be \$918 million annually or \$73.40 per loan. The share of the recurring costs on small business is \$471 million. This Chapter 6 examines in greater detail the compliance and other costs associated with the GFE and HUD-1 forms and its tolerances.

The new GFE in the final rule has some features that would increase the cost of providing it and some that would decrease the cost. Practically all of the information required on the GFE is readily available to originators, suggesting no additional costs. The fact that there are fewer numbers and less itemization of individual fees suggests reduced costs. On the other hand, there could be a small amount of additional costs associated with the optional trade-off table but that is not clear. Thus, while it is difficult to estimate, it appears that there could be a net of zero additional costs. However, if the GFE added 10 minutes per application to the time it takes to handle the forms today; annual costs would rise by \$255 million at 1.7 application per loan or (\$12 per application or \$20 per loan) or \$405 million at 2.7 applications per loan (\$32 per loan). We assume the high-cost scenario for summary table 6-5 (See Section VII.C.1 of this chapter for further details.)

The presence of tolerances will lead to some additional costs to originators of making additional arrangements for third parties to provide settlement services. If the average loan originator incurs an average of 10 minutes per loan of effort making third-party arrangements to meet the tolerances, then the total cost to originators of making third-party arrangements to meet the tolerance requirements comes to \$150 million (\$12 per loan). (See Section VII.E.2 of this chapter.)

There is the potential of additional underwriting costs if the number of applications requiring a credit check rise beyond the current ratio of 1.7 applications per loan. Thus, if this ratio remains constant, there will be no recurring compliance costs from additional underwriting. If, however, the demand for preliminary GFEs increases to 2.7 applications per loan, then the total costs for originators will be \$138 million or \$11 per loan (See Section VII.C.).

In addition to the recurring costs of the GFE, there will be one-time adjustment costs of \$383 million in switching to the new form. Loan originators will have to upgrade their software and train staff in its use in order to accommodate the requirements of the new rule. It is estimated that the software cost will be \$33 million and the training cost will be \$58 million, for a total of \$91 million (see Section VII.B.1 of this chapter). We assume that, of the loan originators' software and training costs, \$73 million is attributable to the new GFE and \$18 million to the new HUD-1. Once the new software is functioning, the recurring costs of training new employees in its use and the costs associated with periodic upgrades simply replace those costs that would have been incurred doing the same thing with software for the old rule. They represent no additional costs of the new rule.

Similarly, there will be a one-time adjustment cost for legal advice on how to deal with the changes related to the new GFE. The one-time adjustment cost for legal fees is estimated to be \$116 million (see Section VII.B.2 of this chapter). Once the adjustment has been made, the ongoing legal costs are a substitute for the ongoing legal costs that would have been incurred under the old rule and do not represent any additional burden.

Finally with respect to the GFE, employees will have to be trained in the new GFE beyond the software and legal training already mentioned. This one time adjustment cost is estimated to be \$194 million (see section VII.B.3). Again, once the transition expenses have been incurred, any ongoing training costs are a substitute for the training costs that would have been incurred anyway and do not represent an additional burden.

There are few recurring costs associated with the revised HUD-1. For originators the burden could be very small: loan originators will not have to collect additional data beyond what is required for the GFE. In certain cases, the burden may be noticeable so we assume that the *average* burden is ten minutes per loan for loan originators. Settlement agents may face a recurring cost, although this is not likely either since loan originators are responsible for providing the data. The settlement agent will have to add final charges not known by the originator, and may have to fill out the entire form if the lender does not transmit the information on an already completed HUD-1 page 3. The settlement agent may also want to check the information concerning settlement costs, tolerances, and loan terms to make sure they agree with the GFE. In some cases, the settlement agent will have to calculate the tolerances. We assume that it will add five minutes *on average* to the time it takes to prepare a settlement. The actual distribution of the total additional time burden will differ by transaction depending on how much of the work is done by the lender. Taking loan originators into account, the total time burden is 15 minutes per loan, for a cost of \$18 per loan. The recurring compliance cost to the industry would be \$225 million annually, of which small business would bear \$107 million annually. During a high-volume year (15.5 million loans annually), the annual recurring compliance cost of the HUD-1 would be \$279 million annually (see Section VIII.C. of Chapter 6)

There will be one-time adjustment costs of \$188 million in switching to the new HUD-1 form. Settlement firms will have to upgrade their software and train staff in its use in order to accommodate the requirements of the new rule. It is estimated that the software and training cost will be \$80 million (see Section VIII.B. of Chapter 6). Once the new software is functioning, the recurring costs of training new employees in its use and the costs associated with periodic upgrades simply replace those costs that would have been incurred doing the same thing with software for the old rule. They represent no additional costs of the new rule.

**Table 6-2. Summary of One-Time Adjustment Costs (in millions)**

Source of Cost	<i>GFE</i>		<i>HUD-1</i>		<i>Total</i>	
	All Firms	Small Firms	All Firms	Small Firms	All Firms	Small Firms
<b>Software and training</b>	\$73	\$52	\$80	\$59	\$153	\$111
<b>Legal consultation</b>	\$116	\$70	\$37	\$18	\$153	\$88
<b>Training on rule</b>	\$194	\$146	\$71	\$62	\$265	\$208
<b>Total</b>	<b>\$383</b>	<b>\$268</b>	<b>\$188</b>	<b>\$139</b>	<b>\$571</b>	<b>\$407</b>

Similarly, there will be a one-time adjustment cost for legal advice on how to deal with the changes related to the new HUD-1. The one-time adjustment cost for legal fees is estimated to be \$37 million (see Section VIII.B. of Chapter 6). Once the adjustment has been made, the ongoing legal costs are a substitute for the ongoing legal costs that would have been incurred under the old rule and do not represent any additional burden.

Finally, employees will have to be trained in the new HUD-1 beyond the software and legal training already mentioned. This one time adjustment cost is estimated to be \$71 million (see Section VIII.B. of Chapter 6). Again, once the transition expenses have been incurred, any ongoing training costs are a substitute for the training costs that would have been incurred anyway and do not represent an additional burden.

The consumer savings, efficiencies and costs associated with the GFE are discussed further in Chapter 6 and in Chapters 3. A summary of the compliance costs for the base case of 12.5 million loans annually is presented below in Table 6.1.

**Table 6-3. Compliance Costs of the Final Rule (if 12.5 million loans annually)**

	One-time Compliance Costs incurred during the first year		Recurring Compliance Costs		
	(in millions)		(in millions annually)		\$ cost per loan
	All Firms	Small Firms	All Firms	Small Firms	
<b>GFE</b>	\$383	\$268	\$693	\$364	\$55.40
<b>HUD-1</b>	\$188	\$139	\$225	\$107	\$18.00
<b>Total</b>	<b>\$571</b>	<b>\$407</b>	<b>\$918</b>	<b>\$471</b>	<b>\$73.40</b>

A natural question to raise is whether the costs of the rule will overwhelm the benefits of the rule. The assumption that consumers will benefit by a reduction of settlement costs of at least \$668 per loan has not been forcefully challenged. Indeed, results from a recent statistical analysis of FHA data imply that the savings to consumers may be as much as \$1,200 per loan. To accomplish this, however, industry will incur both adjustment and recurring costs. Suppose

firms impose these additional costs on consumers by raising prices. It is likely that the adjustment costs will be spread out over many years, just as the cost of an investment would be. Suppose, for the sake of illustration, that all adjustment costs are all imposed on first-year borrowers only. In a normal year of 12.5 million loans, this cost would \$46 per loan. The recurring compliance costs of the rule is \$73.40 per loan regardless of the year. In such a scenario, the total compliance cost is \$120 per loan in the first year as compared to \$74 for later years. If all compliance costs were passed onto consumers then the net consumer savings is \$548 the first year and \$594 in subsequent years (see table 6-4 for a summary). Note that this assumes that all costs are borne by borrowers and not at all by the applicants who do not get a loan. It would be reasonable to assume that in the high-application scenario, where there is an increase in preliminary underwriting costs, that the cost of an initial credit report would be passed on to all applicants.

**Table 6-4. Predicted Reductions in the Cost of a Loan  
(if firms impose all first-year adjustment costs on first-year borrowers)**

<b>Source of Gain or Loss</b>	<b>First Year</b>	<b>Afterwards</b>
<b><i>Average Consumer Savings</i></b>	<b><i>\$668</i></b>	<b><i>\$668</i></b>
One-time Adjustment Costs	-\$46	-\$0
Recurring Compliance Costs	-\$74	-\$74
<b><i>Net Consumer Savings</i></b>	<b><i>\$548</i></b>	<b><i>\$594</i></b>
Firms' Efficiencies	+\$93	+\$93
Borrowers' Efficiencies	+\$55	+\$55
<b><i>Net Benefits to Consumer</i></b>	<b><i>\$696</i></b>	<b><i>\$742</i></b>

There are other potential benefits to the consumer besides savings on settlement costs. There are aspects of this rule that will save time for industry. The value of these efficiencies could be \$1,166 million for loan originators and settlement agents, for a per loan efficiency of \$93. In a competitive industry, firms would pass these gains along to borrowers in the form of lower costs, a consumer benefit. Borrowers themselves will save time through the new GFE. These time savings are estimated at \$1,169 million but are derived from a time savings worth \$55 per applicant (seventy-five minutes at \$44 per hour). In the summary of net benefits, we only include the per applicant time savings for borrowers. We make the cautious assumption that successful borrowers have submitted only one application. A fraction of the additional 8.25 million applications (in excess of 12.5 million loans) consist of: applications approved but not accepted; applications denied by the financial institution; and applications withdrawn by the applicant. Although these individuals also realize time savings, it would be misleading to include them in a “per loan” figure in that the time savings of rejected applicant would not benefit the borrower. Adding the firms’ and borrowers’ value of time efficiencies to the net of compliance cost consumer savings gives us an estimate of the potential consumer benefits per loan: \$696 in the first year and \$742 afterwards.

#### **II.C.4. Alternatives Considered to Make the GFE More Workable for Small and Other Businesses**

Chapter 3 discusses the many comments that HUD received on the GFE in the 2002 and 2008 proposed rules and the 2005 RESPA Reform Roundtables. Chapter 4 discusses

alternatives. The most basic alternative was to make no change in the current GFE. The final rule allows both the current GFE and the new GFE to be used for one year after the GFE is introduced, but requires the new GFE and HUD-1 to be used beginning January 1, 2010. This approximately one-year adjustment period responds to lenders' comments that there would be significant implementation issues with switching to a new GFE.

The main alternative concerning small businesses considered the brokers' argument that they were disadvantaged by the reporting of yield spread premiums. The new GFE was designed to ensure that there will not be any anti-competitive impacts on the broker industry. A summary page is included that presents the key cost figures for borrower shopping, that does not report yield spread premiums, and that provides identical treatment for brokers and lenders. The final GFE includes language that clarifies how yield spread premiums reduce the upfront charge that borrowers pay. Section III.E of this Executive Summary discusses this in more detail.

HUD designed the GFE to make it workable for small lenders and brokers. Some examples of the changes are the following:

- In response to concerns expressed by lenders and brokers about their ability to control third-party costs and meet the specified tolerances in the 2008 proposed rule, HUD raised the tolerance on government recording charges from zero to ten percent.
- Consistent with the above, the rule creates a new definition of "changed circumstances" that clarifies and expands on the definition of "changed circumstances" in the proposed rule. For example, material information that was either not known at the time the original GFE was provided or not relied on in providing the original GFE, or information that has changed in a material way since application, may be the basis for providing a modified GFE. For example, if the actual loan amount turns out to be higher than the loan amount indicated by the borrower at the time the GFE was provided, and certain settlement charges that are based on the loan amount increase as a result, the loan originator may provide a revised GFE reflecting those higher amounts. Compliance with the tolerance provisions would be evaluated by comparing the revised GFE with the actual amounts charged at settlement.
- HUD has adopted a streamlined single application process for the final rule. The new definition will allow loan originators more flexibility in determining the information they need to underwrite a GFE.
- The reading at settlement of a closing script is no longer required. Much of the same information will be transmitted to the borrower via a new page 3 of the HUD-1.

**Alternatives.** This chapter and Chapter 4 and Chapter 6 discuss other major alternatives that HUD considered in developing the final rule from the 2008 proposed rule. These chapters discuss the pros and cons of these alternatives and why HUD decided not to include them in this final rule.

## II.C.5. Market and Competitive Impacts on Small Businesses from the Final Rule

**Transfers from Small Businesses.** It is estimated that \$4.13 billion, or 49.5 percent of the \$8.35 billion in consumer savings comes from small businesses, with small originators contributing \$3.01 billion and small third-party firms, \$1.13 billion.<sup>11</sup> Within the small originator group, most of the transfers to consumers come from small brokers (\$2.47 billion, or 82 percent of the \$3.01 billion); this is because small firms account for most of broker revenues but a small percentage of lender revenues. Within the small third-party group, most of the transfers come from the title and closing industry (\$0.68 billion, or 60 percent of the \$1.13 billion), mainly because this industry accounts for most third-party fees. In the title approach, small title and settlement closing companies account for \$0.95 billion of the \$2.5 billion in savings. Section VII.E.2 of Chapter 3 explains the steps in deriving these revenue impacts on small businesses, and Section VII.E.4 of Chapter 3 reports several sensitivity analyses around the estimates. In addition, Chapter 5 provides more detailed revenue impacts for the various component industries.<sup>12</sup>

The summary bullets in Section I.C highlight the mechanisms through which these transfers are expected to happen. Improved understanding of yield spread premiums, discount points, and the trade-off between interest rates and settlement costs; improved consumer shopping among originators; more aggressive competition by originators for settlement services; and increased competition associated with discounting -- all will lead to reductions in both originator and third-party fees. As noted earlier, there is substantial evidence of non-competitive prices charged to some in the origination and settlement of mortgages due to information asymmetry between originators and borrowers. Originators (both small and large) and settlement service providers (both small and large) that have been charging high prices will experience reductions in their revenues as a result of the new GFE. There is no evidence that small businesses have been disproportionately charging high prices; for this reason, there is no expectation of any disproportionate impact on small businesses from the new GFE. The revenue reductions will be distributed across firms based on their non-competitive price behavior.

**Small Brokers.**<sup>13</sup> The main issue raised by the brokers concerned the treatment in the 2008 proposed rule of yield spread premiums on the proposed Good Faith Estimate. Mortgage Broker representatives asserted that the proposed mortgage broker disclosure would achieve the opposite result and would detract from the consumer's ability to understand and comparison shop. They recommended that lenders should be treated similarly to facilitate shopping and promote consumer understanding. The current final rule addresses the concern expressed by

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<sup>11</sup> In the more conservative scenario of \$6.48 billion in consumer savings, small businesses would account for \$3.21 billion of the transfers to consumers, with small originators accounting for \$2.36 billion, and small third-party providers, \$0.84 billion.

<sup>12</sup> In Chapter 5, see Section II for brokers, Section III for the four lender groups (commercial banks, thrifts, mortgage banks, and credit unions), Section IV for the various title and settlement groups (large insurers, title and settlement agents, lawyers, and escrow firms), Section V.A for appraisers, Section V.B for surveyors, Section V.C for pest inspectors, and Section V.D for credit bureaus.

<sup>13</sup> Practically all (98.9%) of the 30,000-44,000 brokers qualify as a small business. The Bureau of Census reports that small brokers account for 70% of industry revenue.

brokers that the reporting of yield spread premiums in the 2008 proposed rule would disadvantage them relative to lenders.

The Department hired forms development specialists, the Kleimann Communication Group, to analyze, test, and improve the forms. Starting with the GFE form proposed in 2002, they reworked the language and presentation of the yield spread premium to emphasize that it offsets other charges to reduce settlement charges, the cash needed to close the loan. The subjects tested seemed to like the trade-off table that shows the trade-off between the interest rate and up-front charges. It illustrates how yield spread premiums can reduce upfront charges. There is the summary page designed to simplify the digestion of the information on the form by including only the total estimated settlement charges from page two. This is the first page any potential borrower would see. It contains only the essentials for comparison-shopping and is simple: a standard set of yes-no questions describing the loan and a very simple summary of costs and the bottom line. Yield spread premiums are never mentioned here. Lender and broker loans get identical treatment on page 1. A mortgage shopping chart is included on page 3 of the GFE, to help borrowers comparison shop. Arrows were added to focus the borrower on overall charges, rather than one component. All of these features work against the borrower misinterpreting the different presentation of loan fees required of brokers vis-à-vis lenders.

HUD has designed the GFE form to focus borrowers on the right numbers so that competition is maintained between brokers and lenders. The forms adopted in the final rule were tested on hundreds of subjects. The tests indicate that borrowers who comparison shop will have little difficulty identifying the cheapest loan offered in the market whether from a broker or a lender.

We do not believe that the customer outreach function that brokers perform for wholesale lenders is going to change with RESPA reform. Wholesale lending, which has fueled the rise in mortgage originations over the past ten years, will continue to depend on brokers reaching out to consumer customers and supplying them with loans. Brokers play the key role in the upfront part of the mortgage process and this will continue with the final GFE.

RESPA reform is also not going to change the basic cost and efficiency advantages of brokers. Brokers have grown in market share and numbers because they can originate mortgages at lower costs than others. There is no indication that their cost competitiveness is going to change in the near future. Thus, brokers, as a group, will remain highly competitive actors in the mortgage market, as they have been in the past.

While there is no evidence to suggest any anti-competitive impact, there will be an impact on those brokers who are charging non-competitive prices. And there is convincing evidence that some brokers (as well as some lenders) overcharge consumers (see studies reviewed in Chapter 2). As emphasized throughout the Regulatory Impact Analysis, the new GFE will lead to improved and more effective consumer shopping, for many reasons -- the new GFE is simple and easy to understand, it includes reliable cost estimates, it effectively discloses yield spread premiums and discounts in brokered loans without disadvantaging brokers, it provides a vehicle to show consumers options, and it explains the trade-off between closing costs and interests rates to aid in understanding of yield spread premiums. This increased shopping by consumers will reduce the revenues of those brokers who are charging non-competitive prices.

Thus, the main impact on brokers (both small and large) of the final rule will be on those brokers (as well as other originators) who have been overcharging uninformed consumers, through the combination of high origination fees and yield spread premiums.<sup>14</sup> As noted above, small brokers are expected to experience \$2.47 billion in reduced fees.

**Small Lenders.** Lenders include mortgage banks, commercial banks, credit unions, and thrift institutions.<sup>15</sup> There are over 10,000 lenders that would be affected by the RESPA rule, as well as almost 4,000 credit unions that originate mortgages. While two-thirds of the lenders qualify as a small business (as do four-fifths of the credit unions), these small originators account for only 23 percent of industry revenues. Thus, small lenders (including credit unions) account for only \$540 million of the projected \$2.35 billion in transfers from lenders.<sup>16</sup>

In general, there was less concern expressed by lenders (as compared with brokers) about potential anti-competitive impacts of the GFE on small businesses. Small lenders -- relative to both brokers and large lenders -- will remain highly competitive actors in the mortgage market, as they are today. Small mortgage banks, community banks and local savings institutions benefit from their knowledge of local settlement service providers and of the local mortgage market. Nothing in the final GFE rule changes that. Generally, lenders and their associations opposed the proposed GFE on the grounds that in their opinion the form is too lengthy and would only confuse borrowers.

Lenders had numerous comments on most aspects of the 2008 proposed GFE form -- some of them dealing with major issues such as the difficulty in predicting costs within a three day period and many dealing with practical and more technical issues. HUD responded to many of the issues and concerns raised by lenders; Sections V, VI, and VIII of Chapter 3 discuss lenders' comments and HUD's response.

Some lenders were concerned about their ability to produce firm cost estimates (even of their own fees) within a three-day period, given the complexity of the mortgage process. Lenders wanted clarification on their ability to make cost adjustments as a result of information they gain during the full underwriting process. The tolerances in the final rule require that lenders play a more active role in controlling third-party costs than they have in the past. However, some lenders emphasized that they have little control over fees of third-party settlement providers, while others seem to not anticipate problems in this regard. As explained in I.B above, the final rule made several adjustments to the tolerance rules, which should make

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<sup>14</sup> As explained throughout this chapter, it is anticipated that market competition, under this proposed GFE approach, will have a similar impact on those lenders (non-brokers) who have been overcharging consumers through a combination of high origination costs and yield spread premiums.

<sup>15</sup> While it is recognized that the business operations and objectives of these lender groups can differ -- not only between the groups (a mortgage banker versus a portfolio lender) but even within a single group (a small community bank versus a large national bank) -- they raised so many of the same issues that it is more useful to address them in one place.

<sup>16</sup> Section III of Chapter 5 describes the characteristics of these component industries (number of employees, size of firms, etc.), their mortgage origination activity, and the allocation of revenue impacts between large and small lenders. That section also explains that the small business share of revenue could vary from 20 percent to 26 percent

them workable for lenders. In addition, the final rule allows average cost pricing, which should help lenders reduce their costs. Practically all lenders wanted clarification on the definition of application, and HUD did that.

There will be an impact on those lenders (both large and small) who are charging non-competitive prices. Improved consumer shopping with the new GFE will reduce the revenues of those lenders who are charging non-competitive prices. Thus, as with brokers, the main negative impact on lenders (both small and large) of the new GFE will be on those lenders who have been overcharging uninformed consumers.

**Small Title and Settlement Firms.** The title and settlement industry -- which consists of large title insurers, title agents, escrow firms, lawyers, and others involved in the settlement process -- is expected to account for \$1.79 billion of the \$2.47 billion in third-party transfers under the GFE in the final rule. Within the title and settlement group, small firms are expected to account for 38.1 percent (\$0.68 billion) of the transfers, although there is some uncertainty with this estimate.<sup>17</sup> Step (8) of Section VII.E of Chapter 3 conducts an analysis that projects all of the consumer savings in third-party costs coming from the title industry; evidence suggests there are more opportunities for price reductions in the title industry, as compared with other third-party industries. In this case, consumer savings in title costs (\$150-\$200 per loan) ranged from \$1.88 billion to \$2.50 billion. To a large extent, the title and closing industry is characterized by local firms providing services at constant returns to scale. The demand for the services of these local firms will continue under the final GFE.

Section VIII.C of Chapter 3 summarizes the key competitive issues for this industry with respect to the final rule. As noted there, the overall competitiveness of the title and closing industry should be enhanced by the RESPA rule. Chapters 2 and 5 provide evidence that title and closing fees are too high and that there is much potential for price reductions in this industry. Increased shopping by consumers, as well as increased shopping by loan originators to stay within their tolerances, will reduce the revenues of those title and closing companies that have been charging non-competitive prices.<sup>18</sup> Excess charges will be reduced and competition will ensure that reduced costs are passed through to consumers.

The title industry argued that greater itemization was needed in order for consumers to be able to adequately comparison shop among estimates. HUD's view is that the consolidated categories on the new GFE form provide consumers with the essential information needed for comparison-shopping. Itemization encourages long lists of fees that confuse borrowers.

It is important to keep in mind the local nature of the title industry when considering the impacts of the final RESPA reform (new GFE, tolerances, etc.) on the title industry. The title industry demonstrates a high degree of geographic specialization. Although title insurance companies do not need to be close to the properties insured, until there is widespread use of

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<sup>17</sup> Section IV of Chapter 5 describes the component industries and estimates the share of overall industry revenue going to small businesses.

<sup>18</sup> The reasons why the proposed GFE and its tolerances will lead to improved and more effective shopping for third-party services by consumers and loan originators has already been discussed, and need not be repeated here.

standardized electronic land record keeping accessible by the Internet,<sup>19</sup> the information-gathering service the industry provides will require proximity to land title records (or the establishment of “title plants,” i.e., duplicates of local records, the maintenance of which requires proximity to local government records). Even if a provider is efficient and charges low prices, it will not be able to compete against title and closing firms who are located sufficiently closer to the site in question. Thus, title and closing companies are by economic necessity provided by local firms. Reinforcing the local orientation are the value of local expertise and the importance of personal networks in receiving referrals.

The local orientation of the title industry could change over time. However, it is unlikely that RESPA reform would be the catalyst. The advances in technology that would change business practices are independent of what HUD does about RESPA. The only change that the final rule will introduce is that title and closing services may occur at lower prices negotiated between providers and lender originators. There will be no significant change in the local provision of title and closing work. Nor will there be a reduction of the number of these services purchased since this reform will not result in a drop in the number of mortgages that require these services. Large lenders will have to deal with multiple settlement services providers in order to ensure complete geographic coverage, and large multi-jurisdictional title firms have no apparent cost advantages over smaller title firms. In fact, large multi-jurisdictional title firms may have location-related cost disadvantages. There is no reason to believe that small title firms charging competitive prices will be adversely impacted by the changes in this rule. The demand for the services of these local firms will continue under the final GFE.

**Appraisers.** Like surveys and pest inspections, traditional appraisals are provided on-site at the mortgaged property. The transportation cost of visiting individual sites, especially the opportunity cost of the time spent in transit, adds substantially to the cost of providing the service. The transportation costs counterbalance, or overwhelm, any scale economies that may otherwise exist in the production of these services. The countervailing transportation cost pressures creates an effective constant returns to scale production function for this industry and can serve to explain the wide range of firm size as well as the continued success of small businesses in the appraisal industry. This explains why approximately 99.8 percent of traditional appraisal firms qualify as small businesses.

Even if large appraisal firms are efficient and charges low prices, they will not have the same advantage as providers who are located sufficiently closer to the site in question. Thus, traditional appraisals are by economic necessity provided by local firms. Reinforcing the local orientation of the appraisal industry is the value of local expertise. A profound understanding of the characteristics of the local real estate market is essential for a successful appraisal. In addition, local appraisal firms maintain local networks of customers and clients, based on their established track records, which should give them a solid business advantage.

The local orientation of the appraisal industry could change over time. There has been a trend towards the increasing use of automated valuation appraisals, particularly for appraising

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<sup>19</sup> The proposed rule does nothing to advance or retard this fundamental change in the nature of the business. It is possible that governments responsible for maintaining title records could advance to the level demonstrated in British Columbia (Canada), where even title insurance is not part of real estate transactions.

properties that are being refinanced and properties that are being used as collateral for home equity loans. The necessity for appraisers to visit all homes in need of an appraisal could be rendered less by the automated value model (AVM), but it is also the case that the databases used to create AVMs tend not to have data on whether or not there is water in the basement of the subject property. It is unlikely that RESPA reform would be the catalyst for increases in AMVs, as the technological advances are already taking place. While RESPA reform could accelerate the use of AVMs, it will not likely have an impact as to whether AVMs are eventually accepted more broadly by the lending industry. The adoption of AVMs will depend on the accuracy of these estimation models, their appropriateness for different types of properties, and their performance in mitigating the risk of default losses.

### **III. Statement of Need for and Objectives of the Rule<sup>20</sup>**

Acquiring a mortgage is one of the most complex transactions a family will ever undertake. The consumer requires a level of financial sensibility to fully understand the product. For example, consider the trade-off between the yield spread premium and interest rate payments. Borrowers do not have access to the rate sheets that describe this trade-off. Indeed, many consumers may not even understand that there is a trade-off. To further complicate matters, the mortgage industry is continuously evolving: the range and complexity of products expands every year. Because consumers borrow fairly infrequently, the average borrower will be at an extreme informational disadvantage compared to the lender. To exacerbate this situation, the typical homebuyer may be rushed and easily steered into a bad loan because they are under pressure to make an offer on a home. This is especially the case for first-time homebuyers who will not be as likely to challenge lenders, whom they may view as unquestionable experts.

Closing costs (lender fees and title charges) add to the borrower's confusion. They are not as significant as the loan itself and total on average approximately four percent of the loan amount. However, the direct lender fees and the title charges are perhaps just as perplexing to the consumer. First, the multiplicity of fees is confusing (see Exhibits 1-3 of Chapter 3 for a list of the different names of upfront lender fees and settlement charges). The purpose of every fee and title charge is likely to be neither understood nor questioned by the average first-time homebuyer, who may be intimidated by the formality of the transaction. Second, to add to the confusion and uncertainty, even once the charges have been agreed upon, they are subject to change until the day of closing. Such informational asymmetries between the buyer and seller impede the ability of the consumer to be an effective shopper and negotiator.

Consumers have strong incentives to ensure that they are getting the best deal possible on a mortgage loan and the associated third-party settlement costs, but poorly-informed decisions have drastic consequences. First, the household itself will lose by paying more for housing and possibly by ruining their credit history in the event of default. Second, market imperfections stemming from information asymmetries may stand in the way of achieving one of this administration's domestic priorities: expansion of homeownership. There is a wide range of

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<sup>20</sup> For a detailed discussion of problems with the current system, and thus the need for this proposed rule, see Sections IV and V of Chapter 2 and Sections I and VII of Chapter 3.

positive economic externalities from homeownership that have been investigated in the empirical housing economics literature. These include household saving, wealth accumulation, property improvements, a more pleasing urban environment, an increase in political activity, a reduction of crime, better child outcomes, and a positive impact on the labor supply of women. The average loan amount is 3.5 times a household's income: even minor inefficiencies in this market will have sizeable impacts on the U.S. economy.

The current GFE format contains a long list of individual charges that can be overwhelming, often confuses consumers, and seems to provide little useful information for consumer shopping. Current RESPA regulations have led to a proliferation of charges that makes consumer shopping and the mortgage settlement process both difficult and confusing, even for the most informed shoppers. Long lists of charges certainly do not highlight the bottom-line costs so consumers can shop and compare mortgage offers among different originators. In addition, under today's rules, the estimated costs on GFEs may be unreliable or incomplete, or both, and final charges at settlement may include significant increases in items that were estimated on the GFE, as well as additional unexpected fees, which can add substantially to the consumer's ultimate closing costs. The process of shopping for a mortgage can also involve complicated financial trade-offs, which are not always clearly explained to borrowers. Today's GFE is not an effective tool for facilitating borrower shopping nor for controlling origination and third-party settlement costs.

The potential for cost reductions in today's market is also indicated by studies showing relatively high and highly variable charges for third-party services, particularly for title and closing services that account for the major portion of third-party fees. There is not enough incentive for loan originators to control settlement costs by negotiating lower costs from third-party providers; rather, they too often simply pass through increases in third-party costs to consumers. Because of their lack of expertise, consumers may not be the best shoppers for third-party services providers, leaving them to rely on recommendations from real estate agents and lenders. Thus, a framework is needed that would encourage competitive negotiations and other arrangements that would lead to lower third-party settlement prices.

Today's mortgage market is increasingly characterized by the introduction of efficiency enhancing improvements such as automated underwriting systems and, through competition, these improvements are leading to lower prices for consumers. But the one area where current RESPA regulations act as a major barrier to competition and lower settlement services is the production and pricing of settlement services. Under current law, average cost pricing (another cost reduction technique) is inhibited by existing RESPA regulations.

The goal of HUD's RESPA reform is to even the playing field. The rule will accomplish this by requiring lenders to provide consumers information that lenders already have in a format that is transparent. One of the major inefficiencies of imperfect information is the costs of acquiring information. RESPA reform will go a long way toward educating consumers. The first page of the new GFE presents a brief summary of the terms of the loan that would warn prospective borrowers of potentially expensive aspects of the loan including loan amount, maximum interest rate, prepayment penalties, and the total estimated settlement charges. The second page provides more detail on the charges for loan origination and other settlement services. The third page provides a trade-off table so that consumers will learn the relationship

between the interest rate and the yield-spread premium. The third page also includes a table so that the consumer can take notes on alternative loan offers and thus comparison shop. Tolerances will limit how much settlement charges can vary once the GFE has been made and the comparison page of the HUD-1 will serve to double-check the GFE regarding settlement charges and provide a summary of the key terms of the borrower's loan at settlement. The final rule also allows settlement service providers to use pricing based on average charges, making their business operations simpler and less costly. It is expected that the new GFE will encourage shopping, increase efficiency, lower housing costs, and promote the purchase of loans that are more suited to a households' needs.

### **Empirical Evidence of Price Discrimination**

Studies indicate that consumers are often charged relatively high fees and can face wide variations in settlement prices, both for origination and third-party settlement services. Chapter 2 offers convincing evidence that not only do borrowers find it difficult to comparison shop in today's mortgage market, but that they are all too often charged excessive prices. The enormous potential for cost reductions in today's market is indicated by studies showing that yield spread premiums do not always offset consumers' origination costs. Studies show that consumers are, in effect, charged relatively high prices in some transactions involving yield-spread premiums, and that the mortgage market is characterized by "price dispersion." In other words, some borrowers get market price deals, but other borrowers do not. Studies show that less informed and unsuspecting borrowers are particularly vulnerable in this market. But given the fact that a borrower may be more interested in the main transaction (the home purchase), even more sophisticated borrowers may not shop aggressively for the mortgage or may not monitor the lending transaction very closely.

The Urban Institute (2008) collected data on 7,560 FHA loans. The mean total loan closing cost for all loans is \$4,917 for an average loan amount of \$108,237. Total charges are composed of loan charges \$3,081, title charges \$1,329, and other third party charges \$507. It is apparent from the distribution presented below that there is significant variation in closing costs: the standard deviation is \$2,381. For its statistical analysis, the Urban Institute focused on a subsample of 6,366 non-subsidized loans, for which the mean total charges are slightly higher at \$5,245. Lender charges for non-subsidized loans are \$3,390, of which \$1,450 are direct fees and \$1,940 is the average YSP.

<b>Series</b>	<b>5<sup>th</sup> percentile</b>	<b>25<sup>th</sup> percentile</b>	<b>50<sup>th</sup> percentile (median)</b>	<b>75<sup>th</sup> percentile</b>	<b>95<sup>th</sup> percentile</b>
<b><i>Total Closing Cost</i></b>	2.9%	4.1%	5.1%	6.4%	8.9%
<b><i>Total Loan Charges</i></b>	1.3%	2.4%	3.2%	4.2%	6.2%
Yield-spread premium	0.3%	1.3%	2.0%	2.7%	3.8%
Direct loan fees	0.0%	0.8	1.3%	1.8%	3.3%
<b><i>Total Title Charges</i></b>	0.6%	0.9	1.2%	1.6%	2.3%
<b><i>Other Third-Party Charges</i></b>	0.2%	0.4%	0.6%	0.8%	1.4%

A great degree of variation appears in the lender fees. Since total loan charges are correlated with loan amount, it would be useful to examine the distribution of closing costs as a percentage of loan amounts to ascertain whether the variation in fees is still present. HUD calculated the distributed of these ratios for non-subsidized loans from a data set of closing cost provided by the Urban Institute. There is slightly less variation when measured as a percentage but it is still substantial: the ratio of what the 75<sup>th</sup> percentile pays as a percentage of the loan to what the 25<sup>th</sup> percentile pays is 1.8 for total loan charges, 2.1 for the yield spread premium (indirect loan fee), and 2.4 for direct loan fees.

It is apparent that half of the borrowers pay loan charges equal or greater than 3.2% of their loan amount; one-quarter pay loan charges of at least 4.2% of their loan amount; and five percent pay loan charges of at least 6.2% of their loan amount. The variation is similar for title charges and other third-party charges. Half of the borrowers pay total closing costs equal or greater than 5.1% of their loan; one-quarter pay closing costs of at least 6.4% of their loan amount, and five percent pay closing costs of at least 8.9% of their loan amount.

HUD believes that these data provides strong indications of large price dispersion and thus price discrimination. Price discrimination will always lead to a loss in consumer surplus and unless price discrimination is perfect, it will also lead to a loss in social welfare. It should also be noted that if the variation of fees and charges paid is greater than the actual costs of providing the services, then that constitutes evidence of a violation of RESPA, which explicitly prohibits mark-ups.

**First, in a competitive market the price of the good should depend on its quality and not to whom and how it is sold.** If there is dispersion because the negotiations are face-to-face, this would suggest that the nature of the market exacerbates the consumer's informational disadvantage. Indeed, there is strong evidence that individuals pay different prices for reasons other than how costly service provisions will be. The Urban Institute report (2008) finds that African Americans pay an additional **\$415** for their loans and that Latinos pay an additional **\$365** (after taking into account borrower differences such as credit score and loan amount). These loans are not subprime loans but standard FHA loans. Other researchers have found similar results: Jackson and Berry (2002, see the Regulatory Impact Analysis for reference) find that mortgage brokers charge African-Americans (by **\$474**) and Hispanics (by **\$580**) substantially

more for settlement services than other borrowers. Discrimination by race or ethnicity is not economically efficient and would not survive in a perfectly competitive market.

**Second, reconsider the yield-spread premium.** We mentioned that this is one of the elements of a mortgage that a consumer is not likely to understand. The yield-spread premium is compensation to the broker for selling a loan with a higher interest rate. Thus, as the interest rate rises so should the yield-spread premium. This relationship appears to hold in the data analyzed. The broker earns income from two sources: a yield-spread premium that is paid by the lender and fees that are paid by the consumer. However, the burden of the yield-spread premium is on the consumer, who pays a higher interest rate for loans with a higher yield-spread premium. If consumers were perfectly informed, there would be a negative one-to-one relationship between up-front fees and the yield-spread premium. They simply represent two different ways of compensating the broker for the effort required to originate a loan.

The Urban Institute (2008) finds no strong trade-off between the yield-spread premium and upfront cash payments. Ideally, each dollar of YSP generated by a higher interest rate would result in a one dollar reduction in upfront fees. The reality is that this is not even close to being true. The Urban Institute finds that paying one dollar of YSP to a mortgage broker reduces upfront fees by only 7 cents.<sup>21</sup>

This result is derived from a sample of nonsubsidized loans above with a rate above 7 percent, which is appropriate for investigating YSPs. FHA borrowers appear to get no benefit from YSPs on brokered loans with coupon rates above 7 percent. The result is not much better when using the larger data set of all nonsubsidized loans:

The Urban Institute finds that broker loan-origination fees, instead of being lower by a dollar for each dollar of YSP, are *higher* by 16 cents. This result is stunningly bad for borrowers. Clearly, the average FHA borrower has no idea a higher interest rate can be used to reduce upfront charges. Such a relationship is contrary to what one would expect in a market where there were only minor imperfections. Further evidence is from Jackson and Berry (2002) who studies only brokered transactions, a description of which can be found in Section IV.D.2 of Chapter 2 of the Regulatory Impact Analysis. They find that the problem of price dispersion occurs when yield spread premiums are present, because in these situations there is no single price for broker services: “Most borrowers pay more than 1.5 percent of loan value; more than a third pay more than 2.0 percent of loan value; roughly ten percent pay more than 3.5 percent of loan value.” Jackson and Berry find this “price dispersion” troubling, as it suggests that brokers use yield spread premiums as a device “to extract unnecessary and excessive payments from unsuspecting borrowers” (page 9).

**Third, consider the confusion that the variety of loan products and permutations of those products can create.** If informational asymmetries are significant, then lenders will be able to earn more when selling more complex products. Borrowers who simplify their mortgage

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<sup>21</sup> In a sample, which is appropriate for investigating YSPs, of nonsubsidized loans with a rate above 7 percent, the Urban Institute finds that broker loan-origination fees, instead of being lower by a dollar for each dollar of YSP, are *higher* by 16 cents. This result is stunningly bad for borrowers. FHA borrowers appear to get no benefit from YSPs on brokered loans with coupon rates above 7 percent.

shopping by rolling all lender/broker fees into the interest rate (i.e., get “zero-cost” loans) pay **\$1,200 less** for their loans than brokers who pay lender or broker fees as measured by implicit YSPs. Borrowers who pay points realize only \$20 of benefits for every \$100 of points paid, for a net loss of \$80. It appears that the industry is able to take advantage of loan complexity, which is evidence of price discrimination not related to the cost of originating the loan.

**Fourth, consider other settlement charges.** Title insurance is an industry with a strong potential for natural monopoly. The costs of title insurance are primarily related to research of property transactions. There is a large fixed cost of entry which is compiling a database of transaction and lending records. There should not be a great variation in settlement charges since the only component that does vary substantially is the insurance premium. The Urban Institute (2008) finds an average \$1,329 title charge in their sample of all loans with a standard deviation of \$564. They also find a significant variation by state with New York, Texas, California, and New Jersey all costing at least \$1,000 more (holding property values constant) than North Carolina, the lowest-cost state. A reasonable question is what extra benefits people in the high-cost states get relative to those in low cost states, or why costs are so high if there are no extra benefits. It is also useful to analyze total title costs on a state-by-state basis due to the different legal requirements that exist among the states and the different customs that might have evolved in them as well. HUD examined within state variation of settlement fees. One measure of variability that we calculated for each state was the difference between the median of the highest quartile of title charges and the median of the lowest quartile. This is a measure of the difference between the typical charge for the highest fourth of the borrowers and the lowest fourth of the borrowers within each state. This difference was over \$1,000 for nine states. Due to the extent of price dispersion, we can expect significant savings from the final rule.

The primary purpose of this discussion was to show that there is great variation in closing costs and thus room for price discrimination. HUD would like to emphasize that the goal was *not* to portray lenders, and especially mortgage brokers, as unscrupulous and harmful to economic welfare. On the contrary, HUD recognizes that mortgage brokers and other lenders have played a crucial role in recent trends in home ownership. It is also clear from the statistical evidence presented in this section that there are many ethical loan originators. One quarter of the borrowers in this sample paid no more than 2.4% in loan charges and 4.1% in total closing costs. Consider that if the entire market mirrored this more efficient segment, then RESPA reform would not be as urgent.

#### **IV. Issues Raised in Comments on the 2008 Initial Regulatory Flexibility Analysis**

Section IV.A presents a review of comments on the 2008 IRFA. Sections IV.B and IV.C serve as roadmaps to other issues regarding the rule.

##### **IV.A. Comments Concerning the Initial Regulatory Flexibility Analysis**

This section describes how HUD responded in this Final Regulatory Flexibility Analysis (FRFA) to comments received on the Initial Regulatory Flexibility Analysis of the 2008 proposed rule. The primary comments on the 2008 IRFA included: a report from the National Association of Realtors, prepared by Ann Schnare, who claimed that HUD had underestimated

the costs of the rule; criticisms from advocates of small business that HUD had not adequately analyzed the impacts of its rule on industry structure; and an assertion by Representative Manzullo that HUD used obsolete data in its analysis.

#### **IV.A.1. “HUD Underestimated the Compliance Costs” (National of Association of Realtors)**

Ann Schnare prepared alternative estimates<sup>22</sup> for the National Association of Realtors (NAR) of the compliance costs of HUD’s 2008 proposed reform of the Real Estate Settlement Procedures Act (RESPA) to simplify the process and reduce the costs of obtaining a mortgage loan. Their report contains worthwhile suggestions, such as performing a sensitivity analysis with respect to the number of applications per loan. However, their cost estimates are inaccurate. In Sections IV, HUD discusses the NAR’s major comments that are applicable to the Regulatory Impact Analysis of the final rule. Below is a summary of the NAR’s comments and HUD’s responses.

The NAR states that HUD ignored a major compliance cost of the rule incurred by loan originators: the hedging costs of guaranteeing the interest rate for the shopping period of ten days. Including hedging costs dramatically increases compliance costs by a factor of four. However, the NAR made an erroneous assumption about the proposed GFE: there is no requirement of an interest-rate guarantee. Thus, hedging costs will be zero (See Section VII.D.1.).

A second criticism of the analysis of the compliance cost of the GFE is that HUD does not consider the possibility that the rule could increase the administrative costs to loan originators by generating a greater demand for GFEs. Although HUD believes that it is just as likely that applications do not increase, HUD has included a sensitivity analysis of compliance costs by the number of applications. (See Section VII.D.2.)

The NAR points to another cost not included in the IRFA: the cost of preliminary underwriting. However, this would only be a factor if the application to loan ratio were to increase. HUD assumed in the IRFA that this ratio would be constant. HUD’s response was to include this cost in a high application-to-loan scenario. (See Section VII.D.3)

HUD was criticized for using inconsistent estimates of the value of time in order to raise the value of the benefits of the rule relative to the costs. In fact, the reverse is true: HUD used a higher rate to estimate the costs and a lower one to estimate the benefits (See Section VII.D.4).

The NAR questions the potential benefits of the GFE. For support, Schnare turned to a study that used a sample suffering from selection bias (See Section V.A.1.g of Chapter 2 for a description) and questioned whether the rule would solve the problem of “bait and switch” or any other misleading business practice. PD&R has recently received *A Study of Closing Costs for FHA Mortgages* (summarized above in Section III and at length in Chapter 2). The results strongly indicate that HUD’s RESPA reform efforts are aimed directly at very serious problems in the market for these loan origination and other settlement services.

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<sup>22</sup> Ann E. Schnare, “The Estimated Costs of HUD’s Proposed RESPA Regulations,” prepared for the National Association of Realtors s (June 3, 2008).

#### IV.A.2. Impact of the Rule on Industry Structure

Many industry commenters stated that there were elements of the rule that disadvantaged small business. One of the primary concerns of small title firms is the potential adverse effect of volume discounting. The 2008 final rule set a clearer standard for compliance in the context of the new GFE. HUD merely clarified that volume discounting is legal as long as the savings are passed along to the consumer. ALTA, ICBA, NAMB, and NAR contend that volume discounts will favor large settlement service providers and loan originators/lenders at the expense of small businesses and place them at a disadvantage. The Office of Advocacy formally endorsed this position in their comment letter (June 11, 2008) and predicted that HUD's proposed clarification "may cause small businesses to leave the market and result in higher prices for consumers in the long term."

ALTA stated that the ability to negotiate volume discounts on the local services that are incidental to the issuance of a title policy (such as a title search) will disadvantage the small title insurance agency that does not have the resources to guaranty a stream of business to a third party or discount its own services when the services are performed in house. In addition, ALTA expressed concern that mortgage lenders and brokers will add to the anticompetitive effects by favoring affiliated title companies or those companies that can provide title related services on a nationwide basis.

**Comment.** Both the NAR and ALTA asserted that the Regulatory Impact Analysis of the proposed rule did not adequately address the anti-competitive issues of the proposed rule.

**Response.** In its Regulatory Impact Analysis, HUD very meticulously outlined the proportional impacts of the rule on small business. HUD continues to believe that as long as a small businesses is not charging consumers excessive fees, then small business will not suffer disproportionately.

To a large extent, the issue of unfavorable impacts on small business is mute. The greatest objection by small business was to volume discounts. In response to the numerous objections to HUD's clarification, HUD will not address volume discounts in the rule. HUD wants to ensure that any change will adequately protect consumers while at the same time providing adequate flexibility and due consideration to small business concerns. It remains HUD's position, however, that discounts negotiated between loan originators and other settlement service providers, or by an individual settlement service provider on behalf of a borrower, where the discount is ultimately passed on to the borrower, is not, depending upon the specific circumstances of a particular transaction, a violation of section 8 of RESPA. If the borrower fully benefits from the discount, these types of mechanisms that lower consumer costs are within RESPA's principal purposes.

There may be other facets of the rule, such as tolerances, that are thought to have a disproportionate impact on small business, even on those small firms that are not charging excessive prices. Instead, HUD believes that the rule will create opportunities for efficient firms to expand their operations. This opinion is based on our observations that a distinguishing characteristic of the real estate industry is that it is very locally oriented. The value of proximity and local expertise make small firms more efficient in providing services to consumers. RESPA

reform will not change that essential characteristic of the real estate industry. (See Section II.C.5. for a discussion).

#### **IV.A.3. Timeliness of Data**

**Comment.** Some criticized HUD for using “old” data in its Regulatory Impact Analysis of the 2008 proposed rule. For example, Representative Don Manzullo wrote in his comment letter that the market has changed significantly since the data was obtained in 2002 and 2004; that these changes may impact how the rule is implemented; and that should wait until it has data on current market conditions before moving forward with the rule.

**Response.** HUD’s initial regulatory flexibility analysis of the proposed RESPA rule, which was completed in late 2007, used the latest, at that time, officially available federal government data on small businesses provided by the Small Business Administration (SBA) as derived from two Census Bureau data sources: the 2002 Economic Census (business income or receipts), and the 2004 County Business Patterns data (number of businesses and firm employment size). These data are augmented, when possible, by highly regarded data from industry sources. For example, the SBA/Census data on mortgage brokers do not agree with estimates of the size of that industry made by the National Association of Mortgage Brokers and other observers. HUD ultimately based its analysis of the mortgage broker industry on these private sector data.

Chapter 5 of the RIA provides extensive documentation of the characteristics of the industries directly affected by the rule, including various estimates of the numbers of small entities, reasons why various data elements are not reliable or unavailable, and descriptions of methodologies used to estimate (if possible) necessary data elements that were not readily available. The industries discussed in Chapter 5 of the RIA included the following (with Chapter 5 section reference): mortgage brokers (Section II); lenders including commercial banks, thrifts, mortgage banks, credit unions (Section III); settlement and title services including direct title insurance carriers, title agents, escrow firms, and lawyers (Section IV); and other third-party settlement providers including appraisers, surveyors, pest inspectors, and credit bureaus (Section V); and real estate agents (Section VI).

The SBA does not expect to have an update (from the 2007 Economic Census) of the 2002 Economic Census data (business income or receipts) available until sometime in 2010, well beyond the time horizon for this rulemaking effort. Thus, the FRFA of the final RESPA rule will continue to rely in part on data from 2002.

More importantly, HUD’s estimate of the annual regulatory burden depends primarily on our assumptions concerning the compliance cost per loan. HUD has used generous estimates of the costs of the rule but has received no hard data from industry that would allow us to refine our estimates. The aggregate impact of the rule depends on mortgage volume. Our approximation of the average year is 12.5 million transactions. It is probable that the level of originations in 2008-2009 will be lower than this amount. However, the final rule requires a twelve-month implementation period. By the time the rule is in effect, the average mortgage volume is expected to return to that of the average year.

## **IV.B. Alternatives Considered to Minimize Impact on Small Businesses**

Section VI of this chapter provides discussion of the alternatives considered by HUD in developing the final rule with a focus on those alternatives considered to minimize the impact on small business. Section VI includes a summary discussion of the following major alternatives: maintaining the status quo; not including the yield-spread premium calculation in the GFE; requiring the preparation and reading of a closing script; and clarification in the rule of the legality of volume discounting;. Section VI also includes a discussion of steps HUD took to make the new GFE easier to implement for small businesses.

## **IV.C. Comments and Responses to Other Issues**

Chapters 1-5 of the Regulatory Impact Analysis include detailed summaries of the comments submitted by small businesses and other firms on various aspects of the 2008 proposed rule and in response to the 2008 IRFA. Detailed discussion of comments received can be found in the preamble. Detailed analysis responding to comments received can be found in Sections VI and VIII of Chapter 3. Detailed discussion of comments related to the compliance burden of the rule can be found in Sections VII, VIII, and IX of this chapter. Analysis responding to some specific comments on the 2008 IRFA can be found in Chapter 3. Changes made to the 2008 proposed rule in response to comments received are summarized in Section VI of this chapter.

## **V. Description and Estimate of the Number of Small Entities**

Chapter 5 provides extensive documentation of the characteristics of the industries affected by the rule, including estimates of the numbers of small entities. The industries discussed in Chapter 5 included the following (with industry code and Chapter V section reference): mortgage brokers (Section II); lenders including commercial banks, thrifts, mortgage banks, credit unions (Section III); settlement and title services including direct title insurance carriers, title agents, escrow firms, and lawyers (Section IV); and other third-party settlement providers including appraisers, surveyors, pest inspectors, and credit bureaus (Section V); and real estate agents (Section VI). The specific industry names and industry codes (North American Industry Classification System, or NAICS code) for the mortgage originators and third-party firms covered in Chapter V are as follows:

### **Mortgage Origination Firms**

1. Mortgage Loan Brokers (522310)
2. Commercial Banks (522110)
3. Savings Institutions (522120)
4. Real Estate Credit/Mortgage Bankers (522292)
5. Credit Unions (522130)

### **Third-Party Service Firms**

1. Direct Title Insurance Carriers (524127)
2. Title Abstract and Settlement Offices (541191)
3. Offices of Lawyers (541110)
4. Other Activities Related to Real Estate (531390)
5. Offices of Real Estate Appraisers (531320)
6. Surveying and Mapping (except geophysical) Services (541370)
7. Credit Bureaus (561450)
8. Exterminating and Pest Control Services (561710)
9. Offices of Real Estate Agents and Brokers (531210)

Chapter 5 supports Chapters 3 and 6 by providing basic mortgage-related data on each industry and by explaining the various methodologies for estimating the share of industry revenue accounted by the different component industries and by small businesses within each component industry. Chapter 5 presents an overview of the industries involved in the origination and settlement of mortgage loans (see above list). Industry trends are briefly summarized and special issues related to RESPA are noted. There is also a description of the economic statistics for each industry, with an emphasis on each industry's share of small business activity. Both the estimation of the revenue share for various industry sub-sectors (e.g., large title insurers' share of total revenue in the title and settlement industry) and the estimation of the small business share of mortgage-related revenue within the industry, often involve several technical analyses that pull together data from a variety of sources, in addition to Census Bureau data. This leads to several sensitivity analyses to show the effects of alternative estimation methods and assumptions. This chapter also reports the revenue transfers from the RESPA rule for the specific industry sectors; these transfers are reported in dollar terms and, where possible, as a percentage of industry revenue. Finally, a number of technical issues and special topics, such as techniques for estimating the distribution of retail mortgage originations, are discussed. A technical appendix to Chapter 5 provides relevant definitions and explains the methodology associated with the economic data obtained from the Census Bureau. A data appendix in Chapter 5 includes tables with the economic data (number of firms, employment, revenue, etc.) for each industry sector.

Thus, the Regulatory Impact Analysis pulls together substantial data from the Bureau of the Census and industry sources to provide estimates of revenue transfers for different industries and for small businesses within those industries. Chapter 5 provides a full technical review of the data used and the various methodologies for estimating the small business share of industry revenues.

Drawing from the analysis in Chapters 3 and 5, Appendix A to this chapter provides estimates of the revenue impacts from the new GFE. These data are presented in aggregate form (\$ million) and on a per firm basis, covering all firms (both employer and non-employer), small firms (small employer firms plus non-employer firms), and very small firms (very small employer firms plus non-employer firms). Separate data for non-employer firms are also

provided. In some cases, different projections are provided for some of the more important sensitivity analyses conducted in Chapters 3 and 5. The technical analyses presented in Chapter 5 indicate some uncertainty around some of the numbers (such as the number of small mortgage banks, the split of revenue among different sectors of the broad title industry, etc.). Readers are referred to the technical discussion in Chapter 5 for various qualifications with the data and for various sensitivity analyses that illustrate the effects on the estimates of alternative assumptions. In addition, Chapter 5 explains the definitions of small and very small being used here.

## **VI. Alternatives Which Minimize Impact on Small Businesses**

Under the Initial Regulatory Flexibility Analysis, HUD must discuss alternatives that minimize the economic impact on small entities consistent with the stated objectives of applicable statutes, including a statement of the factual, policy, and legal reasons for selecting the alternative adopted in the final rule and why each of the other significant alternatives to the rule considered by the agency was rejected. Many of the alternatives that HUD considered and implemented were directed at making the GFE less burdensome for small businesses. These changes are described below. A more detailed discussion of the changes to make the GFE easier to implement for small businesses are provided in Section VIII of Chapter 3. For a discussion of all of the major alternatives considered to the final GFE, see Chapter 4.

This Regulatory Impact Analysis discusses several steps that HUD took that will assist small businesses involved in the mortgage origination and settlement process. Examples include simplifying the new GFE form (fewer numbers, etc.), designing the new GFE form so that there is a level playing field between lenders and brokers, and delaying the phase-out of today's GFE for twelve months. HUD also made numerous other changes that were designed to make the GFE easier to use, particularly for small businesses. These changes are discussed throughout Chapter 3 and summarized in several places in the Regulatory Impact Analysis. This section will list them again, as it is useful to provide a record of the changes made to the 2008 proposed rule that should make the new GFE easier to implement for small businesses. Considered as a group, these changes are important. While many are designed to address a problem faced by large as well as small lenders, for the most part, they address problems that would place a greater burden on small than large businesses. Examples of the changes that HUD made are the following:

- **Volume-based discounts.** Small businesses, especially closing attorneys and escrow companies stated that lenders seeking volume discounts would place them at a competitive disadvantage to larger entities and force them out of business. HUD responded by not addressing volume discounts in its final rule.
- **Tolerances.** Some commented that large lenders would have an easier time meeting tolerances than small businesses by contracting with large third-party settlement-service providers, and thereby placing small settlement service providers at a competitive disadvantage. If exceeding the tolerance was an infrequent and unpredictable event, larger firms may be able to diversify the risk over a larger pool of loans. The final rule provides loan originators with an opportunity to cure any potential violation of the tolerance by reimbursing the borrower any amount by which the tolerances were exceeded. The opportunity to cure will permit loan originators to

give an estimate of expected settlement charges in good faith, without subjecting them to harsh penalties if the estimate turns out to be lower than the actual charges at settlement. This change reduces the potential damages of exceeding the tolerances.

## **VII. Compliance Costs and Regulatory Burden: New GFE**

This section focuses on the compliance, regulatory, and other costs associated with implementing the final rule. It examines compliance and regulatory impacts of the new GFE on originators. There are two types of compliance and regulatory costs – one-time start-up costs and recurring costs. Section VII.B discusses start-up costs, noting that HUD has lengthened the phase-in period for the new GFE in order to reduce any implementation burden on the industry, particularly small firms. Section VII.C discusses recurring costs that are related to implementing the new GFE. The simplicity of the new GFE, plus the changes that HUD has made to improve the new GFE, will limit these annual costs, as discussed in Section VII.D. Section VII.E discusses compliance issues related to tolerances on settlement party costs. Finally, Section VII.F outlines efficiencies associated with the new GFE.

Before examining the specific regulatory and compliance costs, Section VII.A reviews the basic data used in estimating these costs. For a similar description of the costs on the settlement industry, see Section VIII.

### **VII.A. Data Used in Compliance Cost Estimates**

The following tables provide a summary of the industry characteristics data used to develop compliance cost estimates for the GFE. Details on the derivation of these data are available in Chapter 5. The compliance costs of the GFE provisions of the rule apply mainly to retail loan originators. While wholesale lenders, for example, are involved in the mortgage origination process, they are not responsible for issuing the GFE – rather the originating lender or broker is responsible for the issuing the GFE to the borrower.<sup>23</sup> Therefore, data are presented only for those brokers and lenders that do retail mortgage loan originations. Settlement agents do not generate GFEs and therefore they would not be subject to these GFE-related costs. Settlement agents will, however, be involved generating HUD-1s; since there are some changes to the HUD-1 form, there are compliance costs on settlement agents associated with that change. In most cases, HUD expects that loan originators will complete the comparison page of the HUD-1 form. However, a portion of the compliance cost will be the burden on settlement agents of completing the comparison page accurately in cases where there is additional information required from the settlement agent. Other third-party providers (e.g., appraisers) will face no compliance costs from the GFE provisions of the rule.

Chapter 5 provides information on the total number of brokers and lenders that are likely to be affected by the new RESPA rule and its revised GFE form. Section II of that chapter explains that the number of brokers has grown substantially in recent years. In 2000, there were

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<sup>23</sup> If the wholesale lender generates the GFE, then there would be a charge to the originator (either a direct charge or a reduction in fees, compared with the case where the originator issues the GFE).

30,000 brokers, but with the increase in refinancing, the number of brokers rose to 33,000 in 2001 and then jumped to 44,000 in 2002 and then to 53,000 in 2004. According to Census Bureau data, practically all brokers (99.1%) qualify as a small business. Thus, it is estimated that small broker firms have ranged from 32,703 to 52,523 over the past few years. As explained in Section III of Chapter 5, lenders that will be affected by the RESPA rule include: 7,402 commercial banks (4,426 or 59.8% are small), 1,279 thrift institutions (641 or 50.1% are small), 1,287 mortgage banks (1,077 or 83.7% are small), and 3,969 credit unions (3,097 or 78.0 % are small).<sup>24</sup> Altogether, there are 13,937 lenders (including credit unions) affected by the RESPA rule, and 9,241 of these qualify as a small business.

Table 6-6 provides the distribution of retail mortgage originations among the various industries and for small firms within each industry. Totals are estimated based on the number of mortgage originations (12,500,000 loans) that would occur in a “normal” year of mortgage originations (that is, not in a high-volume year with a refinancing boom). The data below assume that brokers account for 60% of mortgage originations and lenders, the remaining 40%.<sup>25</sup> (See below for alternative origination volume and broker share estimates.)

**Table 6-6 Volume of Retail Mortgage Originations**

<b>Industry</b>	<b>All Originations</b>	<b>Percent of Originations</b>	<b>Originations by Small Firms</b>	<b>Percent Industry Originations by Small Firms</b>
<b>Mortgage Brokers</b>	7,500,000	60.00%	5,250,000	70.00%
<b>Commercial Banks</b>	2,053,150	16.43%	389,893	18.99%
<b>Thrifts</b>	974,750	7.80%	120,089	12.32%
<b>Mortgage Banks</b>	1,551,500	12.41%	644,803	41.56%
<b>Credit Unions</b>	420,600	3.36%	122,563	29.14%
<b>TOTAL</b>	<b>12,500,000</b>	<b>100.00%</b>	<b>6,527,349</b>	<b>52.22%</b>

As shown in Table 6-6, it is estimated that 52% of mortgages are originated by small brokers and lenders.

Table 6-7 provides the total number of workers and the number of workers in small firms engaged in retail mortgage origination by industry. It is based on the mortgage origination volumes depicted in Table 6-6 and productivity rates of 20 loans per worker per year for mortgage brokers and lenders. See Section II.B.2.c of Chapter 5 for the derivation of the 20 loans per worker in the broker industry and see Section III.B.5.g of Chapter 5 for a discussion of the 20 loans per worker in the lender industry. Given the uncertainty around these estimates (and particularly the lender estimate which is obtained by simply assuming that lender workers are as productive as brokers), alternative estimates and sensitivity analyses are provided in Chapter 5. As noted in Chapter 5, one alternative would be to choose a lower productivity number for

<sup>24</sup> See Section III.B.5 of Chapter 5 for issues related to the number of small mortgage banks. As also explained in that section, the credit unions are the ones that report some mortgage origination activity.

<sup>25</sup> See Section III.B.5.d of Chapter 5 for the derivation of the distribution of retail originations among commercial banks, thrifts, and mortgage banks; the distribution used here is the “adjusted distribution” for the number of loans. See Chapter 5 for reasons why there is some uncertainty with the estimated distribution and for analysis of an alternative distribution.

lenders, which would be consistent with the widely held belief that brokers are more productive than lenders; in addition, it may be more appropriate to overestimate the number of lender employees affected by the RESPA rule than to underestimate them.<sup>26</sup> However, this analysis starts by assuming equal productivity for lenders and brokers.

**Table 6-7 Workers Engaged In Retail Mortgage Loan Origination**

<b>Industry</b>	<b>Total Workers</b>	<b>Workers in Small Firms</b>	<b>Percent of Workers in Small Firms</b>
<b>Mortgage Brokers</b>	375,000	288,750	77.00%
<b>Commercial Banks</b>	102,658	19,495	18.99%
<b>Thrifts</b>	48,738	6,004	12.32%
<b>Mortgage Banks</b>	77,575	32,240	41.56%
<b>Credit Unions</b>	21,030	6,128	29.14%
<b>TOTAL</b>	<b>625,000</b>	<b>352,617</b>	<b>56.42%</b>

As shown in Table 6-7, it is estimated there are 625,000 workers engaged in mortgage origination, with 352,617 of these operating in small businesses. As noted above, the mortgage volume figure (12,500,000 loans based on \$2.4 trillion in originations) reflects industry projections of mortgage originations for 2008. Chapters 3, 4, and 5 conduct sensitivity analyses with a higher level of originations. For example, one could consider an environment where 15,500,000 loans were originated (compared with the 12,500,000 loans in the base case). In this case, the figures in Tables 6-6 and 6-7 would change. For example, the number of workers in the broker industry would increase to 438,038 (with 337,293 in small firms) and the number of workers in the combined lender group would increase to 271,250 (with 69,296 in small firms).<sup>27</sup> Below, sensitivity analyses cover these higher estimates of the number of workers affected by the RESPA rule.

## **VII.B. Compliance and Regulatory Burden: One-Time Costs**

Several one-time compliance burdens can be identified that will result from the new rule. All involve the adjustment process from the old rule to the new rule. Although HUD received comments on the one-time compliance cost issues associated with the new GFE, commenters did not provide any useful data on the magnitude of these costs.

<sup>26</sup> A comment should be made about the small business share for brokers. Section II.B.1 in Chapter 5 reports that small brokers account for 70% of broker industry revenue. Table 6-6 assumes that small brokers account for the same percentage (70%) of the number of loans originated by all brokers; it is possible that this percentage could be too low, given that Section II.B.2.c of Chapter 5 derives an estimate of 77% for the share of industry workers in small broker firms. The 77% figure is used in Table 6-7 (288,750 divided by 375,000) for estimating the share of workers in small broker firms. The small business share of the number of workers in each of the four lender industries in Table 6-7 is assumed to be the same as in Table 6-6 for the number of loans. See Section III.B.5 of Chapter 5 for the derivation of the small lender shares of lender originations.

<sup>27</sup> As explained in Chapter 5, this scenario assumes that the increase in mortgage originations comes mainly from brokers; the loans-per-worker assumption is increased to 23 for brokers (consistent with that number increasing in Olson's surveys during higher volume years) but kept at 20 for lenders since their volume does not increase much during this scenario.

There are three major areas of expected one-time compliance costs of the new GFE. Those who generate the new GFE forms, loan originators, will need new software in order to produce the new forms.<sup>28</sup> Their employees will need to be trained in the use of the new forms and software. Loan originators may seek legal advice to be certain that the arrangements they make to ensure that third-party service prices are accurate and within tolerances comply with the regulation. Loan originators may also seek legal advice regarding tolerances and average-cost pricing. In this section, it is estimated that these one-time compliance costs will total \$383 million, although it is recognized below that these costs could vary with several factors such as different levels of overall mortgage activity. Small brokers and small lenders firms will experience \$268 million (or 70%) of these one-time compliance costs.

### **VII.B.1. Software Modification and Training Costs**

Loan originators would need alterations to their software to accommodate the requirements of the new rule since they generate the new GFE. There would be one-time costs for production and installation of the new GFE (software development, etc.). Software modification, or new software, is needed because the GFE has been changed. The implementation of software varies with business size. Small originators are likely to use commercial off-the-shelf (COTS) software products while larger originators may produce their own software if in-house development is cheaper than buying from outside suppliers. HUD reviewed several software products for loan origination and closing advertised on the Internet.<sup>29</sup> Prices ranged from a flat \$69<sup>30</sup> for one license to undisclosed negotiated prices based on the number of users and feature sets purchased. Software is generally priced according to the number of users (e.g., one license per user, or enterprise licenses based on the expected number of users in the enterprise).

One new requirement, implicit from the tolerances, is that originators will have to keep track of the costs listed on the GFE in order to ensure that the tolerances are not exceeded at settlement. Most of the software products HUD examined have the capability to access databases of information, including pricing information, of third-party service providers. Because these systems have the capability to access other databases, they would not need to be redesigned to carry forward prices from the GFE to the closing documents in order to determine if final settlement prices remain within tolerances. The GFE portion of the software would need

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<sup>28</sup> This analysis assumes that the mortgage broker, not the wholesale lender, produces the GFE in transactions involving mortgage brokers. To the extent that the wholesale lender is involved in producing the GFE the use of the broker data will result in an overestimation of the impact on small businesses (since small businesses make up a much larger portion of broker businesses than they do of wholesale lender businesses).

<sup>29</sup> Examples are: Vantage ILM, <http://www.vantageilm.com>; Utopia Originator from Utopia Mortgage Software, <http://www.callutopia.com/support.html>; The Mortgage Office™ from Applied Business Software, <http://www.themortgageoffice.com/main.asp>; and MORvision Loan Manager from Dynatek, <http://www.dynatek.com/products.asp>.

<sup>30</sup> Good Faith Settlement Software by Law Firm Software; <http://www.lawfirmsoftware.com/software/good-faith-estimate.htm>. Note that this is very basic software compared to other alternatives. More sophisticated software is more expensive.

to be modified to display the consolidated expense categories mandated in the rule. Redesigning the form appears to constitute a minor alteration of the software.

The new GFE also requires additional information. The first page summarizes worst case scenarios for the borrower: the maximum monthly interest rate, the maximum monthly mortgage payment, and maximum loan balance. Such information is obvious for most types of loans but could require more effort to calculate for more exotic loans such as a negative amortizing loan. Some loan origination software will already possess analytical capabilities. However, producers of less sophisticated programs will need to write a few additional lines of code to create the output for the first page of the new GFE. Nonetheless, the final rule will have no impact on the primary function of origination software and would require only minor changes.

Changes to the HUD-1 will have implications for loan origination software. The comparison page, which features a summary of the loan terms, requires lenders to provide information on the loan and settlement costs for pa3 3 of the HUD-1. Indeed, it is possible that most producers of loan origination software will begin to feature an application that generates an almost complete HUD-1 for the settlement agents to finish. One could add this application to loan origination software fairly easily. It will be a minor change since lenders enter most of the information needed for the comparison page for the GFE. The task facing the programmer will be to set up an interface for entry of additional escrow information needed in the comparison page, populate page 3 of the HUD-1 form with settlement cost and loan term data and print out the HUD-1 form. The software would also perform the important task of calculating the difference between the figures on the initial GFE and the actual settlement costs and then check whether they are within the tolerances.

Depending on the software that a firm has purchased there are three possibilities as to who pays the direct cost of developing new software. The first scenario is that a firm purchases an update of the program. This is a fairly standard option and is generally less than half the price of new software. Given that the changes required by the final rule are fairly minor, the price of an update should compensate software companies for the cost involved in altering their programs.

The second possibility is that a firm purchases new software, in which case the cost of redesigning the forms to comply with the rule will be built into the purchase price. Firms that would purchase new software would include new entrants into the industry, pre-existing firms that would have bought new software for reasons unrelated to the final rule, and firms that use software for which updates are not offered. Many users routinely upgrade software as new versions are released and build the expected expenses into their business plans. To the extent that software is routinely upgraded, the extra costs of implementing the GFE changes will be reduced. In these cases, the software cost to the firm of the final rule is not the purchase price of the software but rather the increase in the purchase price as a result of the costs of redesigning software to meet RESPA guidelines.

A third scenario is that software companies are obliged or volunteer to offer free updates, in which the case the software cost of the final rule falls directly on software developers. However, indirectly, the cost of the new software will be shared by real estate and software firms. Software companies that offer free updates will price the risk of changes into the purchase

price of the software. If a large unexpected change occurs, then the software company will bear the burden. However, the change required by RESPA will not be unexpected because the final rule will be made public and will not be costly for reasons previously discussed.

In all three scenarios, the cost of an update is a good approximation of the software cost of the rule. In the first scenario in which firms purchase an update, it would probably be an overestimate of the cost to a purchaser because an update may contain other useful improvements to the software. However, it is a reasonable estimate of the cost in that many firms would not purchase an update if not for the final rule. In the second scenario, in which a firm purchases new software, the price of an update could serve as an approximation of the cost of implementing the required changes and thus an estimate of the resulting increase in the price of new software. In the third scenario, where the software companies bear the direct cost of the change, the price of an update could serve as an estimate of the cost to software firms of producing free updates.<sup>31</sup>

In the first two scenarios, where firms bear the burden of the change in the software; the costs of new or updated software will depend upon the number of employees in the firm using the software. Virtually all software companies providing software to lenders for loan origination offer volume discounts. Such a pricing policy reduces the average cost for large firms. Second, in larger firms many employees will have specialized duties that do not include completing the new GFE form and so will not require updated software. Thus, it is likely that small firms will bear a greater per employee software cost from the final rule.

Based upon the discussion above and an examination of software pricing schemes, it is reasonable to make three assumptions in order to estimate the software costs of the final rule: 1) the cost per user is the cost of an update; 2) updates cost less than half of the cost of new software; 3) the costs per user for a firm decline significantly with the number of users. An example of the type of software that a firm might purchase is Bytepro Standard (by Byte Software, Inc., <http://www.bytesoftware.com>). This software has many analytical features such as the ability to calculate maximum loan amounts, which would be required by the new GFE. The software costs \$395 for a two user package and \$400 for five additional users. The per user cost for the first two is \$198. The cost per user for an additional five is \$80.

We can safely assume that the industry average of the cost of an update would be no more than \$150 for the first user, \$100 per user for the average small firm, and \$50 for the average large firm.<sup>32</sup> Second, we assume that the proportion of workers involved in origination that use the software declines with the size of the firm. For small firms, we assume that three-quarters of all workers use the software and will need an update. For large firms, we assume that only half of the workers use origination software and need an update. Given these assumptions,

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<sup>31</sup> Correctly estimating the cost to software firms is difficult given the nature of the output. Development is a one-time fixed cost, whereas the cost of delivering software to one user is very low. Given the decreasing average costs, the aggregate economic impact to the software industry would depend upon the number of firms.

<sup>32</sup> Byte Software, Inc. offers an annual support service, which would include updates, for up to ten users for \$300 per year. Every additional user over ten cost \$30.

the total cost to the industry of an update would be \$33 million, of which \$26 million is borne by small firms.<sup>33</sup> This amounts to an average software update cost of \$83 per user.

In addition, each employee using the new software would require some time to adjust to the changes. The actual amount of time required to familiarize ones self with the new software is unknown. For this example it is assumed that 2 hours are required. If the opportunity cost of time is \$72.12 per hour (based on a \$150,000 fully-loaded annual salary), then the opportunity cost of software training would be \$144 per worker using the new software. Software users often learn about new modifications without formal training by using them with very little loss of time or productivity. Thus the software training costs estimated below are likely an upper bound. Table 6-8 shows the distribution of these costs by industry and the amount borne by small businesses within each industry. The table uses worker distributions from Table 6-7 and assumes half of the workers in large firms and three-quarters of the workers in small firms use the software and will require upgrades and training. Given these assumptions the total software training cost is \$58 million, of which \$38 million is borne by small firms. The grand total for software upgrade and training cost is \$91 million, of which \$65 million is borne by small firms.

**Table 6-8 One-time Software Upgrade and Training Costs of the Rule to Loan originators**

<b>Industry</b>	<b>Total Software Upgrade and Training Cost</b>	<b>Small Business Cost</b>	<b>Percentage Small</b>
<b>Mortgage Brokers</b>	\$61,267,428	\$52,891,226	86.3%
<b>Commercial Banks</b>	\$11,647,288	\$3,570,897	30.7%
<b>Thrifts</b>	\$5,249,891	\$1,099,855	21.0%
<b>Mortgage Banks</b>	\$10,308,241	\$5,905,531	57.3%
<b>Credit Unions</b>	\$2,569,710	\$1,122,511	43.7%
<b>TOTAL</b>	<b>\$91,042,558</b>	<b>\$64,590,020</b>	<b>70.9%</b>

Alternative estimates could be made. If 4 hours (instead of 2 hours) of software training were required, then total costs would rise by \$57 million to \$148 million (with \$103 million being the small business cost). Assuming that only two hours are required, but that the proportions of software users were raised to all of the workers in small firms and three-quarters of the workers in large firms, then the total software cost (including training) of the final rule would be \$126 million, of which \$86 million would be borne by small firms. If the proportions are increased (as in the latter scenario) and the hours are increased (as in the former scenario), then the total cost would be \$206 (with \$137 million being the small business cost).

The estimates in Table 6-8 above are based on a “normal” level of mortgage origination activity and not that of a high volume year which might occur as a result of low interest rates. High volume years bring with them increases in productivity by existing firms and employees (higher rates of loans per employee), new employees, and new entrants. New employees and new entrants would require additional software licenses even if there were no new rule changing the GFE. For this reason, basing the software upgrade compliance burden on a high volume year would overstate the burden. Using the higher rates of productivity associated with refinancing

<sup>33</sup> To demonstrate that our estimate is a safe ceiling, suppose that there are one hundred software firms and that each one pays six programmers an average of \$150,000 a year to upgrade the software to reflect the changes incurred by the proposed rule. The total cost to the software industry would be \$90 million.

booms to compute software upgrade costs would tend to understate them. Therefore, use of the normal business volume probably provides the most appropriate estimate of this cost. Still, assuming a higher level of origination activity (15,500,000 loans) and a 65% market share for brokers, estimated software costs would be \$118 million, and \$86 million would be accounted for by small businesses (with one-half of employees at large firms and three-quarters of workers at small firms using the software and requiring 2 hours of training). As noted earlier, the costs of software upgrades required to implement the new GFE apply only to retail loan originators. These costs do not apply to wholesale lenders.

Another way of presenting the software and training costs to loan originators is to distinguish between the costs of the new GFE versus the HUD-1. This break-out is somewhat arbitrary but is useful for the discussion of the costs of the different components of the rule. Suppose the HUD-1 alterations constitute 20 percent of the software and training costs to loan originators, then of the \$91,042,558 total costs to loan originators, \$72,834,046 stem from the GFE and \$18,208,512 from the HUD-1. The costs to small business would be distributed similarly: \$52 million from the GFE and \$13 million from the HUD-1. One could experiment with different ratios of HUD-1 to GFE costs but the total would not change.

## **VII.B.2. Legal Consultation**

Using the new GFE will entail a change in business practices, including making arrangements with third-party settlement service providers to ensure that prices charged will remain within the tolerances of the prices quoted. Loan originators will want to ensure that these arrangements do not violate RESPA. It is highly likely that the trade associations for the mortgage loan origination industries will produce model agreements or other guidance for members to help them comply with the new rule. Loan originators may also want to better understand if there any legal implications of average-cost pricing. Some originators may feel no further need for additional legal advice so that they would have no legal consultation expenses as a result of the rule. Larger originators may wish to seek a greater amount of legal advice, as they perceive themselves to be at greater risk of class action RESPA litigation.

The actual amount and cost of legal services that will be incurred because of the new GFE are unknown. While it is recognized that all firms might not seek legal advice, it would seem that many firms engaged in retail mortgage origination would want some minimal legal advice, so that they understand the new rules and regulations. If all 57,937 firms sought two hours of legal advice at \$200 per hour, the fixed legal consultation expense would amount to \$23 million. In addition, firms will seek further legal advice based on their volume of transactions; in this analysis, the total volume-based legal expense amounts to 4 times the fixed expense or \$93 million. To show that this is a reasonable estimate, suppose a large originator, operating in all 50 states and the District of Columbia, required state-by-state legal reviews averaging 1-person-week (40 hours) per state. At \$200 per hour, this would amount to \$408,000. If all of the 100 largest originators acquired a similar amount of legal advice, the cost would come to \$40.8 million, which leaves approximately \$52 million for variable legal costs for other originators.<sup>34</sup>

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<sup>34</sup> If the per hour cost of legal consultation were greater than \$200 per hour, then these estimates would rise proportionately with the increase in hourly legal costs.

Under these estimates, total legal consultation expenses associated with the new GFE are expected to total \$116 million and are distributed among industries and small businesses, which bear 60.3% of the legal cost, as depicted in Table 6-9, which uses information on the distribution of firms and originations.

**Table 6-9 One-time Legal Consultation Costs of the New GFE**

<b>Industry</b>	<b>Total Legal Consultation Cost</b>	<b>Small Business Cost</b>	<b>Percentage Cost to Small Business</b>
<b>Mortgage Brokers</b>	\$73,219,520	\$56,375,264	77.0%
<b>Commercial Banks</b>	\$18,186,829	\$4,934,375	27.1%
<b>Thrifts</b>	\$7,740,284	\$1,182,697	15.3%
<b>Mortgage Banks</b>	\$12,020,625	\$5,212,708	43.4%
<b>Credit Unions</b>	\$4,706,743	\$2,147,722	45.6%
<b>TOTAL</b>	\$115,874,000	\$69,852,767	60.3%

The costs of legal consultation required to implement the new GFE apply only to retail loan originators. Wholesale lenders and settlement agents and other third-party settlement service providers do not provide GFEs and therefore they would not be subject to these costs.

### **VII.B.3. Employee Training on the New GFE**

Loan originators must fill out the new GFE and be familiar with its requirements so that they can fill out the form correctly and respond to the borrower's questions about it. So, there would be a one-time expense of training loan originators' employees in the requirements of the new rule in a range of issues such as the new forms and average-cost pricing. While the actual extent of the required training is unknown, a reasonable starting point would be that one quarter of the workers in large firms and one half of the workers in small firms would require training concerning the implications of the final rule. We assume that small firms pay tuition of \$250 per worker but that large firms receive a discount and pay only \$125 per trainee. If the training lasts an entire day, then the opportunity cost of the time, at \$72.12 an hour (based on a \$150,000 fully-loaded annual salary) would be \$577 per trainee. The total tuition cost to the industry would be \$53 million and the opportunity cost of lost time would be \$141 million, amounting to a total training cost of \$194 million. The total one-time cost for RESPA training for originator staff in the new rule would come to \$194 million or \$310 per worker (averaged across all workers). The one-time cost for small businesses is \$146 million. Table 6-10 depicts the distribution of training costs among the retail mortgage origination industries and for small businesses in each industry. It uses data on workers from Table 6-7.<sup>35</sup>

<sup>35</sup> Sensitivity analysis shows the effects of changing the number of workers participating in the training. If one half (rather than one-quarter) of workers at large firms and three-fourths (rather than one-half) of the workers at small firms attended training, then the total costs would be \$314 million (with the small business share being \$219 million); the average cost per employee would be \$503. However, as noted in the text, there may be other, less costly ways in which the knowledge necessary to comply with the GFE provisions of the final rule can be imparted to workers, which will reduce the number of workers that need formal training.

**Table 6-10 One-time Worker Training Costs of the New GFE**

Industry	Total Training Cost	Small Business Cost	Percentage Small Business Cost
Mortgage Brokers	\$134,522,236	\$119,387,019	88.7%
Commercial banks	\$22,653,771	\$8,060,292	35.6%
Thriffs	\$9,981,440	\$2,482,613	24.9%
Mortgage Banks	\$21,285,461	\$13,330,070	62.6%
Credit Unions	\$5,148,741	\$2,533,751	49.2%
<b>TOTAL</b>	<b>\$193,591,648</b>	<b>\$145,793,746</b>	<b>75.3%</b>

As explained earlier, the costs of training are probably best estimated using the more normal mortgage environment, since many of the additional employees during a refinance wave are temporary employees who may either do only general office work that does not require any GFE-specific training or who may be trained on-the-job by existing permanent employees. Still, the higher figures are reported for those who believe they are the relevant figures.

The data and table presented above depict what is likely to be an upper bound for training costs. There are other, less costly ways in which the knowledge necessary to comply with the provisions of the final RESPA rule can be imparted to workers. Small firms, in particular, are likely to take advantage of information on complying with the final rule provided by trade associations and their business partners (such as wholesale lenders), and these firms may find the time and expense of formal training unnecessary. To the extent that this is the case, the estimates reported above will over state the impact on small businesses.

We assume that no training specific to the HUD-1 will be required. Any training in the rule concerning the GFE will cover the HUD-1 as well for the loan origination industry. Almost all of the information required for the HUD-1 is from the GFE. Training concerning tolerances is a GFE issue, even though the calculation is presented on the HUD-1.

#### **VII.B.4. Comments Concerning One-Time Adjustment Costs**

**Comments.** Lenders and their trade associations opposed a 12-month implementation period on the basis that 12 months is insufficient time to prepare for compliance with the new requirements. According to one major lender, a 12-month period is far too short given the extensive nature of the changes. This lender estimated that an 18-24 month period will be required for implementation of the proposal as published on March 14, 2008. According to other major lenders, the proposed rule would require significant systems and operational changes well beyond the complex forms changes, and would take a minimum of two years to implement.

**Response.** HUD has determined to adopt a 12-month implementation period. HUD recognizes that operational changes will be required in order to implement the new rule, in addition to training staff on the new requirements. However, the need for a standardized GFE with relevant information about the loan and settlement charges is critical in light of the problems in the current market and further delay is not warranted. HUD believes that a 12-month implementation period will provide sufficient time for systems changes and training to occur. In order to ensure a level playing field, during the transition period, settlement service providers will be required to comply with the current RESPA requirements. The requirements

set forth in the rule will apply to all settlement service providers 12 months after the effective date of the rule.

### VII.C. Compliance and Regulatory Burden: Recurring Costs of the GFE

This section discusses recurring costs associated with the new GFE. Several topics are addressed, some of which have already been discussed in previous sections. We expect that the new GFE will probably be neutral (see the conclusion of Section VII.C.1) but that it may impose a burden of ten minutes per application. Assuming that to be the case and that the ratio of applications per loan remain at 1.7, then the annual recurring compliance cost of the GFE from completing applications would be \$20.40 per loan, \$255 million on all firms, of which \$134 is borne by small business. If the loan to application ratio increases to 2.7, then the annual recurring compliance cost of completing applications will be \$32.40 per loan, \$405 million in total, of which \$213 million is imposed on small business (see Table 6-11 below and section VII.D.2). Costs of the additional time spent to arrange the pricing that protects the originator from the costs of the tolerances being exceeded is estimated to be \$12 per loan or \$150 million annually, of which \$79 million is paid by small business. This additional cost of arranging tolerances does not vary by the number of applications per loan.

**Table 6-11 Recurring Compliance Costs of the New GFE by the Number of Application per Loan**

Source of Additional Cost	Per Loan Cost		Total Cost: All Firms (Millions)		Total Cost: Small Firms (Millions)	
	1.7	2.7	1.7	2.7	1.7	2.7
Processing Applications	\$20.40	\$32.40	\$255	\$405	\$134	\$213
Arranging Tolerances	\$12.00	\$12.00	\$150	\$150	\$79	\$79
Initial Underwriting	\$0.00	\$11.00	\$0	\$138	\$0	\$72
<b>Total Cost of GFE</b>	<b>\$32.40</b>	<b>\$55.40</b>	<b>\$405</b>	<b>\$693</b>	<b>\$213</b>	<b>\$364</b>

A third source of recurring compliance costs is that of underwriting additional applications. If there is no change in the application per loan ratio as a result of the rule, then the compliance costs of underwriting additional applications will be zero. If the application per loan ratio increases to 2.7, then the recurring compliance cost from preliminary underwriting will be \$11 per loan, \$138 million across all firms, of which \$72 million is from small business (see Section VI.D.3). The total recurring compliance cost on loan originators of the rule at 1.7 applications per loan is estimated to be \$32.40 per loan or a total of \$405 million (\$213 million from small business). At 2.7 applications per loan, the annual recurring compliance cost of the GFE is \$55.40 per loan or a total of \$693 million (\$364 million from small business).

#### VII.C.1. Cost of Implementing the New GFE Form

This section examines the various costs associated with filling out and processing the new GFE. In their comments on the 2008 proposed rule, loan originators commented that the proposed GFE was longer than today's GFE and that it would take more time to fill out. In addition to settlement charges, the proposed GFE contained loan terms, a trade-off table, a breakout of lender and broker fees, and a breakout of title agent and insurance fees.

There are several aspects of the new GFE that must be considered when estimating the overall additional costs of implementing it. The following discusses the various factors that will reduce costs and possibly add costs to the GFE process. As is made clear by the discussion, there should not be much, if any, additional cost with implementing the new GFE (as compared with implementing today's GFE).

**(1) Disclosure of YSP.** Under the existing scheme, mortgage brokers are required to report yield spread premiums as "paid outside of closing" (POC) on today's GFE and HUD-1. Page 2 of the new GFE has a separate block for yield spread premiums (as well as for discount points). In order to fill out a GFE under the final rule, the mortgage broker must have a loan in mind for which the borrower qualifies from the information available to the originator. Pricing information is readily available to mortgage brokers, so there is no additional cost incurred in determining the yield spread premium or discount points since they have to look and see if there is a yield spread premium under the current regime anyway. Since it is reasonable to assume that all brokers consult their rate sheets prior to making offers to borrowers, it is reasonable to assume that they know the difference between the wholesale price and par. It does not appear that disclosing the yield spread premium or discount points adds any new burden.

**(2) Itemization of Fees.** The reduction in the itemization of fees will lead to fewer unrecognizable terms on the new GFE.<sup>36</sup> That should lead to fewer questions about them and less time spent answering those questions. Of course, to the extent that the originator is precluded from including junk fees on the GFE, he or she will not have to spend any time trying to explain what they are. The confusion avoided may lead the borrower to better understand what is being presented so that questions on useful topics are more likely to come up and the originator can spend his time giving useful answers (or more time will be spent explaining useful things). In all, the simpler GFE produces a savings in time for originators and borrowers.<sup>37</sup>

**(3) Summary Page.** A summary page has been added to the new GFE in the final rule. But it should be noted that the summary page of the new GFE asks for basic information (e.g., note rate, loan amount) that is readily available to the originator and thus do not involve additional costs. The summary page simply moves items around or repeats items rather than requiring new work.

**(4) Trade-Off Table.** There is a burden to producing and explaining the worksheet in Section IV (on page 3 of the GFE) showing the alternative interest rate and upfront fee combinations (the so-called "trade-off" table or worksheet). Many commenters said customizing the trade-off table with the individual applicant's actual loan information would be difficult; these commenters recommended a generic example, possibly placing it in the HUD Settlement Booklet, rather than providing it with the GFE. However, it is important to remember that the

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<sup>36</sup> The fees in the lender-required and selected services section will still be itemized (e.g., appraisal, credit report, flood certificate, or tax service) as will those in the lender-required and borrower selected section (e.g., survey or pest inspection). There will, however, be no itemization or long lists of various sub-tasks of lender fees or title fees, often referred to as junk fees.

<sup>37</sup> Several items were dropped from the new GFE, as compared with the proposed GFE: the APR, the breakout of the origination fee into its broker and lender components, and the breakout of the title services fee were dropped. These were considered unnecessary for comparison shopping.

information in the worksheet is likely to be a reflection of a worksheet the originator already uses to explain the interest rate/upfront fee trade-off. While there may be a burden to explaining how the interest rate-point trade-off works, this explanation is something all conscientious originators are already doing in the origination process. In today's market, most lenders and brokers likely go over alternative interest-rate-point combinations with potential borrowers. For these originators, there is no additional explanation burden arising from the production of this worksheet. To the extent that some lenders only explain one option to a particular borrower (even though they offer others), there would be some additional costs for those lenders. Today, most originators present to borrowers much more complicated sets of alternative products than captured by the worksheet. It is important to remember that the main purpose of the worksheet is simply to sensitize the borrower to the fact that alternative combinations of interest rates and closing costs are available.

With respect to customizing the worksheet to the applicant's actual offer, the information on the applicant's loan is already on the new GFE, so that would not appear to be a significant problem, as that applicant information can be linked directly into the worksheet. Then, there is the issue of the two alternative combinations, one with a lower interest rate and one with a higher interest rate. Most originators offer loans with several interest rate and point combinations from which the borrower chooses. As noted above, they probably have already discussed these alternative combinations with the applicant. The originator would pick two alternatives from among the options available but not chosen by the borrower when he picked the interest rate and point combination for which his GFE is filled out. The originator would have to punch these other two combinations into his GFE software (two interest rate and point combinations) in order for the software to fill out the form. In the event that the originator does not use software to make these calculations, they would have to be done by hand.

**(5) Documentation Costs.** Loan originators are required to document the reasons for changes in any GFE when a borrower is rejected or when there are changed circumstances that result in cost increases. Once a GFE has been given, there are several potential outcomes. One is that the loan goes through to closing with tolerances and other requirements met. Another is the borrower terminates the application. Borrowers could also request changes, such as an increase in the loan amount. There could also be a rejection, a counteroffer, or unforeseen circumstances.

The March 2008 proposed rule provided that a borrower could be rejected at the GFE application stage if the loan originator determined that the borrower was not credit worthy. The borrower could not be rejected at the mortgage application stage unless the originator determined there was a change in the borrower's eligibility based on final underwriting, as compared to information developed for such application prior to the time the borrower chose the particular originator. Under the proposed rule, the originator would have been required to document the basis for such a determination and maintain the records for no less than three years after settlement.

One lender commented that under HUD's March 2008 proposed rule, lenders would be required to retain the GFE application for three years which is different from the 25 month retention requirement by TILA or ECOA. The lender commented that this difference presents additional expense without a substantive benefit to the consumer.

The first two require no special treatment. Borrower requested changes do not require documentation but do require a new GFE, as explained in (5) above. The case of borrower rejection (which assumes there is no counteroffer accepted by the borrower) requires documentation today under the Equal Credit Opportunity Act (ECOA). Under ECOA, the originator must document the reason for a rejection and retain the records for 25 months, which is also the requirement in the final rule. Therefore, there is no additional documentation required in case of a rejection. There is no documentation requirement for a counteroffer, but the lender must issue a new GFE to the borrower; the minimal burden associated with issuing an additional GFE.

Documentation for changed circumstances adds a new requirement. The additional burden associated with changed circumstances comes from having to document the reasons for the increase in costs and from determining that the amounts of the increases in charges to the borrower are no more than the increases in costs incurred by the changed circumstances. The Department does not require that a justification document be prepared. Since there are no special reporting requirements when changed circumstances occur, compliance could be met by simply retaining the documentation in a case binder, as any other relevant loan information might be retained in a case binder today. For example, itemized receipts for the increased charges would simply be put in the loan case binder (as they probably are today). Case binders are stored now. The additional cost of identifying and storing the documentation in that binder would be de minimus. This would represent little burden on the originator, particularly since unforeseen circumstances will not be the norm.

There may be some record retention issues with small originators, such as brokers. If small originators retain case binders today, then their situation would be similar to other originators. If they do not retain the case binder today, then they may choose to do so, or they may rely on their wholesalers for record retention. It might well become a selling point for wholesalers. Relative costs of storage, reliability, and accessibility would determine who could best perform this function.

**(6) Crosswalk from New GFE to New HUD-1.** The HUD-1 in the final rule has been changed so that it matches up with the categories on the new GFE – making it simple for the borrower to compare his or her new GFE with the final HUD-1 at closing. In addition, a comparison page has been added to the HUD-1 to clarify any changes in settlement fees. The simplification of the GFE does not add any burden for the borrower to the comparison of the figures on the two forms – rather it will be reduced since it will now be easier for the borrower to match the numbers from the GFE (issued at time of shopping) with those on the HUD-1 (issued at closing). Compared with today, it also eliminates the step of adding a pointless list of component originator charges to get the relevant figure, the total origination charge. In addition, the elimination of extra itemized fees on the GFE may lead to the elimination of them on the HUD-1 since they may have been on the GFE only to overwhelm the comparison shopper. Even without the new comparison page, the settlement would have been more transparent for the borrower. However, requiring that an additional page be completed will impose some costs on the industry. Compliance costs of the this change are discussed in detail below.

**(7) Mortgage Comparison Chart (“Shopping Chart”).** The shopping chart is on the third page of the GFE. It is delivered to the borrower as a blank form. The borrower is free to

fill it out and use it to compare different loan offers. The loan originator is only required to hand it out, but has the option of answering borrower questions about it. The short, simple, and self-explanatory nature of the form leads the Department to believe that the additional costs per form, if any, borne by an originator would approach zero.

**Summary.** To summarize, the discussion of the above factors identifies offsetting costs and suggests that there will be little if any additional annual costs associated with the new GFE. Practically all of the information required on the new GFE is readily available to originators, suggesting no additional costs. The fact that there are fewer numbers and less itemization of individual fees suggests reduced costs. The fact that the GFE figures are displayed on the HUD-1 will substantially simplify the closing process. In addition, Section VII.D below lists further changes that HUD made to the form that are likely to reduce costs. On the other hand, there could be some small amount of additional costs associated with the optional trade-off table and documentation requirements. If there were additional costs of, for example, 10 minutes per GFE, the dollar costs would total \$255 million per year (if the number of applications did not increase as a result of the result).<sup>38 39</sup> But given the above discussion of offsetting effects and the improvements made to the form, there are likely to be no additional net costs with implementing the new GFE. Note, however, that there is the potential for recurring costs from changes to the HUD-1 . This issue is summarized in Section VIII.C.

#### **VII.D. Detailed Response to the NAR's Analysis of the 2008 IRFA**

The National Association of Realtors provided an alternative estimate of compliance costs prepared by Ann Schnare (2008). The main thrust of their report was that HUD had grossly underestimated the compliance costs of the 2008 proposed rule. The following four sections summarize major comments relevant to estimates of the compliance costs of the new GFE.

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<sup>38</sup> This calculation assumes a \$150,000 fully-loaded annual salary; dividing by 2,080 hours yields \$72 per hour, or \$12 for ten minutes. Assuming 21,250,000 applications, produces a cost figure of \$255 million. At 15 minutes, the cost estimate would rise to about \$382.5 million. In the higher volume environment (26,350,000 applications), the overall cost figure would be \$316.2 million if the per application cost was \$12 for ten minutes.

<sup>39</sup> We have used a fully-loaded hourly opportunity cost of \$72.12 for highly-skilled professional labor throughout the Economic Analysis. For many functions as well as locations this amount is probably an overestimate of the hourly opportunity cost. However, our goal in the Economic Analysis is to accurately measure the upper bound of the costs of the rule. An alternative method would be to generate an estimate of the average variable cost from industry-specific data. For example, in Tucson, Arizona, the average unit labor cost (salary, bonuses, time off, social-security, disability, healthcare, 401(k), and other benefits) is \$30.73 per hour for loan officers (\$23.97 for a Loan Officer/Counselor; \$28.48 for a Consumer Loan Officer I; and \$39.75 for a Consumer Loan Officer II). Additional costs to be considered are rent (\$2812.50 per month for 1500 square feet) and computer equipment (\$560 per month). Summing this gives us an hourly cost of \$31.14. An additional ten minutes per application from handling the forms and ten minutes arranging tolerances leads to an additional twenty-seven minutes per closing and would increase costs by \$14 per loan. The estimate of the recurring annual burden of the new GFE could reasonably be assumed to be \$175 million, much less than the \$405 million used throughout this analysis.

### VII.D.1. Hedging Costs of the New GFE

**Comment.** The NAR's primary objection to HUD's estimates of the compliance costs of the proposed GFE was that HUD does not account for the hedging costs that an interest rate guarantee would require (Schnare 2008). Indeed, the majority of the NAR's cost estimate for the GFE consists of so-called "hedging" expenses. They claim that the rule would require issuers of GFEs to insure against interest rate movements to keep GFE offers open for the required 10 business days. According to the NAR report, the hedging costs could range from \$136 to \$272 per loan. Making this assumption dramatically increases the cost estimate for the GFE. The NAR's addition of hedging costs *quadruples* HUD's baseline estimate of the compliance cost of the proposed rule from \$45 to \$181.

**Response.** The NAR made an erroneous assumption about the proposed Good Faith Estimate (GFE) that lead them to overstate the compliance costs. A more accurate estimate of the hedging costs would be zero. Neither the proposed rule nor the final rule requires lenders to guarantee an interest rate quoted on a GFE for a period of ten days. Interest-dependent items on the GFE (interest rate, monthly payment, YSP/discount points, adjusted origination fees, and daily interest charges) can have a separate availability period that can be as short as the time until a new rate sheet is issued. Only the prices on non-interest-dependent items on the GFE (total origination fees, appraisal fees, title fees, etc.) must remain available for 10 days. These interest-rate-dependent items only become fixed, for purposes of comparison to the HUD-1 at closing, when the borrower locks the interest rate.

Indeed, the NAR study acknowledges that there is no such requirement. Ann Schnare writes: "HUD's revised GFE has multiple dates for the offer: one for the origination fee and third party settlement costs; one for the quoted interest rate; one for the settlement date; and one for the number of days that the loan must lock before closing (NAR, fn. 6, p. 10)." HUD let these dates differ because HUD is aware that the hedging costs of an interest guarantee for a period as long as ten days would be very costly.

The loan originator will probably choose a shorter guarantee period for the interest rate because of the hedging costs. Ann Schnare admits this to be a possibility: "the originator could choose a lock-in<sup>40</sup> period that is considerably shorter than the 10 business days required for other components of the GFE in order to minimize its hedging costs (NAR, p. 9)." Choosing the guarantee period of the interests rate is a profit maximizing decision made by the originator. The originator will balance the benefits of attracting more customers by extending the guarantee period with the hedging costs of doing so. The current practice of loan originators is to quote an interest rate and other interest-rate-dependent rates with the caveat that the offer would change if market interest rates change. Since there is no reason to believe that hedging behavior will be affected by the rule, hedging costs should not be included as a compliance cost. Once this understanding of the proposed rule is introduced into the NAR's cost estimate of the proposed rule, the NAR's estimate falls from \$181 to \$45 (identical to HUD's estimate of the cost of the proposed rule) in their low-cost scenario; from \$316 to \$101 in their intermediate-cost scenario; and from \$413 to \$141 in their high-cost scenario.

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<sup>40</sup> HUD's understanding is that by "lock-in" period, the NAR meant "guarantee" period.

## VII.D.2. Administrative Costs of More GFE Applications

**Comment.** A second major criticism by the National Association of Realtors of HUD's regulatory impact analysis of the 2008 proposed rule is that HUD underestimated the administrative costs of the proposed rule by not raising the number of loan applications per GFE. HUD's estimate of the ratio of applications to loans after the rule is implemented is equal to its estimate of the observed ratio of 1.7 in HMDA data. The NAR argues that the number of applications would rise because of increased shopping. Thus, the administrative costs of applications should rise.

**Response.** It is reasonable to expect that given the improvements to the GFE and the greater rewards from shopping, that the demand for applications would increase. Note, however, that maintaining a ratio of 1.7 loans per application is not inconsistent with more shopping for loan products. First, consumers may shop around and ask a variety of lenders for informal quotes to compare with their GFE. Every inquiry will not necessitate a new GFE. Second, the rule is likely to lead to lower rejection and withdrawal rates of applications because consumers will be more informed going into the loan. HUD expects applications from increased shopping behavior to replace some mortgage applications that may have otherwise resulted in rejections. However, in response to this comment, HUD provides a sensitivity analysis of the effects on administrative costs of increasing applications per loan.

For reasons explained in the above paragraph, the number of applications per loan may remain at 1.7 applications per loan. If the additional administrative burden of an application imposed by the rule is ten minutes per application (as discussed in Section VII.C.1), then the additional burden of the rule translates to 17 minutes per loan (1.7 applications per loan X ten minutes). To derive the opportunity cost of the rule, we multiply 17 minutes by \$1.20 per minute (equivalent to the \$72 per hour fully-loaded opportunity cost of time, which comes from our \$150,000 annual figure), to per loan cost of additional applications of \$20.40 per loan. The aggregate impact on the loan origination industry of the administrative burden of completing applications is calculated using the per loan figure: the annual recurring compliance cost is \$255 million (12.5 million loans annually X \$20.40 per loan). The small business share of the total recurring compliance cost of this administrative burden is \$134 million (52.2 percent of \$255 million).

Suppose that the number of applications per loans increased by one from 1.7 to 2.7. This was one of the scenarios considered in the NAR's analysis. The NAR hypothesized that this is likely given that consumers may have a greater demand for a GFE once HUD's new GFE, which provides useful and transparent information, is introduced. Calculating the compliance costs due to the additional burden of completing GFEs is straightforward. The additional time spent per loan would be 27 minutes (2.7 application per loan X 10 minutes) and the opportunity cost of that time would be \$32.40 per loan (27 minutes X \$1.20 per minute). The total recurring compliance cost to the origination industry from applications would be \$405 million (12.5 millions loan per year X \$32.40 per loan), of which \$213 million is borne by small business (52.2 percent of \$405 million).

### VII.D.3. Multiple Preliminary Underwritings

**Comment.** Every application under the new rule requires preliminary underwriting. Since borrowers who shop may seek out multiple GFEs, there will be multiple underwritings. Commenters said this will add to the underwriting burden firms incur today. The National Association of Realtors calculated an additional cost of multiple underwriting at \$30 per loan for an application per loan ratio of 2.7.

**Response.** Every application under the final rule that generates a GFE will require preliminary underwriting in order to come up with an early offer for the borrower. Originators can charge a fee for issuing a new GFE limited to the cost of a credit report. It is hoped that the charge for this, if any, would be small enough so that it is not a significant deterrent to effective shopping. But whether or not there is a charge, there are real resource costs associated with preliminary underwriting. The additional cost generated depends on the number of applicants and the number of GFEs they receive. Since every completed loan eventually gets underwritten in full, the additional cost of preliminary underwriting depends mainly on the number of additional times that preliminary underwriting occurs beyond the one associated with the full underwriting that would have occurred under the existing scheme.

It cannot be determined how many additional GFEs the average borrower would get under the new rule. Borrowers might continue the informal shopping method that many use today – gathering information and making inquiries to lenders and brokers about their products and their rates, even before deciding to proceed with the request for a more formal quote using the GFE. In other words, they may formally apply only after deciding who offers the best terms. The simple format and clarity of the new GFE form will enhance this informal information gathering process; in fact, the increased efficiency of informal shopping (calling around, checking web sites, etc.) could be an important benefit of the new GFE. Since shoppers as well as originators will be familiar with the GFE, these forms will likely serve as a guide for practically any conversation between a shopper and an originator, or for any initial request by a shopper for preliminary information about rates, points, and fees. For these borrowers, the new GFE simply pins down the numbers. Others, on the other hand, may obtain multiple GFEs and use them to shop.

Under the final rule, preliminary underwriting should decrease the number of applications that go to full underwriting (e.g., an applicant may be denied during the preliminary without having been charged for an appraisal); that is, some of the 8.75 million that are not originated may be disapproved at the preliminary stage rather than going through full underwriting (as they might today). This savings in appraisal, verification, and other incremental underwriting costs that are avoided would tend to offset the increase in cost resulting from the extra preliminary underwriting noted in the above paragraph. However, it is difficult to estimate these effects.

An implication of a higher ratio of applications per loan is that the total underwriting costs would increase. Others, on the other hand, may obtain multiple GFEs and use them to shop. The National Association of Realtors estimates that the cost of a *preliminary* underwriting is \$30 (\$25 credit report and \$5 labor cost). There are currently 1.7 times as many applications as loans originated. Thus, the additional cost per loan for the scenario of 2.7 applications per loan is \$30  $((2.7-1.7) \times \$30)$  and for 3.4 applications per loan, the additional cost is \$52  $((3.4-$

1.7) X \$30). HUD uses different parameters to estimate the cost of increased applications. Instead of a preliminary credit report cost of \$25, HUD would use \$5. This lower number is not inconsistent with HUD's estimated cost of \$25 for a *full* credit report. A preliminary credit report involves only the FICO score from one credit bureau and so will be much cheaper. Our assumption of an inexpensive preliminary credit report is consistent with what representatives of credit bureaus, in discussions of the effects of the proposed rule, told HUD is likely to happen. Instead of labor costs of \$5 (ten minutes at \$31.14 an hour); HUD uses \$6 (five minutes at \$72 an hour). HUD's estimated total cost of a preliminary underwriting would be \$11, reducing the additional costs from \$30 to \$11 at 2.7 applications per loan.

The aggregate impact on the loan origination industry of multiple preliminary underwriting is calculated using the per loan figure: the annual recurring compliance cost is \$138 million (12.5 million loans annually X \$11 per loan) at 2.7 loans per application. The small business share of the total recurring compliance cost from additional underwriting is \$72 million (52.2 percent of \$138 million). If the ratio of applications per loan does not change (remains at 1.7), then there will be no additional compliance cost from multiple preliminary underwriting.

Finally, it should be emphasized that, under the final rule, preliminary underwriting should decrease the number of applications that go to full underwriting (e.g., an applicant may be denied during the preliminary without having been charged for an appraisal). Some of the assumed 8.75 million applications<sup>41</sup> that are not originated may be disapproved at the preliminary stage rather than going through full underwriting (as they might today). We expect an increase in the ratio of *accepted* applications per loan. This savings in appraisal, verification, and other incremental underwriting costs that are avoided would tend to offset the increase in cost resulting from the extra preliminary underwriting noted above.

#### **VII.D.4. Estimate of the Opportunity Cost of Time**

**Comment.** The National Association of Realtors states (see NAR 2008, fn. 10, p. 11) that HUD used one estimate of the value of an employee's time (\$31.14 per hour) to calculate the burden of the proposed rule but a higher estimate (\$72 per hour) of the opportunity cost of time to calculate the benefits of the time savings of the proposed rule.

**Response.** HUD uses the estimate of \$72 per hour as the opportunity cost of time consistently throughout the regulatory impact analysis to calculate the value of the costs and the benefits of the rule to industry. It is true that HUD includes a discussion of alternative estimates of labor costs in a footnote of Chapter 6 (see below)<sup>37</sup> on page 6-6 of the Regulatory Flexibility Analysis. There, HUD explains that our estimate of \$72 per hour may be far above other estimates of labor costs. HUD provides an example of an estimate based on industry data from Tucson, Arizona, where the hourly-wage weighted by industry is \$31.14. However, this figure was only presented for illustrative purposes and was not used in the body of the analysis. Note

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<sup>41</sup> There are currently 1.7 times as many applications as loans originated; therefore, if originations are 12.5 million, full underwriting is started (and probably completed) for about 21.25 million applications, including 8.75 million (21.25 million minus 12.5 million originations) that are not originated.

also that HUD uses a *lower* value of \$44 per hour as the opportunity cost of time to consumers (see HUD, 3-120)

The NAR uses the \$31.14 hourly wage as a measure of the opportunity cost of an employee's time in their cost estimates of additional underwriting. However, they do not apply this figure consistently throughout their analysis and do not explain why. Because \$31 is only 43% of \$72, a uniform application of the NAR labor cost estimate would lower the burden of the rule significantly. For example, the recurring costs of the GFE would fall from \$32 per loan to \$14 in the case of 1.7 applications per loan. Although HUD will consider the NAR's preference for a lower estimate of labor costs, HUD believes that its fully-loaded and upper-bound estimate of \$72 is more appropriate for a regulatory impact analysis.

### **VII.E. Tolerances on Third-Party Fees**

Under the March 2008 proposed rule, loan originators would have been prohibited from exceeding at settlement the amount listed as "our service charge" on the on the GFE, absent changed circumstances ("zero tolerance"). The proposed rule also would have prohibited the amount listed as the charge or credit to the borrower for the interest rate chosen, if the interest rate was locked, absent unforeseeable circumstances, from being exceeded at settlement. In addition, the proposed rule would have prohibited Item A on the GFE, "Your Adjusted Origination Charges" from increasing at settlement once the interest rate was locked. The proposed rule also would have prohibited government and recording fees from increasing at settlement, absent changed circumstances.

Under the March 2008 proposed rule, the sum of all the other services subject to a tolerance (originator-required services where the originator selects the third party provider, originator-required services where the borrower selects from a list of third party providers identified by the originator, and optional owner's title insurance, if the borrower uses a provider identified by the originator) would have been prohibited from increasing at settlement by more than 10 percent of the sum for services presented on the GFE, absent changed circumstances. Thus, a specific charge would have been able to increase by more than 10 percent, so long as the sum of all the services subject to the 10 percent tolerance did not increase by more than 10 percent.

The rationale for the zero tolerance was that a loan originator should know the price of a service if it required the use of its chosen provider. In the case of making referrals, the loan originator could be expected to have some knowledge of the market. In fact, it should have some knowledge if it is to meet even the weakest concept of "good faith." The 10 percent tolerance seemed like a reasonable limit for price dispersion for services obtained in a market that could be competitive if the buyers had good information. It is also simple for borrowers quickly to compute 10 percent of the total fee and determine if final charges are within the tolerance. In order to protect themselves from charges in excess of the limits set by the tolerances, originators would have to gather price information in the market and possibly set up agreements with some third-party providers to perform settlement services at prearranged prices. Those originators who would have gathered more information than they do today or made more pricing

arrangements than they do today would have incurred an increase in regulatory burden resulting from the new rule.

**Comment.** Loan originators wrote that they should not be required to pay the bills for third-party fees in excess of the tolerances since they do not control those fees. They argued that their expertise is as originators, not as appraisers or title companies. They claimed that they do not know who will perform all these services at application, so the price is indeterminate. In addition, there are occasions when services beyond the normal minimum will be required, but that cannot be known at application. For example, additional appraisal work may be required or some work may have to be done to clear up a title problem. So prices and even some services that end up as being required are unknown at application.

Trade groups representing settlement service providers, especially realtors and title companies, focused on the potential anticompetitive effects of the tolerance provisions. These groups suggested that large lenders would seek to manage the risks associated with tolerances by contracting with large third party settlement service providers, and thereby placing small settlement service providers at a competitive disadvantage.

In addition to their general objections to the tolerance provisions, lenders and trade groups representing lenders and other settlement service providers strongly supported removing government recording and transfer charges from the tolerances. They stated that these charges are outside of the control of the loan originator and cannot be known with any certainty at the time the GFE is provided.

If the loan originator solves its problem by using only those third-parties that agree to fixed prices, that shifts the burden to the third-party. Small third-party providers made the same argument that small originators made. They then will be disadvantaged relative to large third-party providers by having to bear the risk of the unpredictable cost that cannot be averaged out over a large number of transactions.

**Response.** Based on the comments received in response to the proposed rule, HUD has revised a number of provisions dealing with the tolerances, and in particular has clarified the situations where the loan originator would no longer be bound by the tolerances. However, HUD has determined that only limited changes are necessary in the tolerances themselves. Through all of these provisions, the final rule seeks to balance the borrower's interest in receiving an accurate GFE early in the application process to enable the borrower to shop around, with the lender's interest in maintaining flexibility to address the many issues that can arise in a complex process such as loan origination.

Many commenters recommended changes to the size of the tolerances for different categories of settlement costs, especially the zero tolerance for loan originator charges. With one exception (government recording and transfer charges), the final rule does not change the amounts of the tolerances permitted for the different categories of settlement costs. As noted in the rule, HUD considered the best available data on the variation in the costs of settlement services, in particular title services, in determining that a 10 percent tolerance is reasonable. No commenters submitted or identified any alternative data sources that would support expanding the tolerances beyond 10 percent.

With respect to the zero tolerance for a loan originator's own charges, HUD recognizes the comments characterizing the tolerance as a settlement cost guarantee. However, the final rule provides substantial flexibility to loan originators in providing a revised GFE when circumstances, unforeseeable or otherwise, necessitate changes. Section 19(a) provides explicit authority for the Secretary to make such interpretations as may be necessary to achieve the purposes of RESPA. Providing a clear, objective standard for what constitutes "good faith" under section 5 of RESPA is necessary to provide more effective advance disclosure to home buyers and sellers of settlement costs, and as such, falls directly within the Secretary's interpretive authority under section 19(a).

The one exception to the amounts of the tolerances remaining the same as in the proposed rule is the tolerance for the government recording and transfer charges. HUD has adjusted how these charges are treated under the tolerances, based on the numerous comments received on this issue. The final rule splits the government recording and transfer charges into two categories: government recording charges, and transfer taxes. Recording charges will be subject to a 10 percent tolerance instead.

The opportunity to cure potential violations of the tolerances is an important tool for loan originators to manage compliance with the tolerance requirements. Many lenders and groups representing lenders and other settlement service providers objected to the imposition of tolerances because of the difficulty of providing accurate estimates to prospective borrowers early in the application process. The opportunity to cure will permit loan originators to give an estimate of expected settlement charges in good faith, without subjecting them to harsh penalties if the estimate turns out to be lower than the actual charges at settlement.

HUD understands that tolerances will impose some burden on originators. Since the protection of tolerances kicks in only if the originator requires the use of a particular provider or if the borrower comes to the originator and asks where the services may be purchased within the tolerances, the originator must have reliable third-party settlement service provider pricing information. Some originators might simply check out the market prices for third-party services from time to time, formulate estimates such that several of the prices charged by the third parties fall within the tolerance, and trust that nobody to whom they refer the borrower charges a price in excess of the tolerance<sup>42</sup>. Other originators might want more protection and have contracts or business arrangements in place that have set prices for services that are not in excess of the tolerances.

Either case requires the originator to do more than today, although even today originators fill out GFEs with estimates for third-party settlement services. In the first case, the liability in the event a tolerance is exceeded would lead to at least a little more work gathering information prior to filling out the GFE. In the second case, more work would be involved in formalizing an agreement to commit the third-party to a fixed price. But as noted above, originators today have to have a working knowledge of third-party settlement service prices to fill out a GFE. Therefore, it is only the increase in burden that would need to be accounted for here.

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<sup>42</sup> Other originators may rely on vendor management companies (or vendor management departments within their own company) for pricing information about third-party services.

It is difficult to estimate these incremental costs. But to provide an order of magnitude, it is estimated that it takes an average of 10 additional minutes per loan for the originator to arrange the pricing that protects the originator from the costs of the tolerances being exceeded.<sup>43</sup> For a brokerage firm originating 250 loans per year, 10 minutes per loan would come to 42 hours or about one week’s worth of one employee’s time per year. Thus, this seems to be a reasonable starting point for estimation. For the estimated 12,500,000 loans, that comes to 125,000,000 minutes or 2,083,333 hours. At \$72 per hour, which translates to \$12 per loan, this comes to a total of \$150 million for all firms and \$78 million for small firms. If it takes 20 extra minutes per loan instead of 10, these costs come to \$300 million and \$156 million respectively and would be two weeks of one employee’s time per year for a brokerage firm making 250 loans per year. Table 6-12 details the distribution of these costs among the retail mortgage originating industries for the per loan burden of ten minutes. With a larger number of loans (15,500,000), total costs are \$186 million for all firms (at 10 minutes per loan) and \$97 million for small firms.

**Table 6-12 Incremental Costs of Third-party Pricing Arrangements for the New GFE**

Industry	Total Third-party Pricing Arrangement Cost	Small Business Cost
<b>Mortgage Brokers</b>	\$90,000,000	\$63,000,000
<b>Commercial Banks</b>	\$24,637,800	\$4,678,718
<b>Thrifts</b>	\$11,697,000	\$1,441,070
<b>Mortgage Banks</b>	\$18,618,000	\$7,737,641
<b>Credit Unions</b>	\$5,047,200	\$1,470,754
<b>TOTAL</b>	\$150,000,000	\$78,328,183

One wholesale lender, ABN-AMRO, offers a One-fee program to brokers. In it, the borrower gets a fixed price for many services, including many third-party services. Under the new GFE, arrangements like this would solve the broker’s tolerance compliance requirements with the wholesaler making the arrangements for many of the third-party services and negotiating the prices for them. So it may be that (mostly large) wholesalers offer (mostly small) brokers a lower cost alternative to complying with the tolerance requirements of the new rule. If so, then the small business burden above would be an overestimate. Vendor management companies are increasingly appearing in the market, not only providing third-party pricing information, but also offering monitoring and quality control services for originators.

## **VII.F. Changes in the Final Rule to Reduce the Regulatory Burden of the GFE<sup>44</sup>**

The final rule contains several changes from the 2008 proposed rule that are designed to reduce regulatory burden of the new GFE. Several items that commenters were concerned about have been changed from the 2008 proposed to the final GFE:

- **Length of form.** Many industry groups complained that the four-page proposed GFE was too long. HUD reduced the form in the final rule to three pages by consolidating

<sup>43</sup> These 10 minutes would be beyond what the originator spends today to seek out good choices for his borrowers.

<sup>44</sup> See Chapter 3 for or a treatment of changes listed in this section.

the third and fourth pages but still retaining the essential trade-off table and shopping chart.

- **Concept of “GFE application”** Commenters objected to the bifurcated application process (a preliminary “GFE application” followed by the final “mortgage application”), which was designed to promote shopping. There was a fear of commitment by lenders to loan terms based on a preliminary underwriting, as well as fear that the preliminary underwriting would be based on information that was too limited (borrower’s name, social security number, gross monthly income, property address; an estimate of the value of the property; and the amount of the mortgage loan sought). In response, HUD has adopted a single application process for the final rule. Under this approach, at the time of application, the loan originator will decide what application information it needs to collect from a borrower, and which of that collected application information it will use, in order to issue a meaningful GFE. HUD strongly urges loan originators to develop consistent policies or procedures concerning what information it will require to minimize delays in issuing GFEs.
- **Volume-based discounts.** Small businesses, especially closing attorneys and escrow companies stated that lenders seeking volume discounts would place them at a competitive disadvantage to larger entities and force them out of business. HUD responded by not addressing volume discounts in its final rule.
- **Difficulty of meeting tolerances.** Many lenders and groups representing lenders and other settlement service providers objected to the imposition of tolerances because of the difficulty of providing accurate estimates to prospective borrowers early in the application process. The final rule provides loan originators with an opportunity to cure any potential violation of the tolerance by reimbursing the borrower any amount by which the tolerances were exceeded. The opportunity to cure will permit loan originators to give an estimate of expected settlement charges in good faith, without subjecting them to harsh penalties if the estimate turns out to be lower than the actual charges at settlement.

## **VIII. Costs Associated with Changes to the HUD-1**

This section discusses costs on closing agents associated with the new HUD-1. Section VIII.A explains the data and VIII.B the analysis of costs.

### **VIII.A. Data on Settlement Service Providers**

Section VII.A reproduced background data on the retail mortgage origination industries. Since the GFE affects settlement service providers as well as retail mortgage originators, this section recapitulates data from Chapter 5 on the settlement services industries. Readers are referred to Section IV of Chapter 5 for a more detailed treatment of the data.

Table 6-13 provides the total number of firms, the number of small employer firms, the number of nonemployer firms, and the percent of small firms (employer and nonemployer) in industries that provide settlement services (see Chapter 5 for details on the classification of small employer firms in these industries). These constitute all of the firms in these industries in 2004, according to the Census Bureau. As discussed below, for Offices of Lawyers, Other Activities Related to Real Estate (Escrow), Surveying & Mapping Services, Extermination & Pest Control Services, and Credit Bureaus, the figures in Table 6-13 almost certainly overstate the number of firms actually participating in residential real estate settlements.<sup>45</sup>

**Table 6-13. Firms in Industries Providing Settlement Services**

<b>Industry</b>	<b>Total Firms</b>	<b>Small Employer Firms</b>	<b>Nonemployer Firms</b>	<b>Percent Small Firms</b>
<b>Direct Title Insurance Carriers</b>	2,094	1,865	135	95.5%
<b>Title Abstract and Settlement Offices</b>	14,211	7,889	6,203	99.2%
<b>Offices of Lawyers</b>	401,553	165,127	234,849	99.6%
<b>Other Activities Related to Real Estate (Escrow)</b>	463,545	15,119	448,409	99.996%
<b>Offices of Real Estate Appraisers</b>	65,491	15,656	49,802	99.9%
<b>Surveying &amp; Mapping Services</b>	18,224	8,990	9,196	99.8%
<b>Extermination &amp; Pest Control Services</b>	18,000	10,018	7,935	99.7%
<b>Credit Bureaus</b>	1,285	710	545	97.7%
<b>TOTAL</b>	<b>984,403</b>	<b>225,374</b>	<b>757,074</b>	<b>99.8%</b>

**SOURCE: Census Bureau**

Table 6-14 provides the total number of employees in employer firms, and the number and percent of employees in small employer firms for each of the settlement services industries.<sup>46</sup> The Census Bureau does not count owners of employer and non-employer firms as employees. The number of “workers” in these industries is understated by the number of employees as defined by the Census Bureau because in a nonemployer firm the owner is a production worker as is likely also true for the owner of a small employer firm. Using the Census Bureau’s count of employees for computing the compliance burden of a rule may tend to understate the burden.<sup>47</sup> Thus in computing the number of workers in these industries, one

<sup>45</sup> As shown by the fourth column, practically all firms qualify as small businesses. This is partially due to the large number of non-employer firms (which automatically qualify as a small business) included in the Bureau of Census data. See Chapter 5 for further discussion of this issue and for small business percentages for employer firms only. Also note that while the number of firms is drawn from year 2004 data, the small business percentages are based on 2002 data from the Bureau of Census; while they are estimates, they are probably highly accurate ones. Also see Chapter 5 for the source of the small business percentages and for alternative, year-2002-based small business percentages based on firms with less than 100 employees.

<sup>46</sup> The “Total Employees” data in Table 6-10 are for the year 2004. The “Employees in Small Employer Firms” data are obtained by multiplying the total employee data for 2004 by the percentage of employees in SBA-defined small firms obtained from 2002 Bureau of Census data; thus, the small employee data are estimates but probably highly accurate ones. See Chapter 5 for discussion of the 2002 small business percentages.

<sup>47</sup> For example, if worker training were required by the rule, and burden estimates were based on Census Bureau employee statistics, the compliance burden for nonemployer firms would be estimated at zero, while clearly at least one “worker,” the owner, would require the training.

worker is added for each small employer firm and each nonemployer firm to the total number of employees (see Table 6-16 below for these results).

**Table 6-14. Employees In Industries Providing Settlement Services**

Industry	Total Employees in Employer Firms	Employees in Small Employer Firms	Percent Employed by Small Firms
Direct Title Insurance Carriers	75,702	7,144	9.4%
Title Abstract and Settlement Offices	79,819	47,913	60.0%
Offices of Lawyers	1,122,723	657,749	58.6%
Other Activities Related to Real Estate (Escrow)	67,274	40,074	59.6%
Offices of Real Estate Appraisers	45,021	37,300	82.8%
Surveying & Mapping Services	61,623	53,610	87.0%
Extermination & Pest Control Services	95,437	55,565	58.2%
Credit Bureaus	25,555	5,135	20.1%
<b>TOTAL</b>	1,573,154	904,490	57.5%

**SOURCE: Census Bureau (note: non-employer firms not included)**

Table 6-15 provides information on the volume of settlements for various industries that participate in the settlement process and the number and percent handled by small firms within each industry.<sup>48</sup> Note that while the distribution among Direct Title Insurance Carriers, Title Abstract and Settlement Offices, Offices of Lawyers, Lawyers and Escrow, Offices of Real Estate Appraisers, and Credit Bureaus is based on all settlements, the numbers and percentages for the other industries (Surveying & Mapping Services and Extermination & Pest Control Services) represent the proportion of settlements in which they are involved.<sup>49</sup> The allocation is

<sup>48</sup> The small business percentages in Table 6-12 are the shares of revenue accounted for by small business, as reported and explained in Chapter 5 – in other words, the small business share of revenues is being used here as a proxy for the small business share of settlements (or mortgage loans). There are two other points that should be made about these data. (1) Figures for Offices of Lawyers and Other Activities Related to Real Estate (Escrow) are combined into the new “Lawyers and Escrow” category. This is because there is insufficient information to allocate volumes of settlements between these two industries (see Section IV.B.5 of Chapter 5 for further explanation). As explained in Chapter 5, the small business revenue share for the combined “Lawyers and Escrow” category is raised to 90% (versus 47.8% for all lawyers and 86.9% for escrow firms based on 2002 Census Bureau revenue data) under the assumption that lawyer and escrow firms engaged in real estate activity are likely to be the smaller firms operating in these industries. Note that in Table 6-13 below, the 90% figure is also used for the share of employees in small firms in this combined industry. (2) As explained in Section IV.B.4 of Chapter 5, there are probably no small businesses in the Direct Title Insurance Carriers (DTIC) industry, which includes the large title insurance firms. The 4.8% figure in Table 6-12 (as well as the 9.4% figure in Table 6-10) is reported to remain consistent with the Bureau of Census data – including it or excluding it does not affect the results in any significant way.

<sup>49</sup> See Step (9) in VII.E.1 of Chapter 3 for the calculation of the proportion of settlements for Surveying & Mapping Services and Extermination & Pest Control Services. Because of their relatively small shares of the overall mortgage business, different shares for these industries would not materially affect the overall small business shares of revenue. While it is recognized that the other industries may not be involved in every mortgage origination and settlement transactions (e.g., an appraisal may not be required for some mortgage originations), they are certainly involved in most such transactions and, therefore, it is assumed here that they are involved in all transactions.

based upon estimated dollar revenues from settlements for these industries.<sup>50</sup> Totals are estimated based on the number of mortgage originations, 12,500,000 that would occur in a “normal” year of mortgage originations (i.e., not in a year with a refinancing boom).

**Table 6-15. Volume of Settlement Service Activity**

<b>Industry</b>	<b>All Settlements</b>	<b>Percent of Settlements</b>	<b>Settlements by Small Firms</b>	<b>Percent Industry Settlements by Small Firms</b>
<b>Direct Title Insurance Carriers</b>	5,375,000	43.00%	258,000	4.80%
<b>Title Abstract and Settlement Offices</b>	4,749,953	38.00%	2,365,476	49.80%
<b>Lawyers and Escrow</b>	2,375,048	19.00%	2,137,543	90.00%
<b>TOTAL SETTLEMENTS</b>	12,500,000	100.00%	4,761,019	38.09%
<b>Offices of Real Estate Appraisers</b>	12,500,000	100.00%	10,387,500	83.10%
<b>Surveying &amp; Mapping Services</b>	3,600,000	28.80%	2,926,800	81.30%
<b>Extermination &amp; Pest Control Services</b>	5,500,000	44.00%	2,964,500	53.90%
<b>Credit Bureaus</b>	12,500,000	100.00%	1,312,500	10.50%

A larger volume of mortgage activity can also be examined, for example, to reflect a “refinance environment”.<sup>51</sup> In this case, the volume of settlement activity would be distributed as follows: 6,665,000 for Direct Title Insurance Carriers, 5,889,941 for Title Abstract and Settlement Offices, 2,945,059 for Lawyers and Escrow, 4,464,000 for Surveying & Mapping Services, 6,820,000 for Extermination & Pest Control Services, and 15,500,000 for both Offices of Real Estate Appraisers and Credit Bureaus.<sup>52</sup>

The employee figures reported in Table 6-14 misstate the number of workers actually participating in residential real estate settlements. This section offers some estimates of that figure, although it is recognized that they are subject to some uncertainty given the limited information that is available. Table 6-16 provides one estimate of the total number of workers and the number and percent of workers in small firms engaged in performing settlements by

<sup>50</sup> As explained in Chapter 5, there is also some uncertainty about the distribution of mortgage-related business and revenues among the various title-related industries. Table 6-12 assumes the following distribution: Direct Title Insurance Carriers (43.0%), Title Abstract and Settlement Offices (38.0%), and Lawyer and Escrow (19.0%). Section IV.B.5 of Chapter 5 considers other distributions and suggests the following ranges for the specific industry shares: Direct Title Insurance Carriers (35%-50%), Title Abstract and Settlement Offices (29%-43%), and Lawyer and Escrow (17%-29%). Given limited available information, it is difficult to determine a precise estimate, which is why Chapter 5 includes several sensitivity analyses. But obviously, reducing the relative weight of the DTIC or increasing the relative weight of the lawyer-escrow industry would increase the small business share of settlements. Readers are referred to Section IV of Chapter 5 for a more complete analysis of the relative importance of each title-related industry, particularly as it affects the overall small business percentage for title- and settlement-related work.

<sup>51</sup> In the projection given in the text, home purchase loans were assumed to stay the same (7.5 million, or 60% of the 12.5 million in mortgages), while refinances increased from 5 million (or 40% of the 12.5 million mortgages) to 8 million of the 15.5 million total (home purchases remain at 7.5 million).

<sup>52</sup> The settlement volume for small businesses during a high volume year can be obtained using the small business percentages from Table 6-12, giving: 319,920 for Direct Title Insurance Carriers, 2,933,191 for Title Abstract and Settlement Offices, 2,650,553 for Lawyers and Escrow, 3,629,232 for Surveying & Mapping Services, 3,675,980 for Extermination & Pest Control Services, 12,880,500 for Offices of Real Estate Appraisers, and 1,627,500 for Credit Bureaus.

industry. For Title Abstract and Settlement Offices and the combined Lawyers and Escrow industry, it is based on the volumes of settlement activity depicted in Table 6-15 and the productivity level of Title Abstract and Settlement Offices (i.e., settlements per worker).

The figure for total workers in Title Abstract and Settlement Offices is the sum of: all employees (79,819), small firms (7,889), and nonemployer firms (6,203), or 93,911. (Small firms and nonemployer firms are added to count the owners of those firms as production workers as discussed in the description of Table 6-14 above). The corresponding figure for workers in small firms is the sum of: employees of small firms (47,913), small firms (7,889), and nonemployer firms (6,203), or 62,005 workers (representing 66% of all workers in Title Abstract and Settlement Offices). These figures are reported in Table 6-16 below. In this industry, there are 50.6 settlements per worker (obtained by dividing the 4,749,953 settlements from Table 6-15 by the 93,911 workers).<sup>53</sup>

In the combined Lawyers and Escrow industry group, worker productivity is assumed to be half of that in Title Abstract and Settlement Offices on the grounds that these workers may not do settlements full time and because of the general lack of information on the degree of settlement activity in these broadly defined industries. Thus, the number of workers in this category (93,914) is computed by dividing the number of settlements handled by the industry from Table 6-15 divided by one-half the settlements per worker in the Title Abstract and Settlement Offices industry.

For Direct Title Insurance Carriers, many workers are not engaged in actual settlements, but rather in the title insurance function itself. Direct Title Insurance Carriers provide title insurance through agents as well as both direct sales of title insurance and associated settlement services to consumers through branch offices. They also, of course, perform the title insurance function itself. HUD examined the annual reports of the large direct title insurance carrier companies to attempt to estimate the proportion of employees of these companies engaged in providing settlement services. It is estimated that approximately 70 percent of workers in this industry, or 54,391 workers, are engaged in providing settlement services. (See Table 6-16).<sup>54</sup>

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<sup>53</sup> There are two caveats with this estimate. First, the estimate depends on the number of settlements in the Title Abstract and Settlement industry, which, as discussed in an earlier footnote, could differ from the number reported in Table 6-12 (see Section IV.B.5 of Chapter 5 as well as the earlier footnote for possible ranges of estimates). Second, not all workers in the Title Abstract and Settlement industry are engaged in single-family real estate transactions, which means that the number of workers is overstated and therefore the number of settlements per worker is understated. (Unfortunately, there is no information on the proportion of Title and Abstract workers engaged in single-family mortgage activity, although it is likely that most are.) If the number of settlements per worker is too low, the projection will overstate the number of workers needed.

<sup>54</sup> In 2004, the DTIC industry employed 77,702 workers (based on the definition of worker used in the text). HUD estimates that approximately 70 percent, or 54,391, are engaged in providing settlement services. HUD computed an estimate of the proportion of salaries that large title insurance companies paid to workers engaged in settlement services as follows: (1) the amount of revenue required to carry out the insurance function for policies written by agents was computed as the difference between agent-generated revenue and agent commissions (or agent retention expenses); (2) two percentages were then calculated, (a) the percentage of agent-generated revenue required for the insurance function in agent-written policies as (1) divided by total agent-generated revenue, (b) the percent of all insurance revenue required for the insurance function for agent-written policies as (1) divided by total insurance revenue; (3) the salaries for employees providing the insurance function for agent-written policies was computed by

**Table 6-16. Workers Engaged Performing Settlements**

<b>Industry</b>	<b>Total Workers</b>	<b>Workers in Small Firms</b>	<b>Percent of Workers in Small Firms</b>
<b>Direct Title Insurance Carriers</b>	<b>54,391</b>	<b>6,401</b>	<b>11.77%</b>
<b>Title Abstract and Settlement Offices</b>	<b>93,911</b>	<b>62,005</b>	<b>66.03%</b>
<b>Lawyers and Escrow</b>	<b>93,914</b>	<b>84,523</b>	<b>90.00%</b>
<b>TOTAL</b>	<b>242,217</b>	<b>152,929</b>	<b>63.14%</b>

The estimated numbers of title and settlement workers would be larger under market conditions producing a larger volume of mortgage activity. The estimated distribution of settlements when overall mortgage volume is 115,500,000 was given earlier. To adjust the worker estimates in Table 6-16 to reflect the higher mortgage volume requires information about the increase in productivity (i.e., loans per worker) during the higher volume (or heavy refinance) environment. It is not correct to simply adjust the number of workers up by the percentage increase in mortgage loans because the number of loans per worker increases during refinance booms. The earlier analysis of brokers and lenders provided estimates of additional workers in a higher volume market. That analysis was based heavily on trend data through 2002 for the number of workers in the broker industry, as reported by David Olson and his firm, Wholesale Access. The number of loans per broker increased between low and high volume years. Similar trend data do not exist showing the number of title and settlement workers during recent refinance booms. Thus, any adjustment would be somewhat speculative. But it is also important to emphasize that workers hired during high-volume years, for example, are more likely to be temporary or part-time workers. Temporary workers will likely rely on permanent workers for training or information about new rules and regulations. Thus, the numbers in Table 6-16 providing estimates of workers in the title and settlement industry serve as a reasonable basis for analyzing the effects of the new regulation among the various settlement and title industries, recognizing that the numbers could vary somewhat depending on the volume of mortgages considered in the analysis.

Estimates of the number of single-family-mortgage-related workers in Surveying & Mapping Services, Extermination & Pest Control Services, and Credit Bureaus are not included because there are insufficient data upon which to base an estimate. Mortgage-related work accounts for a relatively small portion of the overall activity of these industries, and information is not available to separate single-family-mortgage-related business from other activity. In addition, data on workers for these industries are not needed for the analysis of cost savings below. While this information is also not needed below for the appraisal industry, it is possible

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multiplying (2)(b) by total salary expenses; (4) the total salaries for employees engaged in direct sales of insurance (including other settlement services) and providing the insurance function for direct-sales policies was computed by subtracting (3) from total salary expenses; (5) the salaries of employees providing the insurance function for direct-sales policies was computed by multiplying (2)(a) by (4); (6) the salaries of employees selling title insurance directly (and providing other settlement services) was computed by subtracting (5) from (4); finally (7) the percent of salaries paid to employees selling title insurance directly (and providing other settlement services) was computed by dividing (6) by total salary expenses. This analysis was carried out using 2005 data from the annual reports of four title insurance companies (First America, Land America, Fidelity National, and Stewart). The percentage computed in (7) ranged from 67.7 percent to 72.8 percent. Based on these results, HUD assumes that 70 percent of DTIC workers are engaged in providing direct title insurance sales and other settlement services.

to produce reasonable estimates of workers for this industry because single-family-mortgage-related work likely accounts for most of the activity in this industry. Using the methodology described above (adding employees of employer firms, non-employer firms, and owners of small firms to arrive at the number of workers), the appraisal industry in the projection year would include 110,479 workers, and 102,758 of these work in small firms.<sup>55</sup> While some of these appraisers focus on multifamily and commercial properties and/or conduct appraisals for local governments (e.g., estimating the value of properties for tax purposes), most are likely involved in single-family mortgage-related activities.<sup>56</sup>

## **VIII.B. One-Time Costs of the New HUD-1**

### **VIII.B.1. Introduction**

The new HUD-1 is simpler than the existing HUD-1. Nevertheless, there will be change in the form, including the introduction of the comparison page, and the settlement industry will need to learn how the new form works. The primary focus will be on how to put the numbers in the right place. The major changes in the HUD-1 itself are to make it more comparable to the GFE. Accordingly, to facilitate comparison between the HUD-1 and the GFE, each designated line in Section L on the final HUD-1 includes a reference to the relevant line from the GFE. Borrowers will be able to easily compare the designated line on the HUD-1 with the appropriate category on the GFE. Terminology on the HUD-1 has been modified as necessary to conform to the terminology of the GFE. For example, since Block 2 on the GFE is designated as “your credit or charge for the specific interest rate chosen”, Line 802 on the HUD-1 is also designated “your credit or charge for the specific interest rate chosen.”

The comparison page of the HUD-1, which is an additional page, will represent a more significant change for the industry than the slight revisions of the current pages. Although some training may be required, it is not likely to be substantial since settlement agents are already very familiar with what information to provide at a closing. The comparison page displays any differences between the settlement charges on the GFE and the HUD-1 on the top half. On the bottom half of the comparison page, there is a summary of loan, in a manner similar to the GFE. The burden of the comparison page of the HUD-1 is most likely to be felt as a one-time adjustment cost imposed on software developers. In response to the March 2008 proposed rule, many lenders expressed the concern that the way the new HUD-1 forms are to be completed

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<sup>55</sup> The total number of workers is derived as follows: 45,021 employees in employer firms (from Table 6-14) plus 49,802 non-employer firms (from Table 6-13) plus 15,656 owners of small firms (from Table 6-13), which yields 110,479 workers. The number of workers in small businesses is derived as follows: 37,300 employees in small employer firms (from Table 6-14) plus 49,802 non-employer firms (from Table 6-13) plus 15,656 owners of small firms (from Table 6-13), which yields 102,758 workers in small businesses.

<sup>56</sup> One would think that practically all of the owners of the 49,802 non-employed firms appraised single-family properties, as well as most of the 37,300 employees in small employer firms. One could argue that the number of workers for the entire industry in 2004 is an upper bound since mortgage activity in that year was higher than in the projection year. Additionally, automated valuation models (AVMs) may have reduced the demand for appraisers; particularly on refinance loans (see Section V.A of Chapter 5 for a discussion of AVMs).

would require numerous changes with significant operational and technology impacts. These costs can be categorized similarly as for the new GFE: software costs (including training), legal consultation costs, and training costs. The total one-time compliance cost to the industry is \$188 million, of which \$139 million is borne by small business.

### **VIII.B.2. Settlement Software Costs**

Developers of settlement software and settlement agents will be subject to software costs. They will face the following two changes: a reorganization of the HUD-1 form and the requirement of the HUD-1 comparison page explaining the crosswalk between the GFE and the final HUD-1. The changes to the HUD-1 form would not require much work from programmers. The only programming to be done is changing the manner in which information is displayed on the HUD-1 form. First, there will be fewer fees. Second, references to the corresponding figures in the GFE would need to be inserted by the software developers.

Including the comparison page would require more effort because it is completely new. The programming itself would not be challenging since the new page only contrasts data from the HUD-1 and the GFE, shows whether the tolerances are met, and displays data concerning loan terms. The more complex calculations concerning the loan terms are not required to be done by the settlement agent but by the lender. Loan originators must transmit settlement cost and loan term data to the settlement agents for page 3 (the comparison page) of the HUD-1 form. As discussed previously, lenders will provide most, if not all, of the data for the comparison page of the HUD-1. Settlement agents will need new software for the simple reason that the form will change. There will also be a strong demand by settlement agents for new software that checks the tolerance calculations given the importance of the comparison page as a means to double check the final figures.

We will assume that the costs of software updates and software training to the settlement industry are the same as for the new GFE. Given the number of workers and the distribution by firm size, the total cost of new software and training is \$62 million, of which \$46 million is borne by small business. The cost of the changes to software is \$14 million (of which \$11 million is borne by small business) and the opportunity cost of the time spent learning the new software is \$48 million (of which \$34 million is borne by small business).

To arrive at a total one-time cost for the HUD-1, we add the additional cost of \$18 million of new loan origination software as a result of the HUD-1 to the \$62 million for the settlement industry's new software, which yields a total one-time software cost of \$80 million to the entire industry. Adding the \$13 million of HUD-1 related software costs from small loan originators to the \$46 million imposed on small settlement firms yields a total of small business one-time compliance costs of \$59 million.

### **VIII.B.3. Legal Consultation Costs**

Legal consultation will be less involved for the HUD-1 form than for the new GFE. However, settlement firms may require additional legal consultation to inform on a diverse set of issues, such as average cost-pricing, to be on the safe side. We make the same assumptions as

for the GFE: all firms purchase a minimum of two hours of legal consultation at a cost of \$200 an hour and that additional legal service are demanded on the basis of the volume of business. We estimate that the total legal costs to the settlement industry will be \$37 million of which \$18 million is borne by small business. The cost of legal fees is lower for the HUD-1 form than for the GFE because there are less firms involved in settlement than in mortgage origination.

#### **VIII.B.4. Training Costs**

Workers who perform settlements will need to learn how to fill out the new HUD-1 form and in some cases, calculate whether the change in settlement fees is within the tolerance. The quantities are provided to settlement agents by the GFE, so training will be much less involved. Assuming four hours of training at an opportunity cost of \$72.12 per hour (based on a \$150,000 fully-loaded annual salary); tuition of \$250 per worker for small firms and a discounted tuition of \$125 per worker for large firms; and that half of the workers in small firms and one quarter of the workers in large firms require training; then the total cost of training is \$71 million, of which \$62 million is borne by small business.

#### **VIII.C. Recurring Costs of the New HUD-1**

There are few recurring costs associated with the revised HUD-1. The revised HUD-1 will very likely have fewer entries than the existing HUD-1 which will require fewer explanations of figures than is true with the existing forms. This is because of the combined subtotals presented in many sections in the new GFE in lieu of the frequently numerous broken out individual fees that we see on the GFE. The same is true when comparing the revised HUD-1 to the existing HUD-1. Comparing the new GFE to the revised HUD-1 should be simpler than in the past because it will be much easier to find entries on the new HUD-1 that correspond to the new GFE because they have the exact same description. And, of course, there are fewer entries to deal with. It is hard to imagine how simpler forms could be more costly to explain to borrowers.

There may be recurring costs from the addition of the comparison page (page 3) of the HUD-1. This new page will serve two purposes: 1) as a crosswalk between the HUD-1 form and page 2 of the GFE and 2) presenting a summary of the loan terms similar to page 1 of the GFE. The costs of completing this page are minor. For originators it could be close to zero. Although the lender has to provide the settlement agent with information on the loan terms and some of the loan settlement charges, it should not constitute an additional burden. First, if the loan originator used a software program to generate the GFE, he or she would already have entered those data. A typical software program would print a HUD-1 for an originator that would contain all of the required data concerning loan terms and settlement costs. The only information that is not already there is information concerning the escrow account. Second, transmitting the information on page 3 to the settlement agent will not constitute an additional burden either: lenders and brokers already send documents to settlement agents, the cost of an additional page will not be noticeable. However, there may be a small burden in certain cases, and so we assume that the *average* burden is ten minutes per loan.

Settlement agents may also face an additional burden, although this is not likely either since the lenders are responsible for providing the data. The settlement agent may have to fill out the form if the lender does not transmit it on a completed HUD-1 page 3. The settlement agent may also want to check the information concerning settlement costs, tolerances, and loan terms to make sure they agree with the GFE. In some cases, the settlement agent will have to calculate the tolerances. Preparing page 3 of the HUD-1 may also alert the settlement agent to inconsistencies that would not have to be resolved before closing. Thus, although the addition of this page may have a very small impact, we assume that it will add five minutes *on average* to the time it takes to prepare a settlement. Taking loan originators into account, the total time burden is fifteen minutes per loan. The compliance cost of the change to the HUD-1 for the industry as a whole is thus \$18 per loan (fifteen minutes at \$72 per hour<sup>57</sup>). The recurring compliance cost to the industry would be \$225 million annually (\$18 per loan X 12.5 million loans annually), of which small business would bear \$107 million annually. During a high-volume year (15.5 million loans annually), the annual recurring compliance cost of the HUD-1 would be \$279 million annually.

The benefits of the comparison page of the HUD-1 are not estimated separately from the benefits of the new GFE (\$6.48-\$8.38 billion, see Section I.B of Chapter 3). It is assumed that page 3, which displays tolerances and loan terms, reinforces the consumer savings of the new GFE by compelling settlement agents and borrower to check the compliance with the tolerances. The comparison page is a vital part of the reform. Requiring it is expected to increase the number of consumers who realize the full benefits of the final rule. The benefit of the comparison page is to double-check the final figures.

#### **VIII.D. Changes in the Final Rule to Reduce the Regulatory Barrier of the HUD-1**

##### **VIII.D.1. Recurring Costs of the HUD-1 Addendum**

**Comment.** Many comments were opposed to the proposed HUD-1 Addendum or “script” of the 2008 proposed rule. The purpose of requiring settlement agents to complete and read this form document was to have them describe, at settlement, the terms of the loan and to compare the settlement charges on the GFE to those on the HUD-1.

The primary objection to the script was the time costs. HUD estimated the worst case scenario of the added time required of a non-conscientious agent dealing with a very complicated loan product to be an additional 45 minutes. We assumed that the script would lead to an additional thirty minutes preparing the script, and an additional fifteen minutes to the actual closing procedure consisting of five minutes reading the script, and ten minutes answering questions. To be cautious, we applied this estimate to establish the outer bound of the

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<sup>57</sup> As for the GFE, an alternative method could be used to generate an estimate of the opportunity cost of time spent on a script. Instead of assuming a \$72.12 opportunity cost (from a \$150,000 fully-loaded salary), one could construct a cost estimate from industry-specific data. For example in Tucson, Arizona, the cost of labor (compensation and benefits) of a Real Estate Clerk is \$16.66 per hour and \$74.61 per hour for a Real Estate Attorney.

opportunity cost of the closing script to the settlement firm at \$54 per settlement. The total cost of the script in a normal year (12.5 million originations) could be \$676 million. Settlement industry groups were concerned about the potential additional costs of preparing and reading the script.

A second objection is that the script could place a settlement agent in the position of committing the unauthorized practice of law. This would occur if they were required to answer questions concerning issues such as the loan terms for which they had no responsibility.

**Response.** At recent roundtables, representatives of the settlement industry have assured HUD that their primary goal is transparency and customer service. HUD assumed that without the script settlement agents would neither take any time to explain the HUD-1 to borrowers nor take any time to answer questions. Thus, HUD's cost estimate of the script may be exaggerated. In the world of the conscientious settlement agent, the additional burden of the script at closing would be closer to zero. However, because of the concern expressed concerning the implications of the potential cost and legal implications of the script, HUD will not require a script in its final rule.

To replace the script, HUD has added a page to the HUD-1 form. This will contain much of the same information but will be much easier to fill out and will not have to be read by the settlement agent. The top half will contain a table that compares settlement charges with those on the GFE and shows the amount and percentage by which the charges have changed (in order to check whether the change is within the tolerance). The bottom half of the page consists of a summary of the loan terms, very similar to the first page of the GFE.

The impact of this change is to reduce the maximum additional time imposed, which is expected to be imposed by the rule, from 45 minutes to 15 minutes per loan. At an opportunity cost of time of \$72 an hour for industry, this translates to a decrease in the regulatory burden of \$36 per loan, or \$450 million over an expected 12.5 million loans.

#### **VIII.D.2. Difficulty Comparing the New GFE and HUD-1**

Under the March 2008 proposed rule, the current HUD-1/1A Settlement Statements would have been modified to allow the borrower to easily compare specific charges at closing with the estimated charges listed on the GFE. The proposed changes would have facilitated comparison of the two documents by inserting, on the relevant lines of the HUD-1/1A, a reference to the corresponding block on the GFE, thereby replacing the existing line descriptions on the current HUD-1/1A. The proposed instructions for completing the HUD-1/1A would have clarified the extent to which charges for individual services must be itemized. The script was proposed to facilitate the comparison.

Many commented that borrowers would require more help in comparing the new GFE to their HUD-1. Lenders, mortgage brokers and title and closing industry representatives generally stated that the HUD-1 should be in the same format as the GFE to enable comparisons of estimated and actual charges. A lender association stated that the proposed changes to the HUD-1 fall short of making the GFE and HUD-1 correspond. Lenders also stated that the proposed HUD-1 is not consistent with the disclosures mandated by TILA.

A consumer group stated that while referencing the GFE lines on the settlement statement is an important step, HUD should mandate a summary settlement sheet that corresponds exactly to the summary sheet of the GFE. According to this group, this would obviate the need for a crosswalk between the GFE and the settlement statement. The consumer group stated that the HUD-1 should be easily comparable to the GFE and should facilitate, rather than hinder TILA and HOEPA compliance.

One broker suggested that HUD had created three different documents--the GFE, the HUD-1 and the Closing Script—that present the same information in completely different formats, and this will add to costs and confusion.

HUD agrees with the many commenters who pointed out the importance of comparability between the GFE and the HUD-1. The main strategy for facilitating comparability between the GFE and HUD-1 will be by inclusion of a new third page comparison chart with the HUD-1. This will clearly present whether settlement fees are within the tolerances on the top half of the page and will present a description of the loan in a similar fashion to the GFE on the bottom half.

The final rule provisions for describing some loan terms in the page 1 of the GFE and page 3 of the HUD-1 are similar to the Truth in Lending Act (TILA) regulations, however the differences in approach between the TILA regulations and HUD's RESPA rule make them more complementary than duplicative. The TILA and RESPA approaches to mortgage loan terms disclosure are most similar when the loans are very simple, e.g., fixed interest rate, fixed payment loans. The approach differs for more complex loan products with variable terms. In general, TILA describes how variable terms can vary (e.g., the interest rate or index to which variable interest rates are tied, how frequently they can adjust, and what are the maximum adjustment amounts, if any), but forecasts the "likely" outcome based on an indefinite continuation of current market conditions (e.g., the note rate will be  $x$  in the future based in the index value  $y$  as of today). The RESPA disclosures in the GFE and HUD-1 comparison page focus the borrower on the "worst case scenario" for the loan product to ensure borrowers are fully cognizant of the potential risks they face in agreeing to the loan terms. The disclosures on the GFE are meant to be as simple and direct as possible to communicate differences among loan products. HUD's approach to these disclosures thus supports consumers ability to shop for loans among different originators. For a given set of front-end loan terms (initial interest rate, initial monthly payment, and up-front fees), originators have an incentive to offer borrowers loans with worse back-end terms (e.g., higher maximum interest rate, higher prepayment penalty) to the extent capital markets are willing to pay more for loans with such terms. While brokers are required to disclose such differentials on the GFE and HUD-1, lenders are not. HUD's GFE will help consumers to quickly and easily identify and distinguish loan offers with similar front-end terms, but worse back-end terms, while shopping for the best loan. Requiring a comparison page will act to double-check the HUD-1 and thus enhance the realization of the benefits of the simpler GFE.

## **IX. Efficiencies and Reductions in Regulatory and Compliance Burden**

Efficiencies come from time saved by both borrowers and originators as a result of forms that are easier to use, competitive impacts in the market, the decrease in the profitability of

searching for victims, and the decrease in discouraged potential homeowners. All these are ongoing as opposed to one-time costs. The value of time saved for borrowers is \$1,169 million and for industry \$1,166 million (the sum of time saved answering borrowers' questions and from the simplicity of average-cost pricing).

There are also positive spillovers of increasing consumers' level of awareness. First, consumers will be less susceptible to predatory lenders and therefore this type of wasteful activity will be discouraged, freeing up resources for more productive purposes. Second, by better understanding the loan product, there will be a decrease in the probability of default leading to foreclosure, which can dramatic social costs.

### **IX.A. Shopping Time Saved by Borrowers**

Consumers will save time in shopping for both third-party services and mortgage loans as a result of the new GFE. HUD expects that the time savings for consumers will counterbalance some of the costs imposed on industry. The increased burden on originators of arranging third-party settlement services is likely to be much more than offset by a reduction in the aggregate shopping burden for third-party providers incurred by borrowers. Originators will be highly motivated to find low third-party prices. Originators could pass the savings on and make it easier to appeal to borrowers, or alternatively, could raise their origination fee by the savings in third-party fees and earn more profit per loan. Or the final result could fall somewhere in between the two. Regardless of which path any originator chooses, the lower third-party prices work to his or her advantage; originators will probably be aggressive in seeking out lower prices.

The borrower benefits to the extent that, upon receipt of the GFE, he or she immediately has good pricing information on third-party services. The borrower could immediately decide to use the originator's third parties, in which case his or her search is over. Or, the borrower could search further with the originator's prices as a good starting point and available as a fall-back, in which case the borrower's search efforts are likely to be greatly reduced. In both cases the borrower searches less, but spending less time searching does not imply less benefits from the search.

The final GFE also creates time efficiencies by making mortgage loan details more transparent to consumers. Shopping will be encouraged because consumers will have an easier time understanding and comparing loans with a standard and comprehensible GFE. The final rule increases the amount of information processed by consumers; shopping accomplished; and the benefits realized from doing so.

It is possible that under the final rule that some consumers will want to spend more time searching. Although additional time spent searching reduces the time spent on other activities such as leisure, the reward of search is an increase in consumer savings. Assuming that the GFE increases the productivity of every hour of search, it therefore also increases the relative opportunity cost of leisure. Consumers will spend more time shopping to receive additional income. Under these circumstances an increase in the time spent shopping does not constitute a burden imposed by the rule since the increase in time is voluntary. Consumers are free to remain at previous lower levels of shopping and enjoy a lower increase in saving from the rule.

We do not expect the average consumer to spend more time searching because there are other effects that should dominate the incentive described above. First, the higher productivity in search of the new GFE increases a consumer's savings at all levels of search: consumers will be able to reduce their level of effort and retain the same level of saving previous to the rule.<sup>58</sup> Second, we expect that a large portion of the increase in savings will be independent of an individual's shopping behavior. As the market becomes more competitive, shoppers who are less sophisticated or less diligent may still benefit from the competitive pressure of others' shopping. This additional saving will allow consumers to spend less time searching. The time that they do spend searching, however, will be more effective and lead to greater savings. The new GFE will allow consumers to spend more time comparing and evaluating offers and less time trying to decipher the loan details.

Given that consumers will reduce the time spent searching as a result of this rule, then we would be underestimating the benefits to consumers by only counting the gain in income from reduced fees and not the gain in time saved. Considering the number of loans the average originator closes per year, the aggregate decrease in search efforts by borrowers is very likely to exceed the increase in aggregate search effort by the originators. For example, if each borrower saves an average of 15 minutes in shopping for third-party services, then the total savings to borrowers would be \$234 million.<sup>59</sup> As discussed Sections VII.E.1 and VII.E.2 on tolerances, the new form and the tolerances will enable borrowers to save time shopping for loans and for third-party settlement service providers. If the new forms save the average applicant one hour in evaluating offers and asking originators follow-up questions, borrowers save \$935 million.<sup>60</sup> The total value of borrower time saved shopping for a loan and third-party services comes to \$1,169 million.<sup>61</sup>

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<sup>58</sup> These effects are equivalent to the income and substitution effects of consumer theory to understand the effect of a price change on the consumption of a good. In this case, the increase in productivity of shopping should be considered as reduction in the price of savings in terms of leisure. The income and substitution effect move in the same direction for the normal good whose price has changed but the opposite directions for the substitute.

<sup>59</sup> Calculated as follows: 21,250,000 projected mortgage applications (see Chapter 2) times \$44 per hour times 0.25 hour (or 15 minutes) gives \$233.750 million. The \$44 per hour figure is based on the average income (\$92,000) of mortgage borrowers, as reported by HMDA; the \$92,000 income figure is divided by 2,080 hours to arrive at the hourly rate of \$44.23 or \$44. If the borrower saved 30 minutes in shopping time, then the total savings would be \$468 million.

<sup>60</sup> Calculated as follows: 12,500,000 loans times 1.7 applications per loan times 1 hour per application times \$44 per hour, the average hourly income of loan applicants (\$92,000 per year/2080 hours per year). See earlier footnote.

<sup>61</sup> The benefits are calculate using the ratio of 1.7 applications per loan, which is a measure of the current state of affairs. Although we calculate administrative costs for firms at different ratios (1.7 and 2.7), it would be misleading to calculate consumer benefits at higher ratios. Going from an average of 1.7 to 2.7 applications per loan does not save the average consumer more time. It is clear that the consumer will not be harmed because the increase in applications is voluntary but should not be counted as an efficiency. As argued in the text, we believe that the net change in time spent searching will be negative.

## **IX.B. Time Saved by Originators and Third-Party Service Providers**

Originators and third-party settlement service providers will save time as well. If half the borrower time saved in (1) above comes from less time spent with originators and third-party settlement service providers, then originators spend half an hour less per loan originated answering borrowers' follow-up questions and third-party settlement service providers spend 7.5 minutes less with borrowers for a saving of \$765 million<sup>62</sup> and \$191 million, respectively, for a total of \$956 million.<sup>63</sup>

## **IX.C. Time Saved from Average Cost Pricing**

As discussed in Chapter 3, the final rule allows pricing based on average charges. This reduces costs because firms do not have to keep up with an itemized, customized cost accounting for each borrower. This not only saves costs when generating the GFE, it is also saves quality control and other costs afterwards. Industry sources have told HUD that this could be the source of significant cost savings.

As explained above, there will be reductions in compliance costs from average cost pricing. It is estimated that the benefits of average cost pricing (e.g., reduction in the number of fees whose reported values must be those specifically incurred in each transaction) will lead to a reduction in originator costs of 0.5 percent, or \$210 million. No breakdown of fees is needed. No knowledge of an exact fee for each specific service needed for the loan is required for the GFE. In addition, no exact figure for the amount actually paid needs to be recorded for each loan and transmitted to the settlement agent for recording on the HUD-1. The originator only needs to know his or her approximate average cost when coming up with a package price that is acceptable. The cost of tracking the details for each item for each loan is gone.

## **IX.D. Social Efficiencies**

In this section, we discuss two social efficiencies of the rule: the reduction of non-productive behavior and positive externalities of preventing foreclosures.

### **IX.D.1. Reduction in Non-Productive Behavior**

By reducing the profitability of searching for less-informed borrowers, the rule will lead to a more efficient allocation of resources.

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<sup>62</sup> Calculated as follows: 12,500,000 loans times 1.7 applications per loan times 0.5 hours per application times \$72 per hour, the average hourly income of loan originators (\$150,000 per year/2,080 hours per year).

<sup>63</sup> Just as we do for consumers, we estimate the value of time efficiencies using the 1.7 application per loan ratio even when comparing it to costs generated using the higher 2.7 ratio. It would not be logical to claim that we are saving a firm any time by requiring them to process additional applications. However, it may be sensible to reduce the recurring compliance costs from assuming a higher number of applications because the additional application will not be as much of a burden as it was before.

The primary benefit to consumers is the transfer of surplus from firms that charge significant markups. Much of the excess fees earned by loan originators and settlement firms is extracted costlessly. Price-discriminating firms are able to assess the information asymmetry between themselves and potential borrowers and estimate the consumers' willingness to pay a markup beyond the costs of originating a loan. Most loan originators base their estimates of a consumer's level of information on signals from the consumer. They do not need to expend additional time or resources to do so. However, there is a minority of loan originators that devote significant resources to advertising to borrowers with a lower expected level of financial sophistication. If the rule leads to a reduction in predatory behavior, there will be a gain in social welfare equal to the costs of actively searching for less informed borrowers.

The loan originator acts to maximize his or her expected profit. By raising the requested settlement charges above the settlement costs, a loan originator increases his or her mark-up but increases the probability that the consumer will reject the offer. The extent of a consumer's knowledge of the market will also raise the probability of rejecting a markup. The optimal markup is the one at which the net revenues from offering loans at higher prices and a higher rejection rate equals the net revenues from offering loans at lower competitive prices and a lower rejection rate. It is expected that the rule will increase the average individual's information; increase the likelihood that they would reject excessive fees; and thus reduce the prevalence of high markups. This reduction is what constitutes the transfer to borrowers of \$668 per loan.

An aggressive seeker of fees may choose to actively search for less informed borrowers who are more likely to accept loans with excessive fees. The optimal level of search effort is the one at which the marginal cost of searching is equal to the change in probability of acceptance from finding less informed clients times the markup (marginal benefit of search). By increasing the level of information among consumers, the rule will raise the marginal cost of searching for vulnerable borrowers and thus will lead to a lower optimal level of searching by loan originators.

Whenever producers expend substantial effort to extract consumer surplus, there is a deadweight loss. The predatory lender diverts resources from producing output to producing markups (consumer loss). By creating transparency and enhancing consumer's understanding, the rule will not only lead to transfers of excess fees to consumers but will inhibit costly predatory behavior. Reducing this activity will lead to a net gain in social welfare equal to the sum of the marginal costs of extracting the markup.

The total transfer to consumers of \$5.88 billion represents 14 percent of the total revenue of originators, which is projected to be \$42.0 billion. As explained above, this gain in surplus is greater than the loss to producers when firms are engaged in wasteful predatory behavior. If the decline in this activity represented one percent of current originator effort, this would result in \$420 million in social surplus. In the absence of this activity, these resources could be devoted elsewhere making society richer. The transfer to consumers is composed of both the lost excess profits from markups and the deadweight loss from the inhibited predatory activity to achieve those markups. Thus, the gain to consumers will outweigh the loss in profits of predatory firms.

## **IX.D.2. External Benefits of Preventing Foreclosures**

Another social benefit of the rule is its contribution to sustainable homeownership. It is more likely that consumers who understand the details of their loans will avoid default and thus foreclosure. There are two ways in which this rule will contribute to sustainable homeownership. The first is to encourage shopping by providing a transparent disclosure of settlement costs and other loan details. Such competitive market behavior should reduce settlement costs and provide a small cushion for borrowers in the eventuality of financial distress. The second is by educating consumers and helping them choose the loan that is most appropriate. A better understanding of the loan details should lead to a better understanding of the risks inherent in assuming a large financial obligation, and thus a better decision by the borrower as to the best loan or even whether homeownership is the optimal choice.

Factors that precipitate default are downward trends in property values, a loss of income of the borrower, and an increase in interest rates for borrowers with adjustable-rate mortgages (ARMs). None of these events can be predicted with certainty and understanding the loan itself cannot eliminate the uncertainty. However, a full appreciation of the potential risks of the loan should lead to a careful decision as to whether the loan vehicle is the best one given the uncertainty. For example, knowing how high your interest rate and monthly payments can go should make the loan applicant hesitant to accept an ARM unless the borrower has the income security to do so. Given the same information, different borrowers may choose different loans depending on their risk and time preferences. However, it is important that they make an informed decision.

There is strong evidence that borrowers underestimate the costs of adjustable rate loans. Buck and Pence (2008) assessed whether borrowers know their mortgage terms by comparing the distributions of these variables in the household-reported Survey of Consumer Finances (SCF) to the distributions in lender-reported data. The authors find that although most borrowers seem to know basic mortgage terms, borrowers with adjustable-rate mortgages appear likely to underestimate or to not know how much their interest rates could change. Borrowers who could experience large payment changes if interest rates rose are more likely to report not knowing these contract terms. Difficulties with gathering and processing information appear to be a factor in borrowers' lack of knowledge. The final GFE would present critical loan terms such as the maximum monthly payment on the first page in order to better inform borrowers.

The least desirable consequence of an uninformed decision is foreclosure. The Joint Economic Committee of the U.S. Congress estimates the total costs to society at close to \$80,000 per foreclosure. The foreclosed upon household pays moving costs, legal fees, and administrative charges of \$7,200. A study from the Federal Reserve Bank of Chicago reported that lenders alone can lose as much as \$50,000 per foreclosure. Standard and Poor's describes these costs as consisting of loss on loan and property value, property maintenance, appraisal, legal fees, lost revenue, insurance, marketing, and clean-up. Of these costs, the primary cost to lenders is the cash loss on property.

The lender and borrower are not the only parties to suffer from a foreclosure. It is often argued that there are negative impacts to the value of neighboring properties from a foreclosure. There are many reasons for these externalities. There is an amenity value to having an up kept

property next door; foreclosed properties if vacant can attract crime; and there may also be a depressing effect on the local economy. A reasonable estimate of the negative externality of a foreclosure on nearby properties is \$1,508. In addition, the local government loses \$19,227 through diminished taxes and fees and a shrinking tax base as home prices decrease. The total benefits of preventing a foreclosure is \$77,935 in averted costs. It is difficult to estimate how many foreclosures a uniform and transparent GFE with settlement fee tolerances would prevent. However, preventing 1,300 foreclosures nationwide would yield \$100 million of benefits.

### **IX.D.3. Other Efficiencies**

There are other potential efficiencies that are anticipated from the new GFE approach but would be difficult to estimate. For example, studies indicate that one impediment to low-income and minority homeownership may be uncertainty and fear about the home buying and lending process. The new GFE approach should increase the certainty of the lending process and, over time, should reduce the fears and uncertainties expressed by low-income and minority families about purchasing a home (see Section VII.F of Chapter 3). As discussed in Section IV.D.4 of Chapter 2, improvements in lender information (e.g. interest and settlement costs) should also lead to a general increase in consumer satisfaction with the process of taking out a mortgage (see CFI Group, 2003).

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