HUD Reports Find Large, Unexplained Variations in Title and Settlement Costs

This article reviews research that the U.S. Department of Housing and Urban Development (HUD) undertook in support of Real Estate Settlement Procedures Act (RESPA) regulatory reform. The research is again relevant because the Consumer Finance Protection Bureau, which took over HUD's responsibility for RESPA under the Dodd-Frank Financial Reform Act, makes revisions to the forms provided to mortgage borrowers that HUD had required under RESPA since 2010.

Since the mid-1990s, the U.S. Department of Housing and Urban Development (HUD) has examined mortgage regulatory reform to address concerns that abuses were occurring in the market for loan origination and related services. The major areas of concern were lender payments to mortgage brokers that were higher when the interest rates on the loans were higher; bait-and-switch behavior that delivered a loan with terms or fees less favorable to the borrower; and the payment of kickbacks and referral fees explicitly prohibited by the Real Estate Settlement Procedures Act (RESPA), the federal law governing real estate settlements, including most residential mortgage lending activity. After hearing of many complaints surrounding the settlement process, HUD decided to examine a number of HUD-1 Settlement Statements, accounting sheets that RESPA requires for reporting all payments involved in a mortgage transaction, including the property settlement.

Initial Exploratory Inquiry

In 2000, HUD published an exploratory study of closing costs obtained from a sample of 212 HUD-1 Settlement Statements from Federal Housing Administration (FHA) loans closed in 1997. The sample was not scientifically designed, because the main purpose of the study was to see if HUD could use HUD-1s to create a useful database for analyzing closing costs. The study reported means, medians, and interquartile ranges for charges within the major sections of the HUD-1 and for a small number of individual charges. Not much could be said about charges within individual states, because the number of loans examined from any individual state was too small to yield useful results. The study did demonstrate, however, that a closing cost database constructed from HUD-1s collected from FHA loan closings was possible. As a result of this preliminary success, HUD decided to create a large nationwide database of settlement costs, designed to contain 200 loans from each state and Washington, D.C., or approximately 10,000 cases.

The Nationwide Study

Analyzing yield spread premiums (YSPs)—the amount by which the secondary market price for a loan exceeds the loan amount—was a high priority at the time. HUD created this large database with loans closed in May and June 2001, because the time between when borrowers chose a lender and when these closings took place in May and June was a period of fairly stable interest rates. Stable interest rates in the period between loan commitment and settlement allowed HUD to use reported YSPs to construct a reliable prediction of YSPs for cases in which YSPs were not reported. This design enabled HUD to analyze YSPs and all other closing charges for the entire sample, not just those for which YSPs had been reported.

Susan Woodward, under a contract between HUD and the Urban Institute, analyzed these data extensively. The larger focus of this study was loan fees. Lenders can charge loan fees directly to the borrower under a wide array of specific names that do not really matter, because the fees, regardless of name, either go to the lender or do not. For example, an origination fee, an underwriting fee, a document preparation fee, and so on, go to the lender, regardless of what the fee is called. All loans are originated, are underwritten, have documents prepared, and so on, whether or not the lender charges a specified fee for that service. Indirect fees do not appear to be charged to the borrower, but the borrower's payments are the source of these fees. Loans originated at higher interest rates sell for more in the secondary market than do loans originated at lower rates. The lender collects the YSP, which represents fees in excess of the direct fees, when selling the loan. Total loan fees are the sum of the direct and indirect fees. The borrower, however, is the source of the indirect fees, which exist only when the borrower pays higher interest payments each month. The indirect fees are the present value of the expected higher monthly payments. Indirect fees are a major source of confusion to borrowers, many of whom do not comprehend the relationship between their higher interest rate and YSPs, whether retained by the lender or paid to a mortgage broker who might be part of the transaction.

Woodward found that total loan fees vary substantially among borrowers, even holding loan amount constant. In a competitive market, one would expect an extra $1 in fees from YSPs to result in $1 less in direct fees. After all, if one is owed $10, what difference does it make whether one is paid with two $5 bills or one $10 bill, as long as one gets $10 total? This study found that, on average, any extra dollar in YSP caused virtually no reduction in direct fees. It is as if, no matter how many $5 bills the left hand delivers, the right hand is still expected to pay the same number of $10 bills. The lack of effect YSPs have on direct fees reflects a profound lack of borrower comprehension of how the premiums work to compensate lenders and that, on average, lenders exploit this confusion to their advantage.

Woodward also found that minority borrowers pay $500 to $1,000 more for loans than do nonminority borrowers and, using census tract data on education levels, that those buying homes in neighborhoods with no college graduates pay between $1,000 and $1,900 more than those buying in neighborhoods where nearly everyone has a college degree. Not one of these findings is consistent with a competitive market.

In the market for "no-cost" loans, however, in which direct fees are zero and all costs are paid with the proceeds from the YSP, borrowers did much better, saving about $1,300 per loan. Comparison shopping is easier in this segment of the market, because it includes only one loan fee—the interest rate: lower interest, lower cost; higher interest, higher cost. One would not be surprised to find that, in a market in which comparison shopping is easier because the interest rate is the only fee, prices are lower than in a market in which comparison shopping is more difficult because it includes two kinds of fees, the interest rate and a bunch of upfront direct fees. This $1,300 savings in the market in which comparison shopping is easier is further evidence that the rest of the market is not competitive.

After finding these noncompetitive characteristics in the loan market, Woodward looked at the market for title services, the other main component of overall loan-related settlement charges. This story is another of variation. The study found title fees to vary substantially from state to state. Systematic differences among state laws and local customs might be responsible for most of these differences, which can be dramatic.

For example, a comparison of North Carolina with Texas (Figure 1) shows that the two hardly overlap, with charges in Texas much higher than those in North Carolina. No known evidence indicates general borrower or lender dissatisfaction with the settlements performed in North Carolina or that borrowers or lenders in Texas are vastly more satisfied with their settlements than their counterparts in North Carolina. Product quality, therefore, does not seem to be an issue. The two states nonetheless exhibit a dramatic pricing difference.

Even within a given state, however, the study found that title charges vary greatly. Consider Illinois (Figure 2), where title charges can differ by $1,000 to $1,500, even for loans of the same amount. Therefore, although some variation in title charges clearly relates to the state where the property is located, considerable variation remains unexplained, even within a given state.

Furthermore, the systematic relationship between title charges and borrower characteristics should have nothing to do with how much performing title and settlement

Figure 1. North Carolina and Texas

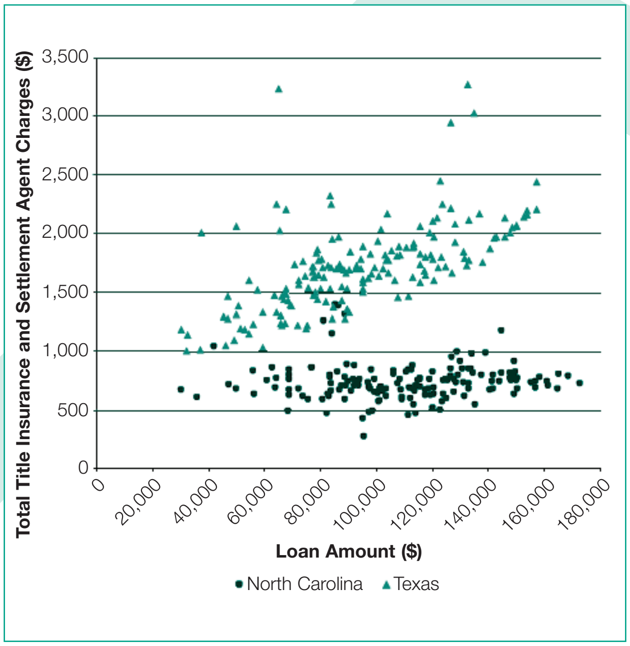
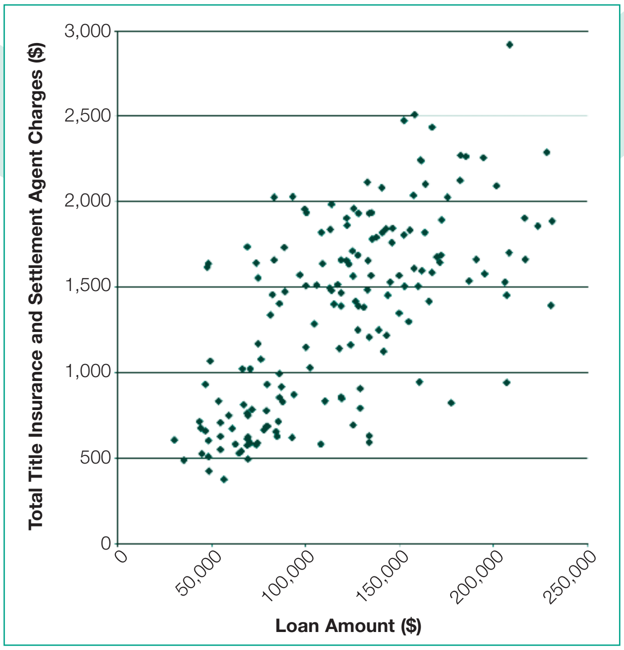


Figure 2. Illinois

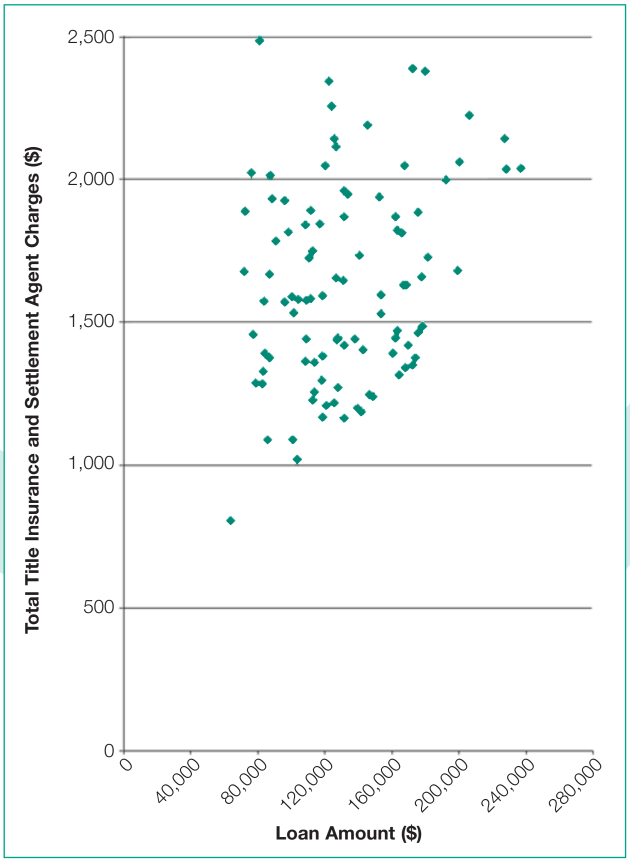


services costs. Hispanic Americans, on average, pay an extra $106, or 9 percent, in title charges, and African Americans pay an extra $123, or 10 percent, all other things held constant. Those buying homes in neighborhoods where few people have a college education pay $200, or 17 percent, more in charges than those buying in neighborhoods with many college graduates. Thus, less educated minority borrowers pay at least $306, or 26 percent, more than their better educated, nonminority contemporaries. Price discrimination of this magnitude, along with substantial unexplained variation even after accounting for all available cost-related variables and borrower characteristics, is consistent with a lack of competition for title services in the market.

If the markets were competitive, those title-service providers trying to charge higher prices to a minority borrower or a person with less education would lose that potential customer because other title providers would offer the borrower lower prices and get the borrower's business. The same would be true of any provider trying to get a high price from anyone; lower priced competitors would undercut the high-priced provider and drive down prices borrowers paid.

The last question to address is whether the differences within states are the result of separate markets within each state that are competitive but have different prices from one another because of differing local effects, such as labor costs or practices for performing title services. Figure 3 presents a story of significant variation in title charges for houses with the same price among the 100 loans in the study from Washington, D.C. No other city in the study had that many loans, however, and any conclusions drawn from the Washington, D.C. title charges are open to challenge on the basis of the small sample or the chance that Washington, D.C., was simply an aberration and systematically different from the cities in the rest of the country.

Figure 3. Washington, D.C.



The Five-Market Study

The HUD five-city title costs study, which is an analysis of five separate individual markets, addresses this issue. Prices should be relatively clustered if the local market is competitive. Although HUD did examine several individual cities in the nationwide sample, the individual city sample sizes were small. Although prices within individual cities looked spread out on scatter diagrams, HUD wanted larger city samples to analyze.

HUD selected five urban counties to analyze: Broward County, Florida; Cook County, Illinois; Maricopa County, Arizona; Philadelphia County, Pennsylvania; and Sacramento County, California. Broward County contains the city of Fort Lauderdale, Cook County includes Chicago, Maricopa County contains Phoenix, Philadelphia County and city are coterminous, and Sacramento County includes the city of Sacramento. The sample size ranged from 543 loans in Broward County to 757 in Cook County. One would expect title providers in each county to be competing with many other title providers in the same county. Because title services involve interactions with land records offices, which are almost universally entities of county governments, the county is a more appropriate area to define as a market than an entire state. Also, different laws and customs or price levels in each county could cause costs to differ among counties. Finally, one is more likely to see competition among title providers within a given county than to see competition among title providers in widely separated areas of an entire state.

HUD controlled for factors that one might expect would affect the cost of providing title services. House price is one such cost factor. Losses from claims probably vary with the amount of coverage, usually related to the loan amount or house price. Title search efforts might be greater for higher priced houses, to avoid the larger potential losses. It is important to remember, however, that most of the title insurance premium is, in effect, a sales commission and eventual claim payouts averaged in the single-digit percentages of title premiums. Therefore, although increased risk is associated with higher house values, the increase in risk is typically small relative to the increase in premium. Foreclosure could be another source of higher claims. The study used the loan-to-value ratio as a proxy for foreclosure risk, because a higher loan-to-value ratio leaves less of an equity cushion for the borrower, leading to an increase in the chance of a foreclosure. Older properties are more likely to have had more previous transactions in the title history, which could lead to higher costs of searching and analyzing the past title transfers. Housing stock turnover could affect cost, so the study included census tract turnover rates as an explanatory variable. Because lot size could positively correlate to search cost, the study accounted for that, as well.

In addition, the study accounted for borrower characteristics, such as race, ethnicity, education, whether the house was in an urban area, and monthly income, as well as for census block average income.

Finally, the study used dummy variables to identify the top 10 settlement agents in each area to see if that could help explain variation and to determine how prices differed among agents.

After including all these cost-related, borrower-related, and agent variables in a regression analysis to identify the determinants of title costs, the study found that more than one-half of the variation remained unexplained in all five counties, with 74 percent left unexplained in Broward County and 87 percent unexplained in Cook County. Some evidence suggests that minority borrowers pay more for title services in Broward and Cook Counties. A comparison of prices among the top 10 title agencies in each market found that those who shopped could save as much as $528 in Broward County and an average of more than $250 in all five markets by finding the lowest average cost provider.

The large unexplained variation in prices for title services in these five markets when employing all available cost-related variables and borrower characteristics that might help explain costs, coupled with the potential savings of hundreds of dollars available to those who comparison shop, is strong evidence that consumers could benefit substantially from an increase in competition in the market for title services.

The New GFE and Enhanced Competition

Increasing competition in the provision of title services by encouraging consumers to shop is a difficult proposition, however, given that title services are a distant third in the considerations consumers make in buying a home and choosing a loan. HUD's (former) regulatory authority in RESPA allowed for a limited set of tools, principally requiring disclosures, to solve market failure problems. HUD's 2008 RESPA reform therefore sought to improve the Good Faith Estimate (GFE) of settlement charges disclosure given to all loan applicants so they would have a good idea of how much a particular loan would cost. The goal was to empower loan applicants so that they could easily compare the cost of various loan offers and identify the lowest cost loan quote they got.

Before the 2008 RESPA reform, lenders and mortgage brokers did not have to follow a specific layout for the GFEs they issued. HUD determined that requiring all cost disclosures to have the same layout would encourage comparison shopping. HUD decided, therefore, that every lender would have to use exactly the same GFE form. In effect, to simplify the presentation and enhance borrower comprehension, HUD designed a GFE form that provided most of the text and blanks where the lender would fill in numbers, generally for broad cost categories, or check boxes to indicate some loan features. In creating the initial closing-cost database, HUD found an incredible array of terms—hundreds of them—used for loan and title fees. Many of these terms were incomprehensible and meaningless to consumers, leaving borrowers potentially overwhelmed and unable to comparison shop without great difficulty. Consequently, HUD limited the opportunity for lenders and other settlement-service providers to engage in itemized fee proliferation on the new GFE (although they were, of course, free to provide detailed breakdowns to any borrower who wanted them). Finally, the standardized GFE provided a grand total of costs for the loan for comparison-shopping purposes.

The new GFE added another feature to promote competition for items such as title and settlement services associated with mortgage lending. The concept of "good faith" now had teeth on the new GFE. Some fees could not rise at all, whereas others could rise no more than 10 percent in total. HUD imposed tolerances to add reliability to the cost estimates and to prevent lenders and mortgage brokers from making bait-and-switch offers. After borrowers locked in the interest rate, loan fees could not rise. Title fees fell into the 10-percent category. The only way in which a lender would not be subject to the 10-percent tolerance on title fees was if the lender provided a suggested title company or companies and the borrower chose to use some alternative title company instead. Those lenders or mortgage brokers not providing the name of a title company to which the tolerances applied subjected themselves to the substantial risk that the borrower, operating alone, would select a high-priced title company whose charges were more than the 10-percent tolerance would cover, and the lender would be liable for the difference.

Thus, the lender had an incentive to avoid unknowable title charge-tolerance violations by arranging for borrowers to receive title services at known prices. Furthermore, because the title charges, like loan fees, are included in the bottom line on the summary page, the lender or broker trying to be price competitive had every incentive to seek out low prices for title services to make the grand total smaller. A dollar saved on title fees affected the bottom line in the same way as a dollar less in loan fees charged to the borrower. The lender's interest and the borrower's interest therefore aligned with respect to title charges. Both would benefit from lower prices.

The lender almost certainly has much better information about conditions in the title services market than does an individual borrower who uses these services on a very infrequent basis. Lenders use these services all the time and are aware of prices because of their frequent involvement in loan closings. Furthermore, lenders are potentially large "buyers" of these services because of the frequency with which they make loans. The lender's expertise and business volume, coupled with the alignment of the lender's and borrower's price incentives, should lead to lenders obtaining very competitive title services prices to be paid by the borrower. Also, if the borrower did decide to shop for title services, the benchmark price provided on the GFE likely would be competitive to begin with, and any borrower comparison shopping would simply reject higher priced title services. High-priced title-service providers would have a hard time maintaining business as usual under these conditions, and borrower savings could be considerable.

The standardized GFE form has the potential to make the loan market more competitive and cut prices for borrowers because of the increased ease in comparing loans. In addition, the presence of tolerances and the inclusion of title fees in the bottom-line total cost of the loan gave lenders powerful incentives to act competitively in obtaining prices for title services, making that industry as a whole more competitive. The overall effect should be to lower charges that borrowers incur in obtaining loans for home purchase or refinancing.

The magnitude of the benefits of increased competition for loans and other settlement services is difficult to calculate with a high degree of accuracy. Some benchmarks are available, however. The more competitive no-cost loans saved borrowers $1,300 per loan. The elimination of discrimination, which is easier to practice in noncompetitive markets, could lead to savings of much more than $1,000 for Hispanic Americans, African Americans, and those with less education. Reduced discrimination in the title market could lead to savings of at least $100 to $300. These estimates are minimum estimates, not taking into account that all borrowers—not just those who are minority borrowers, are less educated, or do not want no-cost loans—might act more competitively in a market in which comparison shopping is much easier with the new GFE forms. The ease of comparison shopping, the effect of tolerances on limiting adverse pricing changes at settlement, and the alignment of the lender's and borrower's interests when the cost of title services appears on the GFE, all work in the borrower's favor to put downward pressure on the cost of obtaining a mortgage loan. If the typical year saw 10 million new loans, for purchase and refinance, a $1,000 savings per loan would yield $10 billion in consumer savings.

HUD's studies on mortgage loan closing and title costs are available at the following websites:

http://www.huduser.org/periodicals/ushmc/spring2000/summary-2.html.

http://www.huduser.org/portal/publications/hsgfin/fha_closing_cost.html.