The Value of the Sunshine Cure: The Efficacy of the Real Estate Settlement Procedures Act Disclosure Strategy

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This article reflects the views of the author and does not necessarily reflect the views of the U.S. Department of Housing and Urban Development.

Abstract

This article examines the efficacy of the disclosure strategy of the Real Estate Settlement Procedures Act (RESPA). Four questions are critical in evaluating the efficiency of federally mandated disclosure by itself as a regulatory strategy: whether lending and title fees are large enough to be worth regulating; whether the Good Faith Estimate mandated by RESPA is an unbiased and consistent estimator of lending and title fees; whether state law has a negligible effect on fees (and therefore only national regulation is pertinent to the problem RESPA addresses); and whether RESPA achieves fairness, in the sense that disclosure so strengthens the negotiating position of buyers and sellers relative to service providers that the principals' personal characteristics do not influence the fees they pay. This article presents preliminary tests on these issues from a small and somewhat unrepresentative sample of FHA-insured loans.

Introduction

The Real Estate Settlement Procedures Act (RESPA) regulates the provision of services involved in the sale of most single-family homes in the United States. Its declared intent is to protect the consumers of those services. The academic literature on the effects of RESPA is rather limited, and most of what has been written is not empirical. This neglect of the effects of regulation on transactions contrasts strangely with the heavy academic attention given to the regulation of transactions in other financial service sectors, such as securities or insurance.

RESPA is a form of sunshine regulation. That is, it regulates not the quality, cost, or other characteristics of the service itself but rather the completeness and timing of disclosure to customers. My goal in this article is to pose what I believe to be four essential empirical questions about the effects of RESPA, a federal regulatory regime, on social welfare:

1. Whether lending and title fees are large enough to be worth regulating.
2. Whether the Good Faith Estimate (GFE) mandated by RESPA is an unbiased and consistent estimator of lending and title fees.
3. Whether state law has a negligible effect on fees (and therefore only national regulation is pertinent to the problem RESPA addresses).
4. Whether RESPA achieves fairness, in the sense that disclosure so strengthens the negotiating position of buyers and sellers relative to service providers that the principals' personal characteristics do not influence the fees they pay.

I do not claim to provide satisfactory answers to these questions. The data analyzed here, a small sample of mortgages insured by the Federal Housing Administration (FHA), are insufficient for that purpose. This article should be viewed as simply a starting point, given the paucity of analytic empirical studies. It is a demonstration that the current regulatory regime merits serious scrutiny but does not itself amount to definitive analysis.

The next section of this article explains the provisions of the statute. The following section reviews the relevant literature and the social welfare implications of sunshine regulation in general. The third section places RESPA in several contexts: it discusses the services for which fees are charged, the constraints on buyers and sellers, and the conceivable alternatives to RESPA. The four propositions above are developed within this context for empirical testing. The fourth section describes the data, the fifth section presents the results of the analysis, and the article ends with concluding remarks.

The Law

RESPA regulates the conduct of service providers when a single-family home is bought with a loan that (1) comes from a federally insured depository institution or a federally regulated lender; (2) is insured by a federal agency; or (3) will be sold to Fannie Mae, Ginnie Mae, or Freddie Mac. RESPA therefore governs most single-family mortgages in the United States.

The declared purposes of RESPA are as follows:

1. "… (M)ore effective advance disclosure to home buyers and sellers of settlement costs;"
2. "… (E)limination of kickbacks or referral fees that tend to increase unnecessarily the costs of certain settlement services;"
3. "… (R)eduction in the amounts home buyers are required to place in escrow accounts….;"
4. "… (S)ignificant reform ... of local record keeping of land title information."

This article analyzes the efficiency of the regulatory strategy inherent in the first goal and, to some extent, the second goal. The treatment of escrow is outside my present scope and so is reform of title recordation by local governments, which, in any case, has not occurred to any meaningful extent.

The relevant substantive provisions of RESPA are as follows:

- Section 4 of the act provides that the U.S. Department of Housing and Urban Development (HUD) must prescribe a standard form for the statement of settlement costs. The person conducting the settlement, who is usually an attorney or escrow agent, must give the form to the borrower at settlement or, on request, 1 day before. This document is the HUD-1.
- Section 5 states that within 3 days of receiving a loan application, the lender must make a GFE of the settlement costs the buyer is likely to incur. The GFE does not have a prescribed form but usually follows in part the format of the HUD-1, in which the corresponding actual costs are detailed.
- Section 8 states that no person may give or receive a kickback, fee, or any other thing of value in return for referring business to a settlement provider. The penalty for violating this provision is a fine of up to $10,000 or a prison term of not more than 1 year. The prohibition does not apply to payments for services actually performed.

Sunshine Regulation

The body of RESPA scholarship by economists is fairly short: Bourdon (1994); Colwell and Kahn (2001); Crowe, Simonson, and Villani (1981); Guttentag (2000); Hofflander and Shulman (1977); Lee and Hogarth (2000); Lexecon, Inc. (1995); Mills (1994); Peat Marwick Mitchell & Co. with Grundfest (1980); Shroder (1997); Villani and Simonson (1982); Weicher (2001, 1997); White (1984); and Woodward (2003). Of these 15 papers, only Guttentag, Lexecon, Shroder, and Woodward attempt to analyze individual data on observed RESPA-regulated behavior.

Lexecon's 1995 study compares settlement fees charged to two groups of homebuyers doing business with particular large brokerages: those who use subsidiaries of the brokerages for title services and those who get title services from independent providers. They find the two groups pay about the same. My 1997 paper views RESPA through the lens of principal-agent theory and has a microscopic sample. Guttentag (2000) and Woodward (2003) document enormous price discrimination by mortgage brokers, conduct that is lawful under RESPA but possibly indicative of failure to achieve the declared regulatory intent, because the "more effective disclosure" fails to deter the discrimination.

This article differs from the previous papers mentioned in analyzing RESPA as a regulatory strategy relying on federally mandated information disclosure. Regulation by disclosure is a common strategy in the United States. Examples include requirements for financial disclosure by publicly held corporations and banks, labeling laws for food and pharmaceuticals, statutes requiring prior notice of plant closings, informed-consent prerequisites for medical experiments, and obligations on car repair garages to provide initial estimates of the cost of repair.

The common theme of such regulation is that the less informed party must receive some minimum information from the more informed party before the transaction is considered lawful.

In regulation by publicity, government does not prohibit any type of transaction as inherently unfair, given the information provision. Louis Brandeis stated the rationale in 1913 in a quote much beloved of lawyers and regulators: "Publicity is justly commended as a remedy of social and industrial diseases. Sunlight is said to be the best of disinfectants; electric light the most efficient policeman." (1914).

Brandeis' language is rather loose: sunlight is not the most powerful of disinfectants (try chlorine or iodine), nor do electric lights have the power to arrest perpetrators. Publicity is often a less costly policy instrument than enforcement, however, so we can read Brandeis as arguing that sunshine regulation may have greater net social benefits, given enforcement costs, than any regulatory alternative, including laissez-faire.

The economic theory of enforcement, summarized recently in Polinsky and Shavell (2000: 70), holds that optimal enforcement "tends to be characterized by some degree of under-deterrence [in that...] by lowering the probability of detection from a level that would lead to first-best behavior, the state reduces enforcement costs, and although more individuals commit the harmful act, these individuals do not cause social welfare to decline substantially because their gains are approximately equal to the harm."

Perhaps in the case of the RESPA kickback rule, the government has, in conformity with theory, implicitly chosen a low probability of detection. From 1995 through 2000, for example, HUD issued no press releases announcing enforcement actions under Section 8 of RESPA, the criminal portion of the statute,[1] although one should note that since about 2003 HUD has been considerably more active in prosecuting referral claims.[2]

On the other hand, the same theory holds that harsh financial penalties for proven offenders should substitute for the low probability of detection. RESPA clearly breaks that rule: nobody ever goes to jail for RESPA violations, and the maximum statutory fine of $10,000 has not been raised since 1974. According to the Bureau of Labor Statistics' inflation calculator, $10,000 in 1974 was worth $40,872 in 2006. Actual penalties can be inferred from the cases detailed in note 3. HUD policymakers and staff may spend thousands of hours annually trying to define what "kickbacks" and "referral fees" mean for thousands of ethical service providers working in a highly complex business environment, but the consumer dealing with an unethical provider must look essentially to the disclosure requirements and his or her own resources for protection.

The general effect of sunshine regulation in a competitive market is to increase the price of the service, with an ambiguous effect on quantity sold. The regulation does nothing to reduce the cost of providing the service; on the contrary, the required disclosures require some effort—how much is an empirical question— and therefore raise the cost.

Nevertheless, the regulation, to the degree that it is effective, ensures that the consumer knows what he or she is purchasing. He or she becomes more confident—how much is an empirical question. The net effect on quantity purchased is ambiguous: the effect of the price increase may offset the greater consumer confidence in the service. The effect on consumer welfare is similarly ambiguous. To characterize the net social benefits of RESPA, we need to look more closely at the market that it regulates.

Character of Settlements and Regulatory Alternatives

Sunshine is a poor remedy if ignorance is not the problem. Consumer ignorance is certainly a factor in the market, because most people do not buy and sell real estate more than half a dozen times in their lives; but two other problems should be noted—timing and control.

Regulated transactions involve three principals: a buyer, a seller, and the ultimate lender and/or that lender's insurer. The settlement services discussed in this article consist of a series of certifications and guarantees provided by agents at the demand of the lender/insurer and sometimes the buyer:

- The buyer's credit history, income, debt load, and net liquid assets must meet minimum standards.
- The buyer must not be paying more than the property is worth, given prices on comparable recent transactions.
- The seller must have the right to sell the property.
- The property must not be encumbered or subject to disputes with neighbors.
- For FHA-backed loans, the habitation must not be subject to sudden depreciation: minimum structural standards must be met, the property must not be in the 100-year flood plain, and the building must not be infested with termites.
- The paperwork associated with all these determinations must be processed on time.
- The lender/insurer and sometimes the buyer must themselves be insured against error, oversight, or fraud in the previously mentioned determination that the seller has the right to sell the property and that it is not encumbered.

These certifications require heterogeneous expertise. An assortment of agents must deliver them competently and punctually. Service quality and timing, as well as price, are considerations for the buyer and the seller.

The buyer and seller usually endure considerable awkwardness or inconvenience if the closing is delayed. Many sales are motivated by divorce, disability, or death, and many purchases by new jobs or household formation. Much may be extracted from people in a hurry, even if they are well informed.

Because most of these services are demanded by the ultimate lender/insurer, it is often the mortgage banker or broker who will select the responsible agent to perform them, yet the banker/broker does not bear the cost. Moreover, two parties—the buyer and the seller—customarily share these expenses. The normal vigilance that consumers maintain over their own spending may be relaxed not only by ignorance and urgency but also by the reflection that somebody else will pay for part of it.

In 1974, the leading legislative alternative to the bill enacted was "lender-pay," under which the lender would be responsible for all settlement costs. Although these costs would then be passed on to the borrower (and indirectly to the seller), competition among lenders would give each lender a strong incentive to control settlement provider fees.

In 1998, HUD and the Federal Reserve Board (the Fed) (Board of Governors and HUD, 1998) endorsed a somewhat modified version of the lender-pay proposal, under which the lender would be required to offer all settlement services as a single package at a fixed price. The lender would have been permitted to offer other pricing alternatives but required to offer a package price as well. If the borrower selected a package price, unexpected deviations in the cost of services would come at the expense of the banker/broker, who would, however, have both the knowledge and the incentive to control them. Many large creditors, as well as HUD and the Fed, advocate legislation to this effect because they consider Section 8 of RESPA an obstacle to profitable offerings of fixed-price closing fees. The prohibition on kickbacks, referrals, and unearned fees might be applied to the volume discounts they would try to obtain from the service providers in a fixed-price context.

Small creditors and service providers oppose this proposal, for essentially the same reason. The ability of large creditors to demand and obtain volume discounts would enhance their competitive position relative to smaller firms and would reduce the prices charged by service providers.[3]

Any consideration of regulatory alternatives should take into account the role of the states. State law defines the rights of the property owner and whether those rights have transferred. I distinguish in this article between "title" services, which follow almost entirely from the rules of the property game defined by the several states, and the other "lending" services, which are defined by national standards. In most cases, the fees for these services are distinct.

Thus, there are at least three conceptual alternatives to the status quo—laissez-faire, lender-pay, and state law reform. The next step is to set out an empirical research agenda around a set of propositions that represent necessary conditions for the status quo to be better than these or other alternatives.

The reader is asked to stipulate that a significant national goal is for most Americans to own their own homes,[4] and that the purpose of regulation is to support that goal by ensuring a fair market in single-family residential transactions. We wish to determine whether mandated federal disclosure is by itself an efficient regulatory strategy. The following propositions follow naturally from the thesis that it is.

Proposition One. Lending and title fees are large enough to be worth regulating.

If the fees were trivial, then mandated disclosure would add to cost without adding enough to consumer surplus to make regulation worthwhile.

Proposition Two. The GFE is an unbiased and consistent estimator of lending and title fees on the HUD-1.

If lenders disclosed expected costs but their predictions were generally wrong, mandated disclosure would not be an effective approach.

Proposition Three. State law has a negligible influence on fees.

If state law had a major role in influencing fees, then state reform would be, at least, a necessary complement to federal statute and, possibly, a replacement for it.

Proposition Four. Disclosure so strengthens the negotiating position of buyers and sellers relative to service providers that the principals' personal characteristics do not influence the fees they pay.

RESPA seems designed to promote equity among principals so that all purchasers of settlement services have a common minimum access to relevant information. Although social science has no universally accepted definition of "fairness," a working definition for empirical purposes might be that people with different identifiable characteristics should not pay different fees for the same services unless those characteristics are linked to higher costs of service provision. If individual characteristics not linked to cost are associated with differences in the level of fees, then disclosure regulation might less efficiently protect some principals than other forms of regulation would.

Data

For this study I examined GFEs, HUD-1s, and credit reports in FHA insurance binders. Two hundred cases were randomly selected by the Urban Institute from the universe of FHA detached single-family home sales in the United States with closing dates in June 1997. The number entering the dataset is 146. A few cases were omitted because the closings did not occur in June, the property was not detached single-family (contrary to the data in the FHA central file), or only the buyer's or seller's costs in the transaction were revealed in the HUD-1; these deletions may be treated as random. A larger number of cases were omitted because the binders could not be retrieved from storage, and these omissions are not random. I have no cases from New Mexico, North Dakota, Oklahoma, South Dakota, Texas, Utah, or Wyoming because of retrieval failure. Delaware, Hawaii, Montana, Vermont, West Virginia, and Wisconsin did not have any cases that fell into the sample, so my findings do not apply at all to 13 states.[5]

A few words are in order on the relationship of the universe from which this sample was taken to other populations that might be of interest. FHA borrowers are less wealthy and more likely to be African American or Hispanic than their conventional counterparts are. They may be more likely to finance a large portion of the settlement cost, rather than pay it at closing. FHA home prices are generally lower than Fannie Mae, Freddie Mac, or jumbo-loan home prices. The FHA may require certain certifications, such as appraisals or home inspections, that other lenders do not require. FHA market share varies from state to state for reasons that are not always clear. Finally, the sampling of transactions from a particular period of time overweights states such as Arizona, where the real estate market was unusually active relative to the total number of homeowners. Exhibit 1 displays the distribution of the sample by state.

Measurement of transaction costs needs to be scaled to the size of the transaction. The putative sales price of the home is misleading, because the seller may agree to a lower (or higher) price in return for a smaller (or larger) share of the closing costs. By agreeing to a $1,000 increase in his or her share of the fees, for example, the buyer can perfectly compensate the seller for a $1,000 reduction in the sales price. In this article, I scale the transaction by the "value to seller" (VTS), which is the net change in the seller's financial assets as a result of the transaction; that is, net cash *plus* payoff of debt. "Debt" includes all mortgages, unsecured debt, ex-spouse's share of the proceeds, delinquent property taxes, unpaid child support, and the like. Debt excludes payments for improvements to the property to meet FHA standards or the buyer's demands; such payments are also not counted as settlement fees.

Exhibit 1

Sample Distribution by State

State	N	State	N	State	N
Alabama	3	Indiana	2	New Hampshire	2
Alaska	1	Iowa	4	New Jersey	4
Arizona	9	Kentucky	1	New York	5
Arkansas	2	Louisiana	4	North Carolina	5
California	27	Maryland	4	Ohio	8
Colorado	2	Massachusetts	2	Oregon	2
Connecticut	3	Michigan	5	Pennsylvania	5
District of Columbia	1	Minnesota	3	South Carolina	1
Florida	10	Mississippi	1	Tennessee	3
Georgia	6	Missouri	1	Virginia	5
Idaho	4	Nebraska	1	Washington	3
Illinois	3	Nevada	3	Total	146

In an arm's-length transaction with third-party financing, there is no on-the-books compensation that would leave the seller indifferent to a reduction in VTS. Suppose, for example, that the sales price is $120,000 with $9,000 in closing costs charged to the seller and an $80,000 mortgage payoff. The VTS is $111,000—the sum of the seller's net cash ($31,000) and the $80,000 payoff. The seller would be just as happy with a sales price of $123,000 and closing costs of $12,000—the price would have changed, but the VTS would be the same.

VTS in the sample averages $84,278, with a standard deviation of $33,470.

The settlement fees analyzed here are those that belong in the 800, 1100, and 1300 series of the HUD-1, with a few exclusions.[6] Essentially the intent is to exclude obvious choice variables, either seller's choices or buyer's. Fees to real estate agents are not of interest, because the seller made a choice about whether to market the property himself or herself. Points paid to the lender, whether for "origination" or for buying down the interest rate, are also not of interest, because the buyer chooses them. How many points, if any, to pay is the essence of the mortgage shopping decision for most people. Payment of the FHA mortgage insurance premium (MIP) at closing ("upfront MIP") rather than over time is also excluded. Taxes to state and local governments are not within the scope of RESPA, and funds paid into escrow are not within the scope of this article.[7]

Title and settlement agent services are frequently performed by the same or related parties and are reported together in the 1100 series. All fees properly reported there, or reported elsewhere and paid to a title or settlement agent, are treated as "title" fees. All the remaining fees are "lending" fees.

Results

Proposition One: Lending and title fees are large enough to be worth regulating

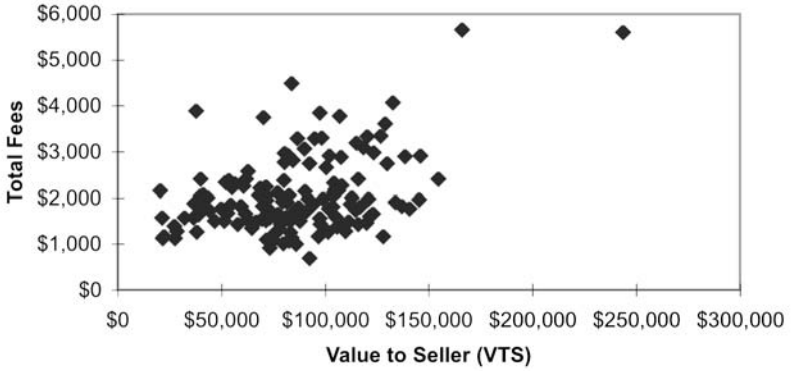
VTS averaged $84,278 in this sample while total lending and title fees averaged $2,060, or 2.4 percent. To repeat, these fees do not include either points or commissions to real estate agents. This

amount is clearly substantial. Lending and title fees vary between $692 and $5,671, or between 0.7 percent and 10.6 percent of the VTS.

Exhibit 2 depicts the scatter plot of VTS against fees. The relationship is linear in a very rough way. At least one important fee, the title insurance premium, is charged per dollar of the sales price or mortgage principal. Other significant fees, however, are in principle based on the time the agent spends on the service, that time being essentially unrelated to the size of the transaction.

Exhibit 2

VTS and Total Fees



The substantial fixed-cost element to settlement fees has the same impact as a regressive tax would on smaller transactions. In terms of efficiency, it rewards the buyer for engaging in larger transactions—for buying a new home, for example, rather than purchasing and renovating an existing one or for buying in high-priced jurisdictions rather than low-priced ones. In terms of equity, the regressivity favors buyers and sellers of more costly homes over less costly ones; however, buyers and sellers of cheap homes tend to have lower incomes than do buyers and sellers of expensive units.

In short, lending and title fees are large in absolute terms, have a structure that may distort the housing market, and will tend to work a disproportionate burden on the least affluent participants in the market. If regulation would do any good—a point that we cannot take for granted—these fees are worth regulating.

Proposition Two: The GFE is an unbiased and consistent estimator of lending and title fees on the HUD-1

The GFE is present in 47 of the 146 FHA binders. It is unfortunate that the sample is so small, but the FHA stopped requiring a copy of the GFE for underwriting purposes in 1996.

Data loss of this extent raises some natural suspicion of selection bias, but such bias is probably negligible. A lender who submitted the GFE in 1997 was either unaware of the rule change or, if aware, decided deliberately that it would be less costly to transmit the GFE than to take the trouble to separate it from the mass of papers that are still required for underwriting. All lenders, however

well informed they might be about the rules, would have known from experience that FHA underwriters were not using the data in the GFE to decide whether the loan met FHA standards, much less to police lending and title fees. While researching my 1997 paper, which was based on 1994 binders, I often discovered binders with no GFEs, although these documents were in theory required at that time, and some GFEs that were present in the binders were illegible. I have conducted one very simple test for bias: in a regression holding VTS constant, presence of a GFE in the binder is not significantly related to total lending and title fees actually paid.[8]

The GFE is for the benefit of the buyer, not the seller. At the point of the loan application the buyer may not have made arrangements with the seller about settlement fees, or this arrangement may be subject to further negotiation. The analyst must interpret whether the line items in the document refer to full costs or to the buyer's costs alone. Some GFEs explicitly separate seller's costs from buyer's costs, but most do not. For this analysis, I have compared the GFE with two versions of the outcome: total lending and title fees on the one hand, and lending and title fees paid by the buyer only on the other. I have assumed that the GFE estimates apply to the alternative where the absolute value of the difference between the estimate and the realization is the smallest.

Regression of the test variable (realized total lending and title fees or the buyer's share of same, whichever is closer to the GFE estimates) on the GFE estimates had the following result (standard errors in parentheses):

GFE test = 290.24 + .825 * GFE, R^2= .276 N=47
(277.63) (.199)

In this regression, a perfect estimator would yield an intercept of 0 and a slope of 1.0. The F-statistic for (0,1) being the true intercept and slope coefficients, respectively, is 189, so we can reject the null hypothesis that the true parameters are, in fact, 0 and 1 at conventional confidence levels, even if we cannot reject the parameters individually.

To put these results in plain English, the GFE is right "on average," but many GFEs are off by a lot. The average value of the difference between the test variable and the GFE estimate is just 75 cents, but the mean of the test variable is $1,832 and the mean of the GFE estimate is $1,332. In this sample, most buyers got, on average, small overestimates (29 cases too high out of 47) and a minority received, on average, large underestimates. The average absolute value of the error is $328, so the typical estimate is off by about 18 percent.

My 1997 paper, based on a smaller and more heterogeneous sample, reported that the GFE is unbiased but imprecise. The average absolute value of the error reported in that paper, by coincidence, was also $328. Upon further study, I now believe the GFE is usually biased, but that the bias is conditional on factors that may not be observable. Many lenders seem to prefer small overestimates of the title and lending fees to make sure the buyer will have enough money on hand to close. More troubling are the minority of cases in which very large underestimates occur. Lenders also routinely fail to forecast fees arising from delays in underwriting. I have yet to see a prediction of a courier or fax fee in a GFE, although these fees are common.

Proposition Three: State law has a negligible influence on fees

I believe this proposition is not true. Common sense would warn any analyst that title fees, in particular, are highly sensitive to state law, if only because the clarity of state law determines the clarity of the title that is being transferred.

It is not easy to make the commonsense case with data from a small sample with a large number of states. Exhibit 3 shows average fees and VTS in the five states with at least six observations in the sample; but, on casual inspection, the HUD-1 forms from these states do not exhibit striking deviations from the norm.[9]

In the examination of mortgage insurance binders, two states stood out. Title determinations in New Jersey seem to require much higher involvement by attorneys, with their higher-than-average wage rates, and much higher premiums per dollar of title insurance coverage than in other states. The office of the state treasurer has assumed responsibility for title insurance in Iowa, and, from casual inspection, premiums appear to be lower there by hundreds of dollars than they are in other states. Exhibit 4 reports regression results that tend to support this impression. (Note from exhibit 1 that there are only four Iowa cases and five New Jersey cases, so high standard errors are to be expected.) Iowa fees are lower and New Jersey fees are higher than one would otherwise expect.

Exhibit 3

Lending and Title Fees in Best Represented States

State	Fees	Average Percentage of VTS	VTS	N
United States	$2,060	2.8%	$84,278	146
Arizona	$2,217	3.0%	$78,652	9
California	$2,870	3.0%	$105,144	27
Florida	$2,382	3.6%	$70,272	10
Georgia	$2,190	3.3%	$71,961	6
Ohio	$2,052	2.6%	$84,948	8

VTS = value to seller.

Exhibit 4

Effects of State Law on Title Fees

Explanatory Variable	Coefficient	Standard Error
Constant	589.9	90.03
VTS	0.00644 **	0.000944
New Jersey	529.49 **	181.33
Iowa	– 232.96	201.23
N	146	
R^2	0.299	

VTS = value to seller.
*** Significant at the 99-percent confidence level.*
Note: Dependent variable is title fees.

Proposition Four: Disclosure so strengthens the negotiating position of buyers and sellers relative to service providers that the principals' personal characteristics do not influence the fees they pay

Wild variation occurs in the detailed fees charged. For example, the credit report is a standard national, largely automated, service that typically costs about $50, but charges range from $25 to $100. The scatter plot in exhibit 2 confirms huge deviations in total lending and title fees paid for transactions with similar VTSs.

What can explain these differences? I present two different regression models.

Title vs. Lending Fees

Consider some alternative approaches to deviant fees. One hypothesis is that a high fee for one service is completely independent of the fee for another service because these fees are quite distinct in character. In that case, there would be zero correlation between one fee category total and another.

A second hypothesis is that compensation occurs within the overall transaction, an apparent overcharge on one line effectively paying for other services. In that case, there would be a negative correlation between one fee category total and another.[10]

The third hypothesis might be termed the Eli Wallach version of reality, from the reasoning of the bandit leader in *The Magnificent Seven*—"If God had not meant them to be sheared, he would not have made them sheep." In this line of reasoning, a sheep can be sheared on one side (for lending fees) and on the other side, too (for title fees), because some people are candidates for high fees in both title and lending. It would follow that there would be a positive correlation between these categories.[11]

Exhibit 5 indicates that holding VTS constant, $1 more of lending fees translates into another 24 cents worth of title fees as well. Cross-fee compensation is not occurring, and the fees for different services are not independent of each other. This result does not prove but is consistent with the sheep-shearing hypothesis.

Exhibit 5

Mutual Dependence of Lending and Title Fees

Explanatory Variable	Coefficient	Standard Error
Constant	411.69	94.9
VTS	0.00611**	0.000985
Lending Fees	0.238**	0.0614
N	146	
R^2	0.321	

VTS = value to seller.
*** Significant at the 99-percent confidence level.*
Note: Dependent variable is title fees.

Effects of Individual Characteristics

A more comprehensive approach to this proposition would require an effort to explain the level of title and lending fees as a whole. I hypothesize that title and lending fees should be a function of the VTS, of state law, and of buyer and seller characteristics.

Successful builders and developers who plan on a large number of similar transactions can capture whatever economies of scale exist in lending and title processes. For example, some new home sales do not appear to have appraisal or survey fees, possibly because of special banking arrangements that the seller has made, and some appear to have reduced title fees. A dummy variable (New Home) shows whether the seller is a homebuilder.

The Troubled variable has a value of unity if the sale appears motivated by a divorce, or if there is substantial delinquency on property taxes. This variable could raise fees by one of three routes—by increasing the complexity of the transaction; heightening the time pressure on the seller, who must pay bonuses to speed up the process; or reducing the seller's resistance to agent opportunism.

The Premium variable denotes a reported payment outside of closing by the lender to the broker for an above-average interest rate on the mortgage. Mortgage brokers—but not bankers—are obliged to report all such payments on the HUD-1.[12] These "service release" or "above par" premia are substantial, ranging from 1 to 4 percent of the loan principal in this sample.[13] Perhaps such premia are paid in exchange for discounts on closing fees; other things being equal, their disclosure on the HUD-1 should strengthen the bargaining position of the buyer. If, however, they merely reflect the buyer's naïveté or some high value of time relating to his or her situation, there will be no compensation in lower lending fees.[14]

One version of the model also regresses fees on credit score variables. Credit scoring has become a standard, although far from definitive, method of summarizing and evaluating the large amounts of data in a borrower's credit record. Pennington-Cross and Nichols (2000: 330) report that credit history "plays an important role in determining the FHA-conventional mortgage choice," so credit history might affect the type of lender available to the borrower.

Lenders differ in their loan standards, and some are more willing to work with lower scoring applicants than others. Borrowers with bad credit presumably represent more work for the lender and a higher risk that the loan will not pass muster with the FHA. It seems plausible that higher risk borrowers might be sorted with higher cost lenders. In this scenario, the lower cost lenders would screen out applicants with poorer credit so they can remain competitive in serving higher credit, cheaper-to-serve borrowers.

The value I recorded for credit score is the median of all credit scores reported for all applicants on the loan. Scores are often separately available from each of the national credit reporting agencies (Equifax, TRW, and TransUnion). A husband and wife, for example, might each have one score from each agency, so it is common to find six scores for one application.[15] If the buyer's median credit score was in the lowest quintile for the sample (below 611), the dummy variable Bad Credit takes a value of 1. The dummy variable Good Credit is determined symmetrically, if the buyer's median score is in the highest quintile (above 722). The dummy variable No Credit Score captures the cases in which there is no credit score, usually because the buyer has no credit history.

Exhibit 6 shows that lending and title fees go up about one penny per dollar of VTS, with a $1,200 intercept indicating a substantial fixed cost unrelated to the transaction scale. Coefficient estimates for New Jersey and Iowa are consistent with the previous findings but do not reach statistical significance.

Exhibit 6

Effects of Buyer and Seller Characteristics on Total Fees

Explanatory Variable	Coefficient	Standard Error	Coefficient	Standard Error	No. Cases Where Value=1
Constant	1192.58	164.49	1163.82	174.85	
VTS	0.00984**	0.00182	0.00993**	0.00184	
New Jersey	295.47	330.58	318.31	345.04	6
Iowa	– 310.98	35.25	– 260.52	371.41	4
New Home	– 385.07*	219	– 369.32*	223.53	12
Troubled	1053.44**	263.19	1036.15**	266.17	8
Premium	120.18	217.65	100.96	221.92	12
Bad Credit			55.58	169.74	26
Good Credit			– 81.86	168.71	26
No Credit Score			247.28	202.71	15
N	146		146		
R^2	0.294		0.304		

VTS = value to seller.
** Significant at the 90-percent confidence level.*
*** Significant at the 99-percent confidence level.*
Note: Dependent variable is total lending and title fees.

Fees for new home sales average about $400 less than fees for sales of existing homes, all things being equal. Current institutional arrangements for property transfer amount to an unplanned suburbanization policy—a differentially higher tax on existing homes.

Sale by a troubled seller leads, on average, to another $1,000 to $1,100 of fees, presumably at the seller's own expense. It is difficult to understand how marital or property tax troubles could so inflate title costs.

I find no evidence that FHA borrowers receive any relief in fees when they borrow at above-market rates: the coefficient on the Premium variable is insignificantly positive. The absence of disclosure by mortgage bankers biases the coefficient toward 0. It is suggestive that the coefficient takes a relatively high positive value in these circumstances rather than the negative value that indirect compensation would dictate. It seems that the premium must reflect either exploitation of the buyer's ignorance of the market or an urgent need on the buyer's part for some unmeasured characteristic of performance, such as speed, by service providers.

The pattern of coefficient signs for the credit variables is roughly consistent with the notion of sorting among lenders suggested above, with high-scoring borrowers paying a bit less, low-scoring borrowers a bit more, and borrowers with no scores quite a bit more in fees. None of these coefficients, however, reaches statistical significance.

Conclusion

At first glance, lending and title fees seem to be appropriate targets for regulation. The federal government created and, through a variety of means, maintains the long-term amortizing home mortgage market; the services for which fees are paid are often federally mandated, and title services are intended to verify that state law on the transfer of property is satisfied. Thus, the federal and state governments require that lending and title services should be performed, and these governments have some responsibility for the orderly functioning of the market for services and the underlying market for housing.

This argument does not necessarily support the current RESPA regime, a form of sunshine regulation implicitly founded on the proposition that the only problem in the market is consumer ignorance, solved by federal action. Consumer ignorance might not be the only problem in the market, and nonfederal action might be preferable.

Sunshine regulation raises costs and may or may not increase consumer surplus. For the current regime of mandatory federal disclosure to be an *efficient* and *sufficient* regulatory strategy, four empirically testable propositions, which vary from the previous four propositions, must follow: (1) lending and title fees are large enough to be worth regulating, (2) mandated fee estimates are consistent and unbiased, (3) state action is ineffectual, and (4) disclosure neutralizes the effects of buyer and seller personal characteristics on the level of fees.

From the small sample analyzed in this article, only tentative conclusions about these propositions are possible. The topic deserves a much deeper research effort than this one. When that deeper effort occurs, I would expect it to confirm the following results:

1. Title and lending fees create a large wedge between what the buyer pays in a transaction and what the seller receives, amounting to perhaps 2.4 percent of VTS on average, but sometimes much more. These fees are worth regulating, if regulation can be efficient.

2. A test of the GFE as an unbiased and consistent estimator of fees fails. In practical terms, the GFE is a reasonably good guide to fees for most people (with a tendency, if anything, to overestimate the fees), but, for some borrowers, realized fees are much higher than the estimates. If any form of regulation is needed, its benefits might well reside primarily in the protection of some minority that substantially overlaps this latter group.

3. State action is not ineffectual. For better (Iowa) and for worse (New Jersey), state action appears to strongly influence title fees. Actions to improve the clarity, simplicity, and accessibility of title records could lower fees in many locations, as would reforms such as Iowa's that address inefficient oligopoly structures in the title insurance business. The sample size in the current study is not adequate for an investigation of interstate differences, and additional research into the extent and causes of cost differences among states could have large policy value.

4. Disclosure may not make the market fair, in that buyers' and sellers' characteristics seem to lead to differences in fees for transactions of equal size. Lending and title fees paid for new home sales are notably lower than fees for existing homes, presumably because builders and developers can capture some economies of scale. To the extent that Section 8 of RESPA inhibits

lenders from realizing such economies and passing them on to consumers, this represents a previously unrecognized distortion in the housing market, lowering the prices of new (mostly suburban) homes relative to existing residences.

Buyers' and sellers' characteristics of other sorts also affect market outcomes. Transactions in which the seller pays off an ex-spouse or is seriously delinquent in property taxes seem to generate much higher fees. There does not appear to be any reduction in fees in transactions in which the mortgage broker receives a "service release" or "above-par premium" from the ultimate lender for obtaining an above-market interest rate; in a fair market there probably would be a fee reduction.

In my 1997 paper, I suggested a sunset clause for RESPA, a fate that might be entirely suitable (as well as poetic) for sunshine legislation. The law is inherently informational in character and the delivery of information in our era is undergoing revolutionary change. But lack of information does not appear to be the only problem in this market. The present ambiguous language of Section 8 of RESPA, which prohibits kickbacks and referral fees, neither allows for effective enforcement of violations nor offers sufficient deterrence to violation, although it may deter lender actions that would lower fees to consumers. Both buyers and sellers need transparency and simplicity, and neither is identical with disclosure.

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Notes

1. Strictly speaking, a low frequency of detection does not necessarily imply a low probability of detection. We do not know how many Real Estate Settlement Procedures Act violations are undetected.

2. See the website www.hud.gov for the following examples:

   http://www.hud.gov/offices/hsg/sfh/res/tulsamcgraw.pdf (Tulsa, Oklahoma; $325,000 fine; four firms and six individuals).

   http://www.hud.gov/offices/hsg/sfh/res/downinghomes.pdf (Cordova, Tennessee; $1,382 fine; one firm).

   http://www.hud.gov/offices/hsg/sfh/res/eastwest.pdf (Worcester, Massachusetts; $150,000 fine; one firm).

http://www.hud.gov/offices/hsg/sfh/res/znet.pdf (Atlanta, Georgia; $15,000 fine and $400 rebate per affected consumer; two firms).

http://www.hud.gov/offices/hsg/sfh/res/allied.pdf (national mortgagee; $370,000 fine; one firm).

http://www.hud.gov/offices/hsg/sfh/res/fametitsettl.pdf (Memphis, Tennessee; $680,000 fine; one firm).

3. Whether the savings would be passed on to consumers would depend on the structure of the mortgage market. In the current, highly competitive state of the market, it is plausible that most savings would eventually be passed on.

4. More than two out of three U.S. households own their own homes.

5. U.S. Department of Housing and Urban Development's Office of Policy Development and Research has commissioned a closing costs study with hugely larger sample size. Its reports and data are expected in the near future. Researchers interested in replicating this study should be warned that abstracting data from Federal Housing Administration binders is labor intensive.

6. They may belong in those series of the HUD-1, but they are often inserted elsewhere. I have carefully inspected all parts of the HUD-1 and the Good Faith Estimate for lending and title fees that were omitted from these sections, so that all fees would be captured. Whenever any of these records showed contributions from the lender toward settlement fees, I have subtracted those contributions from total fees paid.

7. Woodward (2003) and in a subsequent personal communication reports that payment of points is associated with higher lending and title fees and that higher real estate commissions are associated with higher title fees.

8. The insignificant coefficient on the Good Faith Estimate (GFE) dummy is positive, which is not consistent with the idea that only the more honest lenders are submitting GFEs.

9. Note that the "average percent fee" is the average of all percentages, not the ratio of the average fee to the average value to seller.

10. All other things being equal, there should be a negative correlation because, in deciding whether some of the miscellaneous fees constituted a "lending" or a "title" fee, I undoubtedly made random errors, and a dollar added mistakenly to one category is necessarily subtracted from the other. Also, more (or less) care in document preparation by the lender leads to less (or more) care required of the escrow agent, and so forth.

11. It is also possible that regional differences in wage levels could introduce positive correlation between the lending and title fees. In a larger sample, one could address this issue by using dummy variables for the states on the right-hand side of the regression. In a personal communication, Woodward reports that she obtained the same parameter estimate (24 cents on the dollar) in her large sample as I have in this small sample, but that when she included state dummies, she obtained an estimate of 12 cents on the dollar, "still too large and too systematic to imagine the lenders and title agents as operating entirely independently."

12. The differential disclosure requirement for mortgage brokers is controversial.

13. I do not count these premia as fees paid by the buyer or seller; first, because they are paid by the ultimate lender, and, second, because they depend directly on the interest rate, which I treat throughout as of the essence of the loan rather than a fee.

14. Above-market rates do not compensate for higher risk borrowing. All Federal Housing Administration borrowers are treated equally in the secondary market.

15. Credit scores in the sample are highly variable, with a range from 502 (very bad credit) to 793 (very good credit); scores are missing for 15 cases, or about 10 percent. The mean score for those with scores is 666, the median 661, and the standard deviation is 66.

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