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UNITED STATES OF AMERICA
DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT

Proposals to Relax the Interpretation of Section 8 with Regard to Home Mortgages

Docket No. R-88-1256

July 15, 1988

STATEMENT OF THE STAFF OF THE BUREAU OF ECONOMICS OF THE UNITED STATES FEDERAL TRADE COMMISSION

I. Introduction and Summary

Section 8 of the Real Estate Settlement Procedures Act of 1974 (RESPA)[1] prohibits compensated referrals for "business incident to or part of a real estate settlement service involving a federally related mortgage loan." Violations of Section 8 are subject to criminal and civil penalties. In a Notice of Proposed Rulemaking (NPRM),[2] the Department of Housing and Urban Development (HUD) announced that it is considering whether to create exemptions to the application of Section 8. This analysis by the staff of the Federal Trade Commission[3] suggests that these, and other exemptions, may provide significant benefits to consumers.[4]

HUD is proposing to exempt from Section 8 payments by a borrower (but not a lender) to mortgage brokers or other intermediaries, such as real estate agents, who assist in bringing the borrower and lender together.[5] HUD is also considering whether to exempt payments by a lender to a mortgage broker or any other person who assists in bringing the borrower

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[1] Real Estate Settlement Procedures Act of 1974, Pub. L. 93-533 (1974) (codified at 12 U.S.C. Section 2601 et seq.).

[2] 53 Federal Register 17424 (1988).

[3] These comments are the views of the staff of the Bureau of Economics of the Federal Trade Commission. They are not necessarily the views of the Commission or of any individual Commissioner. Please contact staff economist Carolyn A. Woj at (202) 326-3434 should you have any questions regarding our comments.

[4] NPRM at 17428. Legal issues pertaining to the inclusion of mortgage loans in the definition of settlement services will not be addressed in this comment.

[5] NPRM at 17429; 24 C.F.R. § 3500.14 (g)(6). If adopted, the proposed regulation would formalize a legal opinion issued by HUD's former General Counsel. This opinion approved a mortgage brokering program involving voluntary payments by borrowers to persons who assisted in bringing the lender and borrower together. NPRM at 17429.

and lender together, as long as that person does not provide any other settlement service in connection with the transaction and does not receive any other compensation from the borrower, seller, or any other person for services related to the transaction ("neutral intermediaries").[6]

The first proposal would formally authorize payments by borrowers to persons who search for loans on their behalf, a practice that is now allowed under an informal legal opinion by HUD's former General Counsel. We believe that this practice may increase consumer welfare relative to an environment where no such payments are permitted. Allowing borrowers to hire agents or brokers to locate loans will, of course, create some risk that the agent will not diligently search for the best loan available. Because the borrower may not have sufficient information to assess the performance of the agent, the agent may not seek the loan with the lowest interest rate, instead settling for the first loan for which a buyer is qualified. Nevertheless, the mere possibility of this harm does not necessarily warrant prohibiting transactions between borrowers and mortgage brokers, for these transactions may create substantial benefits by lowering consumers' search costs. Moreover, since only the consumer pays for the services, there is no risk that the consumer will be steered to only those lenders who pay referral fees.

HUD is also considering whether to allow payments by lenders to persons who bring borrowers and lender together, although only under a restrictive set of conditions. The person cannot provide any other settlement services and cannot receive any other compensation from the

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[6] NPRM at 17429. This exemption would not extend to the payment of referral fees by lenders to real estate brokers, since these persons do provide other settlement services related to the transaction.

seller or buyer. Even under these restrictive conditions, however, permitting the payment of fees by lenders to intermediaries could further increase the available volume of truthful information about home mortgages, which would benefit consumers. Other possible benefits include more rapid development of innovative forms of service, such as computerized loan origination services, and increased competition in the market for home mortgages. In addition, we suggest that HUD consider expanding this option to allow payment of referral fees to any persons, regardless of whether they meet the restrictions. Such fees could encourage real estate brokers and others to provide even more options to borrowers, and to adopt cost saving innovations more rapidly.

Although permitting the payment of fees from lenders to all types of intermediaries may generate consumer benefits, it also creates the possibility of consumer losses. Under certain circumstances, this option may result in non-neutral, or "interested" intermediaries steering consumers to loans whose provisions are less favorable than those offered by a lender who does not pay a fee. These possible costs must be weighed against the possible benefits from lender payments. Though we lack sufficient data to quantify precisely these costs and benefits, our analysis suggests that any possible concerns associated with the payment of referral fees can be adequately addressed through some form of mandatory disclosure, whereby interested intermediaries would be obligated to notify their clients of the existence of referral fee arrangements with lenders.

The remainder of this submission is organized as follows. Section II describes the interest and relevant experience of the Federal Trade Commission staff. Section III reviews the rationale underlying enactment of

Section 8. Section IV examines the likely incentive effects of referral fees and the reasons why their prohibition may sometimes be desirable. Section V discusses the market for home mortgages and provides an analysis of the proposals, including an examination of their potential costs and benefits. In addition, we provide a framework within which to consider the costs and benefits of a mandatory disclosure that a referral fee will be paid. Section VI presents our conclusions.

II. Interest and Experience of the FTC

Under the Federal Trade Commission Act, 15 U.S.C. § 41 et seq., the Commission is charged with preventing unfair methods of competition and unfair or deceptive acts or practices. The staff of the Federal Trade Commission, upon request by federal, state, and local governmental bodies, regularly analyzes regulatory proposals to identify provisions that may impede competition or increase costs without providing countervailing benefits to consumers.

For several years, the Commission staff has examined the competitive effects of various restrictions on state-licensed professionals, including optometrists, dentists, and lawyers.[7] Among the restrictions that we have examined are ones that, like Section 8, prohibit the payment of referral

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[7] See Liang and Ogur, Restrictions on Dental Auxiliaries (Federal Trade Commission, 1987); Improving Consumer Access to Legal Services: The Case for Removing Restrictions on Truthful Advertising (Federal Trade Commission, 1984); Bond, Kwoka, Phelan, and Whitten, Effects of Restrictions on Advertising and Commercial Practice in the Professions: The Case of Optometry, (Federal Trade Commission, 1980).

fees.[8] In addition, the Commission staff has extensively studied the nature of competition in the real estate industry.[9]

[8] Comments of the Federal Trade Commission's Bureaus of Competition, Consumer Protection and Economics re the Development of Regulations Pursuant to the Medicare and Medicaid Anti-Kickback Statute, Presented to the Department of Health and Human Services (December 18, 1987); Letter from Janet M. Grady, Regional Director, San Francisco Regional Office, Federal Trade Commission to Hon. Chuck Hardwick, Speaker of the Assembly of the State of New Jersey, re Assembly Bill 2647, which would have prevented a physician from referring patients for physical therapy to an entity in which the physician's family had any financial interest (May 21, 1987); Letter from Walter T. Winslow, Acting Director, Bureau of Competition, Federal Trade Commission to H. Fred Varn, Executive Director, Florida Board of Dentistry (Nov. 6, 1985); Letter from Walter T. Winslow, Acting Director, Bureau of Competition, Federal Trade Commission to George M. Sanchez, O.D., President, Arizona State Board of Optometry (Oct. 17, 1985). Copies of these comments are available from the Federal Trade Commission's Office of Public Reference.

[9] The Residential Real Estate Brokerage Industry (Los Angeles Regional Office (LARO) of the Federal Trade Commission, 1983); Butters, Consumers' Experiences with Real Estate Brokers: A Report on the Consumer Survey of the Federal Trade Commission's Residential Real Estate Brokerage Investigation (Federal Trade Commission, 1983). Our law enforcement initiatives have also developed expertise within the staff. Florence Multiple Listing Service Inc. of Florence, S.C., No. C-3228 (April 20, 1988) (consent order settling charges that respondent had restrained competition by restricting membership); Multiple Listing Service Mid County Inc. of Brooklyn, N.Y., No. C-3227 (April 20, 1988) (consent order ending practices that allegedly restrained price and service competition among residential real estate brokers); Multiple Listing Service of Greater Michigan City Area, Inc., 106 F.T.C. 95 (1985) (consent order); Orange County Board of Realtors, Inc., 106 F.T.C. 88 (1985) (consent order); Brief for the Federal Trade Commission as Amicus Curiae Coldwell Banker Residential Real Estate Services of Illinois, Inc. v. Clayton, 105 Ill. 2d 289, 475 N.E. 2d 536 (1985).

III. Stated Purpose of the RESPA Section 8 Provision

In the late 1960's, concerns arose that the cost of real estate settlement services could be so substantial as to interfere with the national goal of widespread home ownership.[10] In 1969, concerns over what were considered to be unnecessary and inflated settlement costs led a Congressional subcommittee to hold public hearings.[11] In response to the hearings and subsequent report (which expressed concern over the cost of settlement services), Congress enacted section 701 of the Emergency Home Finance Act of 1970.[12] This provision directed HUD and the Veterans Administration (VA) to study real estate settlement costs.[13]

One of the primary factors[14] identified in the HUD/VA Report[15] as contributing to the allegedly high price of settlement services was a system of rebates and referral fees then existing in the industry.[16] Given its

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[10] Whitman, Home Transfer Costs: An Economic and Legal Analysis, 62 Georgetown Law Journal 1311 (1974).

[11] The hearings were held on conditions then existing in Washington, D.C.

[12] Barron, Federal Regulation of Real Estate: The Real Estate Settlement Procedures Act 11 (1975).

[13] Emergency Home Finance Act of 1970, § 701. USCA 12 § 1710. This provision also directed HUD and the Veterans' Administration (VA) to provide Congress with appropriate recommendations, and to set standards governing settlement costs in connection with Federal Housing Administration (FHA) and VA home loans.

[14] Other factors cited in the report include excessive specialization and excessive duplication in the land title record system.

[15] Senate Committee on Banking, Housing and Urban Affairs, 92d Congress, 2d Session, Mortgage Settlement Costs: Report of Department of Housing and Urban Development and Veterans' Administration (1972).

[16] The report concluded that "[c]ompetitive forces in the conveyancing industry manifest themselves in an elaborate system of referral fees, kickbacks, rebates, commissions and the like as inducements to those firms

authority under Section 701 of the Emergency Home Finance Act of 1970, HUD established proposed maximum fees for certain settlement costs in 1972. Because of Congressional opposition to, and criticism of, the maximum fee schedules, the schedules were not published in final form.[17] RESPA, however, was enacted in 1974, and contained a provision that prohibited the payment or receipt of referral fees for business incident to settlement services involving a federally related mortgage loan.[18] It was thought that a prohibition of referral fees would decrease the cost of providing settlement services and benefit consumers by lowering prices.

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and individuals who direct the placement of business. These practices are widely employed, rarely inure to the benefit of the home buyers, and generally increase total settlement costs." HUD/VA Report at 3.

All of the study's participants did not concur in the study's findings. John C. Payne of the University of Alabama Law School acted as a consultant to the study. He observed that "[t]he basic data collected relates only to FHA and VA insured mortgages, no effort has been made to classify rationally the information obtained, and all elements of transactions other than monetary outlay have been ignored. It is impossible to begin a consideration of the legitimacy of costs until we know exactly who performs what services, for whom, under what conditions, and at what cost." Hearings before the Subcommittee on Housing and Urban Affairs of the Committee on Banking, Housing and Urban Affairs, United States Senate 92d Congress Second Session on Mortgage Settlement Costs March 1, 2, and 3, 1972, p. 219.

[17] Barron, <u>Federal Regulation of Real Estate: The Real Estate Settlement Procedures Act</u> 18 (1975).

[18] Federally related mortgage loans include any loan that is "made in whole or in part by any lender the deposits or accounts of which are insured by any agency of the Federal Government, or is made in whole or in part by any lender which is regulated by any agency of the Federal Government." RESPA Section 3500.2 (b) (2) (i). Most home mortgage loans are covered by RESPA.

IV. The Use of Referral Fees Between Intermediaries and Providers

Referral fees provide intermediaries with an incentive to recommend the use of a particular professional or firm to consumers. In essence, they are, like advertising, a means for a business to attract customers. In a world of perfect information and perfect competition, advertising, referral fees, and recommendations would not be needed.[19] Since any consumer could evaluate the available combinations of price and quality offered costlessly, advertising or a recommendation from a third party would be of no additional value. Firms would appeal to consumers directly, rather than by advertising or by paying third parties to recommend them. Firms could attract customers by simply lowering prices and/or increasing quality.

Advertising and referral fees are used when information is costly to obtain. Both theoretical[20] and empirical studies[21] indicate that by increasing the amount of information on price and quality available to consumers, advertising actually decreases prices. Similarly, commissions or referral fees, by increasing the amount of information available, may increase competition and decrease prices.

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[19] See Pauly, The Ethics and Economics of Fee-Splitting, 10 Bell Journal of Economics 344 (1979).

[20] See Stigler, The Economics of Information, 69 Journal of Political Economy 213 (1961).

[21] Improving Consumer Access to Legal Services: The Case for Removing Restrictions on Truthful Advertising (Federal Trade Commission, 1984); Effects of Restrictions on Advertising and Commercial Practice in the Professions: The Case of Optometry (Federal Trade Commission, 1980); Benham and Benham, Regulating Through the Professions: A Perspective on Information Control, 18 Journal of Law and Economics 421 (1975); Benham, The Effects of Advertising on the Price of Eyeglasses, 15 Journal of Law and Economics 337 (1972).

Through advertising, firms attempt to convey information on price and quality to consumers directly. In many real-world situations, they may also find it advantageous to provide other parties with an incentive to market their products for them. Such agreements between producers and marketers are a form of a "vertical" relationship. The term "vertical" refers to a relationship that involves some financial agreement between a producer and an intermediary (e.g., a dealer, distributor, or broker). A vertical relationship might take the form of a sales commission paid to a dealer, i.e., the dealer receives a percentage of the sales price when the good is sold. This percentage can be adjusted by the producer to increase or decrease the dealer's incentive to market the product. Alternatively, a vertical relationship might take the form of a referral fee, whereby the producer pays a referral fee to the dealer (or, more likely, the "broker") for promoting the producer's goods or services. The difference between a "commission" and a "referral fee" is thus more semantic than economic. As the following examples show, both commissions and referral fees are found in a multitude of settings, and both often provide benefits to producers and the ultimate consumers.

A good example of an efficient vertical relationship can be found in the markets for fire, auto, and homeowners insurance. Many insurers sell their policies through independent agents and brokers, while others employ their own sales force. An independent agent typically sells policies for numerous insurance companies. Consumers can choose between contacting the representatives of different direct writers, each of whom will try to sell a policy of its parent company, or they can contact an independent agent, who will search and evaluate the offerings of a number of different companies.

Many consumers apparently prefer to use independent agents. These agents know about different insurers, so they can search at a lower cost than can a person who is searching for the first time. By providing consumers access to information regarding numerous insurers at one location, independent agents substantially reduce consumers' search costs.

Independent insurance agents are compensated by commissions and bonuses when they sell the policy of a particular company. These commissions are the equivalent of "referral fees," and they can serve a competitive purpose.[22] Independent agents can provide insurers access to markets that they might not have entered because of the high costs of opening individual insurers' offices in those markets. By making entry less costly, independent agents increase competition among insurers.

As an alternative to the payment of referral fees or commissions, a firm that is attempting to attract customers could merge, or vertically integrate, with the referring party. In doing so, the firm could assure itself that its own representatives will refer customers to it. Like referral fees, these sorts of arrangements are widespread and, like referral fees, can provide competitive benefits. In the real estate market, for example, some firms offer "in house" financing with the home purchase.[23] Rather than referring customers to outside lenders, the firm "refers" customers to its

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[22] Another market in which the use of commissions, or referral fees, serves to increase competition is the market for job placement services. The employer typically pays the placement firm a referral fee when the placement firm locates a suitable employee. This arrangement, by reducing the search costs of both job hunters and employers, benefits consumers.

[23] Firms that offer financing with the home purchase include Coldwell Banker, Ryan Homes, Haddon Group, Winchester Homes, Pulte, U.S. Home, Christopher, and Richmar. According to Chuck Recker of Ryan Homes, it is relatively common for builders to offer financing.

own financing division. Consumers are offered the choice of obtaining the home and the mortgage from a single source, or obtaining the home from one firm and the mortgage from another. This practice presents consumers with a "one-stop" shopping option that they may often find convenient.

If referral fees are permitted, independent agents and lenders are encouraged to set up a close working relationship, realizing many of the same benefits as vertically integrated firms.[24] However, a prohibition on referral fees can prevent independent firms from realizing these benefits and place non-integrated firms at a competitive disadvantage. For example, a financial institution could vertically integrate with a real estate broker and thereby assure itself of a flow of referrals without explicitly paying referral

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[24] The "preferred provider organization" found in the health care industry represents another procompetitive referral fee system. Although they exist in many forms, all PPO programs involve an arrangement between "preferred" health care providers (e.g., a set of hospitals) and an intermediary, such as an insurer or self-insured employer. The preferred provider typically charges the PPO a price below what it charges other insurers to induce the PPO to encourage its subscribers to use the provider. This is the economic equivalent of a referral fee. In turn, enrollees in PPOs usually are given financial incentives (e.g., waivers of copayments and deductibles) to induce them to use the lower-priced providers.

These PPO arrangements have many procompetitive aspects and are widely credited with introducing elements of price competition into hospital markets where little was formerly present. See Dranove, et al. The Effect of Injecting Price Competition into the Hospital Market: The Case of Preferred Provider Organizations, 23 Inquiry 419 (1986).

In addition, other areas of retail distribution offer examples of the joint provision of sales services and financing services that are equivalent to firms using unrelated intermediaries who bring the firm and the consumer together. Retail dealers of consumer products such as autos, home appliances, and furniture commonly offer financing as an additional service, as do department stores. Many, if not most, auto dealers offer a financing option along with their primary product, automobiles. Consumers are typically offered the choice of purchasing a car and the loan from one dealer, or obtaining the loan from a different source. Appliance and furniture dealers frequently offer their customers similar opportunities for obtaining credit. These arrangements do not appear to differ in any meaningful respect from a system of referral fee payments, yet quite clearly can benefit consumers by reducing search and transaction costs.

fees. Such vertical relationships can circumvent any prohibition on referral fees. Although vertical integration may benefit consumers, it may do so at a higher cost than if the firms were able to attract business through the use of referral fees.

Referral fee arrangements between unrelated entities and transfer payments within an integrated company are distinguishable in that the existence of a financial relationship between the affiliated components of the integrated company is self-evident, whereas when a lender pays a referral fee to an unrelated agent the relationship need not be publicly known. To the extent that consumer awareness of this relationship may be important (e.g., when interested persons are allowed to pay or receive referral fees), some sort of mandatory disclosure of the arrangement may be merited. In section V.C. below, we discuss the costs and benefits of a mandatory disclosure requirement.

Consumers may not always benefit from referral fees (or the integration of the referring party and the service provider). For some goods or services, it may be difficult for consumers to determine the benefits that are generated by the good or service, even after it has been consumed. In the most extreme case, consumers may be completely unable to evaluate the contribution of the purchased good to the satisfaction of their demands. In such instances, the existence of financial arrangements between intermediaries and service providers can create an opportunity for defrauding consumers. Essentially, the intermediary and the provider can increase their incomes by inducing a customer to purchase a greater quantity of the good, and/or pay a higher price for the good, than the customer would if he or she were perfectly informed.[25]

A similar phenomenon might occur in the provision of auto repair services.[26] A person might wish to buy services from a mechanic in order to produce a "reliably operating car." The mechanic (who jointly provides both a diagnosis and a set of "recommended" repair services) could exploit this person's ignorance of automobiles by providing a misleading diagnosis requiring significant repairs, and then by installing unneeded replacement parts. The customer cannot tell if he was defrauded, since the car runs well after the unnecessary repairs are conducted; hence, he cannot deter such behavior by threatening to withhold future business. This sort of fraudulent behavior can persist even when there is a competitive market for repair services.

The opportunities for this sort of fraud increase as the consumer's cost of evaluating a product or service increase. A customer can secure protection from this sort of fraud by using an intermediary that is financially unrelated to the provider[27] (or by acquiring the requisite expertise himself), but the costs of doing so may be quite high. Even under these circumstances, however, it may be difficult to justify the banning of

[25] See Darby and Karni, Free Competition and the Optimal Amount of Fraud, 16 Journal of Law and Economics 67 (1973).

[26] Another example may be found in the market for physicians' services. Physicians typically diagnose a malady, and then prescribe and supply a course of therapy. Consumer ignorance makes it possible for physicians to prescribe unneeded treatments. This behavior can be constrained (e.g., by soliciting second opinions), but only at a cost.

[27] To provide the intermediary that does not receive referral fees with the incentive to produce an honest diagnosis, the customer can make it clear to the intermediary that another party will provide whatever service is recommended; otherwise, incentives for fraudulent diagnoses will remain.

arrangements between intermediaries and providers, since there may be substantial savings associated with referral fees or with purchasing the recommendation and the service from the same source. These savings may offset the expected costs of fraud.[28]

Whether a ban on the payment of referral fees in the context of home mortgages is, on balance, efficient will be determined by (1) the cost to borrowers of evaluating the "quality" of the services referred (i.e., assessing the terms offered by the referred lender relative to alternatives), and (2) the benefits in terms of efficiencies generated by these arrangements between intermediaries and lenders. If the cost to borrowers of evaluating the quality of the referral is sufficiently low, and the benefits of referrals are sufficiently high, imposing restrictions on the creation of these arrangements may produce a net harm for consumers. Therefore, we would like to offer some observations that may be useful in HUD's evaluation of this issue.

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[28] Using the car repair example, Darby and Karni (Free Competition and the Optimal Amount of Fraud, 16 Journal of Law and Economics 70 n. 6 (1973)) cite the situation where it is necessary to disassemble an engine to diagnose a problem. It may be much cheaper to incur the risk of fraud, and have the repair made when the engine is taken apart, than to reassemble it for repair elsewhere.

Other good examples can be found in the market for medical services. Because physicians typically provide both diagnosis and therapy, the opportunity for fraud (e.g., "unnecessary surgery") exists. For expensive procedures (e.g., coronary bypass), it may pay to seek advice from another physician. For many procedures, however, the costs of soliciting a second opinion will outweigh the expected benefits, and the patient (or his insurer) will find that the best alternative is to purchase both diagnosis and therapy from the same source.

V. Possible Efficiencies From the Use of Brokers

A. Proposal One - Allowing Borrowers to Hire Brokers

Consumers do not have perfect information in the market for financial services. Information on mortgage loan rates, although available, is not free. The time and effort expended searching for the best loan represents a cost to the consumer. Because search involves costs, consumers search until the expected benefits of additional search are equal to the expected costs of additional search.[29] Consumers appear to engage in relatively little detailed comparison shopping for credit. A 1977 Consumer Credit Survey found that only approximately one-quarter of the respondents tried to obtain additional information about other creditors or credit terms prior to engaging in a recent credit transaction.[30] In addition, a 1978 home buyer survey conducted in Rochester, New York revealed that "[m]ost of the people who have a mortgage from a lending institution contacted but one institution to secure it, 84.4 percent in the central city and 89.9 percent in the suburb."[31]

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[29] See Stigler, The Economics of Information, 69 Journal of Political Economy 213 (1961).

[30] Durkin and Elliehausen, 1977 Consumer Credit Survey, 22 (Board of Governors of the Federal Reserve System, 1978). Responses were elicited from persons using credit of at least $200 from institutional sources. This study did not examine consumer search for home mortgages as a separate category. Mortgages were, however, one of the items included in the broad definition of credit.

[31] Benston, Horsky and Weingartner, "The Demand for Real Estate Loans in Rochester --- Central City vs. Suburb" in An Empirical Study of Mortgage Redlining (New York University Graduate School of Business Administration's Monograph Series in Finance and Economics, Monograph 1978-5).

Gains from search, however, do appear to exist. In early 1986, a 30-year fixed rate mortgage in New York City, for example, ranged from 11.5 percent with 3 origination points, to 9.88 percent with 2.5 origination points.[32] Other studies have found that "no single lender - not even the very largest - had the best loan offering on any single day more than 30 percent of the time."[33]

Since search involves some costs, but benefits from search exist, consumers may prefer to designate an agent to undertake this task for them. A large number of consumers rely on their real estate agent. A FTC staff report[34] on the residential real estate brokerage industry revealed that 67 percent of home buyers surveyed thought that the real estate agent's ability to help obtain financing was an important service characteristic.[35] About half (50.8 percent) of those surveyed said that their agent provided this service.[36]

Real estate agents are not the only persons on whom consumers can rely to obtain information on mortgage loans. Mortgage brokers, for a fee,[37] search for the best loan for a particular consumer. The ability of

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[32] Securitising the American Dream, 299 Economist 70 (1986).

[33] Anderman, Take the Byte Out of Computerized Loan Origination, 18 Real Estate Today 39 (1985).

[34] The Residential Real Estate Brokerage Industry (Los Angeles Regional Office of the Federal Trade Commission, 1983).

[35] The Residential Real Estate Brokerage Industry, Buyer Survey, p. 15.

[36] Id. at 17.

[37] Mortgage brokers can simply refer consumers to a particular lender or refer consumers and handle the paperwork associated with the loan application process. If the broker simply refers a lender and the consumer chooses to use that lender, the consumer typically pays $100. If the broker performs the loan application process, a fee approximately equal to 1.5

these intermediaries, including real estate agents, to provide consumers with information on the loan terms of a variety of lenders may substantially benefit consumers.[38] HUD's proposal to allow voluntary payments by a consumer to persons who perform these brokerage services therefore could benefit consumers. The proposal would permit consumers the options of undertaking the search process themselves, paying an agent to research loan availability and make a recommendation, or doing both.

This proposal would not only permit consumers to choose between searching for loans themselves or hiring someone else to do so, but also encourage the diffusion of more efficient technologies. For example, there have been dramatic changes in the technology with which agents undertake the search process. The use of computerized loan origination networks, first started in 1982, is significantly affecting the competitive nature of the industry. These networks assume a variety of forms, but the basic feature of the typical system is that it provides information on the loan terms offered by a variety of lenders.[39] The principal benefit of this system is

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percent of the loan value is paid if the borrower uses that lender. Telephone conversation with Mr. Hogendike, National Association of Mortgage Brokers, June, 1988.

[38] It is estimated that there are approximately 7,500 to 10,000 operating mortgage brokers today in the United States. Telephone conversation with Mr. Hogendike, National Association of Mortgage Brokers, June, 1988.

[39] Another important feature of some of these networks is that the loan application process can be performed by the individual using the system. Absent computer networks, the loan application process was typically performed by the lender at a site that was physically close to the property and the borrower. This arrangement tended to keep markets local. With the computerized systems, however, an individual located in Baltimore, for example, could apply for a loan offered by a lender in California. Guttentag, Recent Changes in the Primary Home Mortgage Market, 3(3) Housing Finance Review 244 (1984).

that it permits lenders to reach markets that otherwise would have been too costly to enter.[40] For example, when one real estate broker in the Philadelphia area joined the "Shelternet" system,[41] a number of lenders outside the Philadelphia area gained access to that geographic market.[42] By facilitating entry and improving information, the computerized networks increased consumer choice, and may have enhanced the competitive nature of credit markets.[43] Since real estate agents or mortgage brokers using the system can provide consumers with access to information on loan rates nationwide, these systems increase the likelihood that consumers will obtain a desirable loan package.[44]

Although computerized loan services are capable of providing substantial benefits to consumers, their use among real estate agents is not yet

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[40] See Kane, Change and Progress in Contemporary Mortgage Markets, 3(3) Housing Finance Review 257 (1984); Guttentag, Recent Changes in the Primary Home Mortgage Market, 3(3) Housing Finance Review 221 (1984).

[41] The Shelternet system, founded in 1982, provides up-to-date information on the rates of a number of lenders. As of 1986, the system linked 100 real estate offices and 20 lenders. The borrower is automatically offered a rate which is the best among the packages offered by participating lenders. Securitising the American Dream, 299 Economist 71 (1986).

[42] Guttentag, Recent Changes in the Primary Home Mortgage Market, 3(3) Housing Finance Review 245 (1984).

[43] Citicorp's computerized network, for example, has enabled it to compete vigorously with local lenders in New Jersey. By offering discounts on loan origination fees and providing other service amenities (e.g., a 10-15 day guaranteed loan commitment), Citicorp has expanded its share of the market. "Citicorp Arouses Mortgage Bankers' Ire," Barrons, June 27, 1988, at 81.

[44] Perhaps not surprisingly, some local lenders, who were otherwise more insulated from competition, are opposed to the use of such arrangements. Others, however, welcome the changes taking place. Len Druger, Vice Chairman of Citicorp, states, "[t]he issue here is fair competition - competition that's ultimately good for the consumer because it cuts prices." "Citicorp Arouses Mortgage Bankers' Ire," Barrons, June 27, 1988, at 81.

widespread. Typically, agents are charged a monthly fee for access to the loan information service,[45] but if they cannot be compensated for providing this service to customers, they have a reduced incentive to offer it. Thus, this proposal, which would make clear that compensation may be paid, should preserve the incentive for agents to adopt this technology. Allowing agents to sell this service at a market-determined price may create benefits for both buyer and seller.

Allowing borrowers to hire intermediaries is not completely riskless. The borrower cannot perfectly monitor the broker's efforts, so there is the possibility that the intermediary will take advantage of the lack of information on the part of the consumer. Whether this would occur with sufficient frequency and magnitude to outweigh the likely benefits of the use of intermediaries is unknown. However, both market forces (e.g., the development of poor reputations and the attendant loss of business)[46] and state and federal law enforcement presence[47] are likely to place constraints on such behavior. Furthermore, the incentive to provide misleading information or to "shirk" one's duty would be no greater than it currently is, and probably less due to competitive forces. If so, the potential net

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[45] Anderman, Take the Byte Out of Computerized Loan Origination, 18 Real Estate Today 38 (1985).

[46] Substandard brokers will actually develop bad reputations only if borrowers discover at some point that they have been ill-served. Whether borrowers are likely to determine this is a point that we discuss in greater detail below.

[47] For example, the FTC issued a complaint against Donald A. Schwab and Associates Mortgage Co., a mortgage broker, for allegedly misrepresenting the availability of credit at low interest rates. The Commission approved a consent decree with the respondent on July 18, 1986. In the U.S. District Court for the Southern District of Ohio an action was brought for injunctive and other relief; a final order was accepted on September 19, 1986 (C-1-86-967).

benefits from adopting HUD's proposal to permit borrowers to hire intermediaries could be substantial.

B. Permitting Lenders to Pay Referral Fees

HUD has also requested comment on whether to add an exemption to Section 8 that would allow referral payments by a lender to "neutral intermediaries." Economic analysis suggests that HUD should consider expanding this proposal to allow lenders to pay referral fees to any persons who bring together the borrower and the lender, rather than limit referral fees to neutral intermediaries. We discuss below the potential benefits and costs of referral fees in this context.

1. Potential Benefits From the Payment of Referral Fees

Permitting lenders to pay referral fees to intermediaries may benefit consumers in a number of ways. First, referral fees may be an efficient means of conveying information to customers. They may represent an attractive substitute for, or complement to, other forms of information dissemination, such as mass media advertising. In a competitive market, innovations in the methods of transmitting information benefit both customers and producers. The FTC and others have found that innovative advertising can benefit consumers and that advertising bans, by increasing consumer search costs, can result in higher prices. Empirical studies have shown, for example, that prices for professional goods and services are lower where advertising exists than where it is restricted or prohibited by law.[48]

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[48] Improving Consumer Access to Legal Services: The Case for Removing Restrictions on Truthful Advertising (Federal Trade Commission,

Further, payment of referral fees may also provide lenders access to certain geographic markets that they otherwise might not have entered. A lender in California, for instance, may find it too costly to appeal to consumers in New York via mass media advertising or other means. Paying referral fees to an agent in New York may be a low-cost substitute for direct advertising; by doing so, the lender may be able to encourage New York agents to inform consumers of its rates.[49] In addition, a New York agent, who might not have otherwise adopted the computerized loan service, may now have an additional incentive to do so. These services often allow individuals to apply for the loan of a consumer's choice through the computer. Since consumers may be unlikely to favor an out-of-town lender without the convenience of this service (and agents receive fees from a lender only if the borrower chooses that lender), referral fees may provide the agent with an incentive to adopt this technology. Referral fees, by facilitating entry and increasing the amount of information on loan rates that agents possess, may increase the range of financing opportunities available to consumers. Discouraging this method of disseminating information could harm consumers.

1984); Effects of Restrictions on Advertising and Commercial Practice in the Professions: The Case of Optometry (Federal Trade Commission, 1980); Benham and Benham, Regulating Through the Professions: A Perspective on Information Control, 18 Journal of Law and Economics 421 (1975); Benham, The Effects of Advertising on the Price of Eyeglasses, 15 Journal of Law and Economics 337 (1972).

[49] Both advertising and referral fees are costs that must be passed on to consumers, but as the studies discussed in the previous footnote demonstrate, these costs are more than offset by the benefits of the increased competition that results from advertising. The costs of referral fees may be lower than the costs of direct advertising, while achieving equal or superior results. For example, referral fees are only paid when an agent recommends a lender; advertising, by contrast, blankets all potential customers, and so could be more costly.

Referral fees may provide agents with an incentive to recommend low-cost lenders. A lender with lower costs[50] (hence larger price-cost margins) than its rivals can induce an agent to recommend its loans. Such lenders could use part of their higher margin to pay an agent a larger bonus or commission, and remit some or all of the remaining margin to the borrower in the form of more attractive credit terms. This arrangement increases the likelihood that a recommendation will be made that benefits the borrower, while preserving the benefits of professional search.

2. Potential Harm From the Payment of Referral Fees

Previously, we discussed the general circumstances under which relationships between related intermediaries and producers could harm consumers.[51] When it is difficult for consumers to evaluate the attributes of a product or service before (or even after) it is purchased, and when it is costly to hire an independent source of expertise to assist in the purchasing decision, then opportunities for fraud may arise even in competitive markets.

To what extent are mortgage loans characterized by these properties? Although the difference is one of degree, not of kind, it would seem that mortgage loans are dissimilar from the types of services (e.g., car repair) that may be most amenable to fraud. Although mortgage contracts may be more complicated than other types of credit agreements, there nonetheless exists a set of observable criteria (e.g., interest rates, points, term of

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[50] Lenders' costs may differ for a variety of reasons. For example, some lenders may be more proficient at evaluating creditworthiness than others.

[51] See Section IV, pp. 12-14.

mortgage, etc.) to facilitate comparisons.[52] Consumer evaluations are facilitated by the affirmative disclosure requirements contained in regulations such as the Truth in Lending Act, which compels the disclosure of information about credit terms and costs.[53] This is not to say that information is so readily available that consumers cannot benefit from the services of an informed and competent agent; what it does suggest is that the information available to consumers may be sufficient to place constraints on the ability of lenders and brokers to take advantage of consumers.

Arrangements that are economically equivalent to referral fees exist in this, as well as other industries. Earlier we described how many home builders and real estate agencies have diversified into consumer finance, thus offering consumers a potentially valuable financing option. Automobile dealers have for years offered similar types of services. These arrangements generate consumer benefits with no apparent adverse consequences. One of the differences between these sorts of arrangements and that in which lenders pay real estate brokers referral fees pertains to the lack of disclosure of the referral fees paid to the brokers. In the home builder and automobile dealer examples, the existence of the arrangement between the service provider and its financing arm is self-evident. Similarly, if lenders

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[52] At minimum, consumers can compare the referred lender's rates to rates of other lenders in the area by consulting the real estate section of the local paper. Information on the terms and conditions for a large number of loans appears to be available in newspapers across the country. An informal phone survey revealed that the Washington Post, Arkansas Gazette, Boston Globe, Los Angeles Times, Detroit Free Press, Cleveland Plain Dealer, Tampa Tribune, and Denver Post, for example, contain such information. Only one paper out of those contacted in the survey, the Des Moines Register, indicated that it did not publish information on mortgage loan rates.

[53] Regulation Z (Truth in Lending) 12 CFR § 226.

are allowed to pay referral fees to neutral intermediaries, the existence of a relationship between the lender and intermediary ought to be apparent.

We have suggested, however, that HUD consider expanding its proposed lender exemption to include interested intermediaries, such as real estate agents. In most cases, if there are sufficient reasons to believe that referral fees are appropriate when paid to certain persons (e.g., neutral intermediaries), then it is not clear why it is not also appropriate to permit the payment of referral fees to real estate agents. If it appears that the expected benefits of lender payments are likely to exceed the corresponding costs, it would seem reasonable to permit these payments without placing restrictions on who may receive them.

In the case of lender referral fees paid to real estate agents, however, the arrangement between the lender and agent may not be apparent. If the only difference between interested and neutral party referral fee arrangements is the consumer's knowledge that a payment is being made, then the appropriate policy measure may consist of a mandatory disclosure requirement at the time of the referral for interested parties.

C. The Costs and Benefits of Mandatory Disclosure

A disclosure requirement could only be warranted if the fact to be disclosed would not be apparent absent the forced disclosure. If HUD limits its lender exemption to neutral intermediaries, there would be no need for a disclosure requirement. If, however, HUD expands its lender exemption to allow referral fees to interested intermediaries, HUD may wish to consider a disclosure requirement applicable solely to these intermediaries.

Disclosure would inform consumers that referring parties have incentives to recommend a particular lender. Since consumers retain the option of choosing another lender when referral fees are used, disclosure is likely to allow consumers to enjoy the benefits of referral fees while insuring that they are informed about intermediaries' incentives, and mitigating the types of concerns discussed above. Accordingly, disclosure is likely to be preferable to a prohibition of referral fees.

Disclosure may induce consumers to search for a loan package against which they can compare the terms offered by the referred lender. If, as we discussed earlier, referral fees provide brokers and agents incentives to recommend appropriate loan packages to the borrower, the benefit of disclosures may be small. If, however, the fees sometimes lead brokers to recommend lenders whose packages would not serve the consumer's best interest, then disclosure may induce the consumer to obtain additional information on the loans of the referred lenders and loans offered by other lenders. This additional information may result in the consumer seeking a more favorable loan package. Thus, if policy makers conclude that the potential for harm caused by referral fees is present, then disclosure at the time of referral might significantly reduce or eliminate these potential costs.

In weighing the desirability of disclosure, however, it is necessary to compare the benefits of disclosure to its costs. The potential costs are twofold. First, there is the obvious direct cost of simply conveying the information. Second, there is the potential "chilling" effect on the use of referral fees caused by the stigma that may attach to disclosure. Compulsory disclosure may suggest that accepting (or paying) referral fees is somehow improper, which would discourage the practice. Consumers may be induced to engage in unproductive search because of a mistaken belief that a better loan package is available.

The timing and form of disclosure is also important. Disclosure should be made early enough in the loan application process so that consumers can consider other loans. If the information is disclosed the day before the loan is to be signed, for example, it is likely to be too late for consumers to search for an alternative source of credit. Also, disclosure via a written form is likely to ensure that consumers actually are put on notice of the possible incentives facing the real estate agent recommending particular lenders.

VI. Concluding Remarks

Allowing the payment of referral fees may benefit consumers significantly. Benefits may include lower search costs, increased information, the increased use of innovative technologies, and lower prices for loan packages. Some of these benefits may be foregone if HUD adopts only the mortgage broker exemption. Real estate agents and other intermediaries may be less inclined to offer potentially valuable services if referral fees are proscribed.

HUD may wish to determine whether the characteristics of mortgage markets are such that referral fees pose a significant risk of harm. As discussed above, we do not believe that these markets are likely to produce adverse effects for consumers if referral fees are allowed. If HUD decides that referral fees generate both benefits and significant costs, however, it may wish to consider whether alternatives to a referral fee ban, such as mandatory disclosure of a referral arrangement between lenders and interested intermediaries, would eliminate these costs while preserving the benefits.