

# The Impact of Mortgage Disclosure Reform\*

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U.S. Department of Housing and Urban Development Working Paper # REP 09-04; February 2009

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

## Introduction

Acquiring a mortgage is one of the most complex transactions a family will ever undertake. It may be difficult for borrowers to understand the financial trade-offs associated with interest rates, discount points, yield spread premiums, and upfront settlement costs. Settlement costs and especially the multiplicity of lender fees and the title charges add to the borrower's confusion. Even once the settlement cost has been agreed upon, they are subject to change until the day of closing. To exacerbate this situation, the typical homebuyer may be rushed and easily steered into a bad loan because they are under pressure to make an offer on a home. The average borrower will be at an extreme informational disadvantage compared to the lender because consumers borrow fairly infrequently. This is especially the case for first-time homebuyers who will not be as likely to challenge lenders, whom they may view as unquestionable and benevolent experts. This imperfection can be exploited by lenders and third-party service providers to charge excessive fees. The goal of the final rule is to improve consumer welfare by reducing market imperfections due to information asymmetry in the mortgage loan and settlement process.

It is expected that the new mortgage disclosure will encourage shopping, increase efficiency in the settlement industry, lower housing costs, and promote the purchase of loans that are more suited to households' needs. The transfer of markups from firms charging excessive fees to consumers has been estimated to be approximately \$670 per loan (a total of \$8.35 billion), but could be as high as \$1,200 per loan. This transfer of economic surplus will impose

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\* The authors would like to acknowledge, Nana Farshad, Justin Fazzari, Chong Gao, Ron Hanson, Michael Hollar, Ian Keith, John Mubiru, William Reeder, and Randy Scheessele for their substantial contributions to the Regulatory Impact Analysis; Gary Cunningham for comments on the Regulatory Impact Analysis; and Mark Shroder for comments and suggestions on a rough draft this article.

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some costs to industry in addition to the transfer of surplus. We estimate \$571 million of one-time adjustment costs related to new software, training, and legal consulting. Once the transition expenses have been incurred, any ongoing costs that are substitutes for the software, training, or legal consulting costs that would have been incurred anyway do not represent an additional burden. There will also be annual recurring compliance costs. It is imaginable that the recurring compliance costs could be close to zero. However, HUD has assumed significant costs ranging from \$630 million to \$918 million (\$50-\$74 per loan) depending on the number of applications per loan. In the high-cost case there are still significant consumer savings even if the full costs of the rule are imposed on consumers.

The rule can be expected to generate economic benefits as well as costs. First, there will be time-savings for consumers and for industry. Second, we can expect two social benefits from the rule: a reduction of wasteful predatory behavior and an increase in sustainable homeownership.

## **Current State of Affairs**

The Department of Housing and Urban Development issued a final rule under the Real Estate Settlement Procedures Act (RESPA) to improve the process of obtaining home mortgages and to reduce settlement costs for consumers.<sup>1</sup> Because the final rule calls for significant changes in the process of originating a mortgage, there are a wide range of benefits, costs, transfers, and market impacts. The effects on consumers from improved borrower shopping will be substantial under this rule.

The Real Estate Settlement Procedures Act (RESPA) is a consumer protection statute, first passed in 1974. RESPA regulations govern the business practices of settlement service providers and require that borrowers receive various disclosures concerning their mortgage loans. When borrowers apply for a mortgage loan, loan originators must provide the borrowers a “good faith estimate” (GFE) of settlement costs, which lists the charges the buyer is likely to pay at settlement. This is only an estimate and the actual charges may differ at closing. Upon settlement, borrowers receive the HUD-1 Settlement Statement, which is a standard form that shows the actual charges imposed on borrowers and sellers in connection with the settlement.

Current rules do not assure that the “good faith estimate” (GFE) is a reliable estimate of final settlement costs. There is little guidance and no meaningful standards for originators in providing good faith estimates of settlement costs. As a result, the final charges at settlement may include significant increases in items that were estimated on the GFE, as well as additional surprise “junk fees,” which can add substantially to the consumer’s ultimate closing costs. The current GFE format contains a long list of charges that often overwhelms consumers and does not highlight the bottom-line. A proliferation of charges makes consumer shopping and the

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<sup>1</sup> The final rule, “A Rule to Improve the Process of Obtaining Mortgages and Reduce Consumer Costs” (FR-5180-F-03) was printed on November 17, 2008, and is available at <http://www.hud.gov/offices/hsg/sfh/res/finalrule.pdf>.

mortgage settlement process both difficult and confusing, even for the most informed shoppers.<sup>2</sup> The current HUD-1 can include an array of charges with names that may be entirely unrelated to anything in the GFE making the consumer's task of judging whether their GFE told them anything useful nearly impossible.

The current GFE does not provide information on important loan terms nor does it explain how the borrower can use the document to shop and compare loans. Also, the GFE fails to make clear the relationship between the closing costs and the interest rate on a loan. The process of shopping for a mortgage involves complicated financial trade-offs, which are not always clearly explained to borrowers by loan originators. The GFE used today is neither an effective tool for facilitating borrower shopping nor for controlling origination and third-party settlement costs.

RESPA rules have also held back efficiency and competition by acting as a barrier to innovative cost-reduction arrangements. For example, average cost pricing is not permissible under RESPA because loan-specific prices are required. Average cost pricing requires less record keeping since the numbers reported to the settlement agent need not be transaction specific, and is thus costly for industry. A regulatory framework is needed that would encourage competitive negotiations and other arrangements that would lead to lower settlement prices. The new GFE will provide such a framework.

## **Overview of Final Rule**

The final RESPA rule includes a new, simplified good faith estimate (GFE) that includes tolerances on final settlement costs and a new method for reporting wholesale lender payments in broker transactions.<sup>3</sup> The GFE format simplifies the process of originating mortgages by consolidating costs into a few major cost categories. The first page of the new GFE presents a brief summary of the terms of the loan that would warn prospective borrowers of potentially expensive aspects of the loan including loan amount, maximum interest rate, prepayment penalties, and the total estimated settlement charges. The second page provides more detail on the charges for loan origination and other settlement services. The third page provides a trade-off table so that consumers will learn the relationship between the interest rate, the yield-spread premium (YSP), and total settlement costs. The third page also includes a table so that the consumer can take notes on alternative loan offers and thus comparison-shop.

The GFE was designed to ensure that in brokered transactions, borrowers receive the full benefit of the higher price paid by wholesale lenders for a loan with a high interest rate; that is, the so-called yield spread premium. The new GFE will disclose yield spread premiums and discount points in brokered loans prominently, accurately, and in a way that should inform borrowers how they may be used to their advantage. Their placement in the calculations that

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<sup>2</sup> See pages 156-160 of Chapter 3 of the Regulatory Impact Analysis for a list of potential fees and charges. These range from an "Access Fee" to the "Yield Spread Premium" for lender fees and from an "Abstract Recertification Fee" to a "Zoning Ordinance Fee" for title charges.

<sup>3</sup> See <http://www.hud.gov/offices/hsg/sfh/res/gfestimate.pdf> for a copy of the GFE

lead to net settlement costs makes them difficult to miss. That placement should also enhance borrower comprehension of how yield spread premiums can be used to reduce up-front settlement costs. The new trade-off table will assist consumers in understanding the relationship between higher interest rates and lower settlement costs.

The Department hired forms development specialists, the Kleimann Communication Group, to analyze, test, and improve the forms in order to arrive at documents that are consumer friendly and efficiently convey the terms of the loan and settlement costs (Kleimann, 2008). The Department conducted multiple rounds of extensive consumer testing of the GFE over six years from August 2002 until September 2008. The testing included qualitative interviews and quantitative evaluation of nearly 1,600 homebuyers, potential homebuyers, and homeowners who had refinanced in 17 cities across the United States. Testing results show that consumers can: identify the lowest settlement charges in nearly all instances when shown two GFEs; compare across multiple GFEs easily; identify key loan details; and understand the reciprocal relationship between settlement charges and interest rates. This success rate is maintained when the number of loan offers increases. Rather than being overwhelming, the additional loan offers help them to focus on the key information.

The Department went to considerable effort to design the new GFE form to focus borrowers on the right numbers so that competition is maintained between brokers and lenders. Participants are highly successful in identifying the cheapest loan with success rates as high as the 90+ percent range whether the broker loan is cheaper, the lender loan is cheaper, or the loans cost the same. Broker bias is not evident.<sup>4</sup>

The new GFE includes a set of tolerances on originator and third-party costs: originators must adhere to their own origination fees, and give estimates subject to a 10 percent upper limit on the increase of the sum of certain third-party fees. Tolerances will limit how much settlement charges can increase once the GFE has been made. The comparison page of the HUD-1 will serve to double-check the GFE regarding settlement charges and the key terms of the borrower's loan at settlement. The tolerances on originator and third-party costs will encourage originators not only to lower their own costs but also to seek lower costs for third-party services.

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

HUD also revised the HUD-1 Settlement Statement form to make the GFE and HUD-1 easier to compare.<sup>5</sup> The revised HUD-1 uses the same language to describe categories of charges as the GFE, and orders the categories of charges in the same way. The final rule introduces a

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<sup>4</sup> Bias does show up in comparisons in which broker and lender loans are otherwise completely identical. In which case, borrowers who do not think of the two loans as identical tend to favor the lender loan. The likelihood of borrowers getting two otherwise identical loans is extremely low however.

<sup>5</sup> See <http://www.hud.gov/offices/hsg/sfh/res/hud1.pdf> for a copy of the HUD-1.

comparison page in the revised HUD-1 that would: (1) compare the GFE estimates to the HUD-1 charges and advise borrowers whether tolerances have been met or exceeded; (2) verify that the loan terms summarized on the GFE match those in the loan documents, including the mortgage note; and (3) provide additional information on the terms and conditions of the mortgage.

We predict that the final rule will create a more level-playing field through a more transparent and standard disclosure of loan details and settlement costs; tolerances on settlement charges leading to prices that consumers can rely on; and a comparison page on the HUD-1 that allows the consumer to compare the amounts listed for particular settlement costs on the GFE with the costs listed for those charges on the HUD-1; and to double check the loan details at settlement.

### Need for the Rule

The potential for cost reductions in today’s market is indicated by studies showing relatively high and variable charges for third-party services, particularly for title and closing services that account for the major portion of third-party fees. The Urban Institute (2008) collected data on 7,560 FHA loans. The mean total closing cost for all loans is \$4,917 for an average loan amount of \$108,237. Total charges are composed of loan charges (\$3,081), title charges (\$1,329), and other third party charges (\$507). There is significant variation in closing costs: the standard deviation is \$2,381. The mortgage market appears to be characterized by price dispersion. In other words, some borrowers get market-price deals, but other borrowers do not.

Since total loan charges are correlated with loan amount, it is useful to examine the distribution of closing costs as a percentage of loan amounts to ascertain whether the variation in fees is still present. HUD calculated the distribution of these ratios for non-subsidized loans from a data set of closing cost provided by the Urban Institute (See Table 1). There is slightly less variation when measured as a percentage but it is still substantial: the ratio of what the 75<sup>th</sup> percentile pays as a percentage of the loan to what the 25<sup>th</sup> percentile pays is 1.8 for total loan charges; 2.1 for the yield spread premium; and 2.4 for direct loan fees.

**Table 1. Distribution of Categories of Closing Costs as a Percentage of Loan Amount  
(calculated by HUD from data provided by Urban Institute)**

<b>Series</b>	<b>5<sup>th</sup> percentile</b>	<b>25<sup>th</sup> percentile</b>	<b>50<sup>th</sup> percentile (median)</b>	<b>75<sup>th</sup> percentile</b>	<b>95<sup>th</sup> percentile</b>
<b><i>Total Closing Cost</i></b>	2.9	4.1	5.1	6.4	8.9
<b><i>Total Loan Charges</i></b>	1.3	2.4	3.2	4.2	6.2
Yield-spread premium	0.3	1.3	2.0	2.7	3.8
Direct loan fees	0.0	0.8	1.3	1.8	3.3
<b><i>Total Title Charges</i></b>	0.6	0.9	1.2	1.6	2.3
<b><i>Other Third-Party Charges</i></b>	0.2	0.4	0.6	0.8	1.4

It is apparent that half of the borrowers pay loan charges equal or greater than 3.2 percent of their loan amount; one-quarter pay loan charges of at least 4.2 percent of their loan amount; and five percent pay loan charges of at least 6.2 percent of their loan amount. The variation is

similar for title charges and other third-party charges. Half of the borrowers pay total closing costs equal or greater than 5.1 percent of their loan; one-quarter pay closing costs of at least 6.4 percent of their loan amount, and five percent pay closing costs of at least 8.9 percent of their loan amount.

The data provide strong indications of price dispersion and thus price discrimination. We are not concerned with price discrimination that is based on costs but rather when it is the result of a markup over costs. Price discrimination will always lead to a loss in consumer surplus and unless price discrimination is perfect, it will also lead to a loss in social welfare. It should also be noted that if the variation of fees and charges paid is greater than the actual costs of providing the services, then that constitutes evidence of a violation of RESPA, which explicitly prohibits mark-ups.<sup>6</sup>

In a competitive market the price of the good should depend on its quality and not to whom or how it is sold. If there is dispersion because the negotiations are face-to-face, this would suggest that the nature of the market exacerbates the consumer's informational disadvantage. Indeed, there is strong evidence that individuals pay different prices for reasons other than the cost of providing the service. The Urban Institute (2008) finds that African Americans pay an additional \$415 for their loans and that Latinos pay an additional \$365 (after taking into account borrower differences such as credit score and loan amount).<sup>7</sup> These loans are not subprime loans but standard FHA loans.<sup>8</sup> Other researchers, reviewed in the Regulatory Impact Analysis, have found similar results. Discrimination by race or ethnicity is not economically efficient and would not survive in a perfectly competitive market. Increasing transparency should reduce price discrimination.

The yield-spread premium (YSP) is one of the elements of a mortgage that a consumer is not likely to understand well. The yield-spread premium is compensation to the broker by the wholesale lender for selling a loan with a higher interest rate. Thus, as the interest rate rises so should the yield-spread premium. This relationship appears to hold in the data analyzed. However, the burden of the yield-spread premium is on the consumer, who pays a higher interest rate for loans with a higher yield-spread premium.

If consumers were perfectly informed, there would be a negative one-to-one relationship between up-front fees and the yield-spread premium. They simply represent two different ways of compensating the broker for the effort required to originate a loan. A mortgage broker earns income from two sources: a yield-spread premium that is paid by the lender and direct fees that are paid by the consumer.

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<sup>6</sup> The goal of this discussion is not to portray loan originators as unscrupulous or harmful to economic welfare. It is clear from the statistical evidence presented here that there are many ethical loan originators. If the entire market mirrored this more efficient segment, then RESPA reform would not have been as urgent.

<sup>7</sup> For its statistical analysis, the Urban Institute focused on a subsample of 6,366 non-subsidized loans, for which the mean total charges are slightly higher at \$5,245. Lender charges for non-subsidized loans are \$3,390, of which \$1,450 are direct fees and \$1,940 is the average YSP.

<sup>8</sup> Susan Woodward, the lead analyst for the Urban Institute study, completed a similar study for *Glover v. Standard Federal Bank* (Civil No. 97-2068, U.S. District Court of Minnesota). See Woodward (2003) for a more-detailed follow-up.

The Urban Institute (2008) finds no strong trade-off between the yield-spread premium (YSP) and upfront cash payments. Ideally, each dollar of YSP generated by a higher interest rate would result in a one dollar reduction in upfront fees. The reality is that this is not even close to being true. In a sample of nonsubsidized loans with a rate above 7 percent, which is appropriate for investigating YSPs, the Urban Institute finds that broker loan-origination fees, instead of being lower by a dollar for each dollar of YSP, are *higher* by 16 cents.<sup>9</sup> Such a relationship is contrary to what one would expect in a market where there were only minor imperfections.<sup>10</sup>

Confusion could also result from the variety of loan products and permutations of those products. If informational asymmetries are significant, then lenders will be able to earn more when selling more complex products. Borrowers who simplify their mortgage shopping by rolling all lender/broker fees into the interest rate (i.e., get “zero-cost” loans) pay \$1,200 less for their loans than brokers who pay lender or broker fees as measured by implicit YSPs. Borrowers who pay points realize only \$20 of benefits for every \$100 of points paid, for a net loss of \$80. It appears that the industry is able to take advantage of loan complexity, which is evidence of price discrimination not related to the cost of originating the loan.

Title insurance is an industry with a strong potential for anti-competitive practices, including price-fixing. There is a large fixed cost of entry, which is compiling a database of transaction and lending records. To make matters worse, Eaton and Eaton (2007) make a strong case that current federal and state policy inhibit competition in the title industry. The costs of providing title insurance are primarily related to research of property transactions. Thus, there should not be a great variation in settlement charges since the only component that does vary substantially is the insurance premium. Eaton and Eaton (2007) find that consumers pay title fees far greater than what is needed to cover costs and earn a reasonable return. The Urban Institute (2008) finds an average \$1,329 title charge in their sample of all loans with a standard deviation of \$564. They also find a significant variation by state with New York, Texas, California, and New Jersey all costing at least \$1,000 more (holding property values constant) than North Carolina, the lowest-cost state. A reasonable question is: what extra benefits people in the high-cost states get relative to those in low cost states; or why costs are so high if there are no extra benefits?

We also examined within state variation of title costs to account for the different legal requirements that exist among the states and the different customs that might have evolved as well. One measure of variability that we calculated for each state was the difference between the median of the highest quartile of title charges and the median of the lowest quartile. This difference was over \$1,000 for nine states. Due to the extent of price dispersion, we can expect significant savings from the final rule.

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<sup>9</sup> In a larger sample of all non-subsidized brokered loans, the Urban Institute finds that paying one dollar of YSP to a mortgage broker reduces upfront fees by only 7 cents, for a net loss of 93 cents on the dollar.

<sup>10</sup> Jackson and Berry (2002) find that consumers get only twenty-five cents of value for every dollar of yield spread premiums. They conclude that the problem of price dispersion occurs when yield spread premiums are present because in these situations there is no single price for broker services. Their research was prepared for the same court case as was Susan Woodward's.

## Transfers from Industry to Consumers

It is difficult to estimate the extent to which the final rule will improve consumer shopping for mortgages and to reduce the costs of closing a mortgage transaction for the consumer. However, the enormous potential for cost reductions in today's market is indicated by the studies showing the wide variation in prices unrelated to costs. Consumer savings were estimated under a variety of scenarios about originator and settlement costs.<sup>11</sup> In the base case, the estimate of borrowers' savings is \$8.35 billion in origination and settlement charges. The transfer constitutes 12.5 percent of total charges (i.e., origination fees, appraisal, credit report, tax service and flood certificate and title insurance and settlement agent charges).<sup>12</sup> This \$8.35 billion represents transfers to borrowers from high-priced producers. Entities that will suffer revenue losses under the final rule are those that charge prices higher than the market equilibrium after consumers become better informed.

Our estimate that the average consumers will benefit by a reduction of settlement costs of \$668 per loan (\$8.35 billion divided by 12.5 million loans) from the improved disclosures and tolerances of the new GFE was never challenged by industry experts. Indeed, results from the Urban Institute (2008) study imply that the savings to consumers may be as much as \$1,200 per loan. A sensitivity analysis was conducted with respect to the methodology of estimating the savings projection in order to provide a range of estimates: the \$6.48-\$8.38 billion of transfers (\$518 - \$670 per loan) represent the substantial savings that can be achieved with the new GFE.<sup>13</sup>

**Table 2. Consumer Savings by Industry (Base Case Scenario and Assuming 12.5 Million Loans)**

Source of Savings	Aggregate Consumer Savings (\$ billion)	Percent of Total (%)	Transfer Per Loan (\$)
<b>Origination Services</b>	<b>5.88</b>	<b>70.4</b>	<b>470.40*</b>
Brokers	3.53	42.3	
Lenders	2.35	28.1	
<b>Third-party Services</b>	<b>2.47</b>	<b>29.6</b>	<b>197.60</b>
Title and Closing	1.79	21.4	143.20
Other Third-party	0.68	8.1	54.40
<b>Total Settlement</b>	<b>8.35</b>	<b>100.0</b>	<b>668.00</b>

\* A loan will be originated by either a broker or a lender. We assume that the savings per loan are equal across type of originator.

We can disaggregate the sources of consumer savings by industry (see Table 2 above). Originators (brokers and lenders) contribute \$5.88 billion, or 70 percent of the \$8.35 billion in consumer savings. This \$5.88 billion in savings represents 14.0 percent of the total revenue of

<sup>11</sup> Government fees, taxes, and escrow items are not included in this analysis, as they are not subject to competitive market pressures.

<sup>12</sup> We double-checked this estimate using an alternative "title" approach and found a similar percentage reduction (12.6 percent).

<sup>13</sup> See the Regulatory Impact Analysis, Section VII.E.4 of Chapter 3, for a description of the alternative estimates of consumer savings.



originators, which is projected to be \$42.0 billion.<sup>14</sup> The \$5.88 billion is divided between brokers, which contribute \$3.53 billion, and lenders (banks, thrifts, and mortgage banks), which contribute the remaining \$2.35 billion. Third-party settlement service providers contribute \$2.47 billion, or 30 percent of the \$8.35 billion in consumer savings. This \$2.47 billion in savings represents 10.0 percent of the total revenue of third-party providers, which is projected to be \$24.74 billion. The \$2.47 billion is divided between title and settlement agents, which contribute \$1.79 billion, and other third-party providers (appraisers, surveyors, pest inspectors, etc.), which contribute \$0.68 billion. Title and settlement agents contribute a large share because they account for 72.5 percent of the third-party services.

## **Economic Costs of the Rule**

Both one-time adjustment and annually recurring costs are expected to arise from the changes introduced by the rule. The total one-time compliance costs to the lending and settlement industry of the GFE and HUD-1 are estimated to be \$571 million. Total recurring costs, in the high-cost scenario, are estimated to be \$918 million annually or \$73.40 per loan. In the lower-cost scenario, recurring compliance costs are estimated to be \$50.40 per loan or \$630 million in aggregate.

### **Costs of the New GFE**

The new GFE in the final rule has some features that would increase the cost of providing the loan and some that would decrease the cost. Practically all of the information required on the GFE is readily available to originators, suggesting no additional costs of collecting the information. The fact that there are fewer numbers and less itemization of individual fees suggests reduced costs. On the other hand, there could be a small amount of additional costs associated with the optional trade-off table. While it is difficult to estimate, it appears that there could be a net of zero additional costs. However, if the GFE adds 10 minutes per application to the time it takes to handle the forms today; then annual costs would rise by \$255 million at 1.7 applications per loan ( \$20 per loan) or \$405 million at 2.7 applications per loan (\$32 per loan).<sup>15</sup>

The presence of tolerances will lead to some extra costs to originators of making additional arrangements for third parties to provide settlement services. Some originators might simply check out the market prices for third-party services from time to time, formulate estimates such that several of the prices charged by the third parties fall within the tolerance, and trust that nobody to whom they refer the borrower charges a price in excess of the tolerance. Other originators might want more protection and have contracts or business arrangements in place that have set prices for services that are not in excess of the tolerances. Either case requires the originator to do more than today. If the average loan originator incurs an average of

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<sup>14</sup> This assumes a 1.75 percent origination fee for brokers and lenders, which, when applied to projected originations of \$2.4 trillion, yields \$42.0 billion in total revenues from origination fees (both direct and indirect).

<sup>15</sup> There are currently 1.7 times as many applications as loans originated; therefore, if originations are 12.5 million, full underwriting is started (and probably completed) for 21.25 million applications, of which 8.75 million are not originated. In the 2.7 application per loan scenario, full underwriting is started for 33.75 million applications, of which 21.25 million are not originated.

10 minutes per loan of effort making third-party arrangements to meet the tolerances, then the total cost to originators of making third-party arrangements to meet the tolerance requirements comes to \$150 million (\$12 per loan).

There is the potential of additional underwriting costs if the number of applications requiring a credit check rises beyond the current ratio of applications per loan. If the ratio of applications per loan does not change from the current ratio of 1.7, then there will be no additional compliance cost from multiple preliminary underwriting. In the high-cost scenario, demand by the average consumer for preliminary GFEs increases by one application per loan to 2.7 applications per loan. A preliminary credit report involves only the FICO score from one credit bureau and so will cost only \$5 per report as compared to a more expensive full credit reports (at \$25). HUD estimates additional labor costs of \$6 (five minutes at \$72 an hour) for the loan originator of ordering the report. HUD’s estimated total cost of a preliminary underwriting is \$11. The aggregate impact on the loan origination industry of multiple preliminary underwriting is \$138 million annually (12.5 million loans annually X \$11 per loan) at 2.7 loans per application.

It cannot be determined how many additional GFEs the average borrower would receive under the new rule. Some borrowers might continue the informal shopping method that many use today – gathering information and making inquiries to lenders and brokers about their products and their rates, even before deciding to proceed with the request for a more formal quote using the GFE. Others may obtain multiple GFEs and use them to shop.

Preliminary underwriting should decrease the number of applications that go to full underwriting (e.g., an applicant may be denied during the preliminary without having been charged for an appraisal). Some of the applications that are not originated may be disapproved at the preliminary stage rather than going through full underwriting (as they might today). We expect an increase in the ratio of *accepted* applications per loan. This savings in appraisal, verification, and other incremental underwriting costs that are avoided would tend to offset the increase in cost resulting from the extra preliminary underwriting noted above.

**Table 3 Recurring Compliance Costs of the New GFE by the Number of Application per Loan**

Source of Additional Cost	Per Loan Cost		Total Cost: All Firms (Millions)		Total Cost: Small Firms (Millions)	
	1.7	2.7	1.7	2.7	1.7	2.7
Processing Applications	\$20.40	\$32.40	\$255	\$405	\$134	\$213
Arranging Tolerances	\$12.00	\$12.00	\$150	\$150	\$79	\$79
Initial Underwriting	\$0.00	\$11.00	\$0	\$138	\$0	\$72
<b>Total Cost of GFE</b>	<b>\$32.40</b>	<b>\$55.40</b>	<b>\$405</b>	<b>\$693</b>	<b>\$213</b>	<b>\$364</b>

Our estimates of the recurring compliance cost range from \$32 to \$55 per loan and from \$405 million to \$693 million in aggregate.

Schnare (2008) claimed that HUD made two serious errors in estimating the recurring compliance costs of the GFE. We found her first contention to be unsubstantiated but the second one to be worthwhile investigating. The report states that HUD ignored a major compliance cost of the rule incurred by loan originators: the hedging costs of guaranteeing the interest rate for the shopping period of ten days. Including such hedging costs dramatically increased Schnare’s

estimates of the recurring compliance costs. However, there was no requirement of an interest-rate guarantee in the proposed rule. A more accurate estimate of the hedging cost would be zero. Only the prices on non-interest-dependent items on the GFE (total origination fees, appraisal fees, title fees, etc.) must remain available for 10 days. Interest-dependent items on the GFE (interest rate, monthly payment, YSP/discount points, adjusted origination fees, and daily interest charges) can have a separate availability period that can be as short as the time until a new rate sheet is issued. This misunderstanding of the rule led to estimates that, compared to HUD's, were inflated by as much as factor of four.

The second major criticism by Ann Schnare was that HUD did not consider the possibility that the rule could increase the administrative costs to loan originators from a greater demand for GFEs. Although HUD believes that it is just as likely that applications will not increase, HUD responded by including a sensitivity analysis of the application-to-loan ratio (outlined in Table 3).

In addition to the recurring costs of the GFE, there will be one-time adjustment costs of \$383 million in switching to the new form. Loan originators will have to upgrade their software and train staff in its use in order to accommodate the requirements of the new rule. It is estimated that the software cost will be \$33 million and the training cost will be \$58 million, for a total of \$91 million<sup>16</sup>. We assume that, of the loan originators' software and training costs, \$73 million is attributable to the new GFE and \$18 million to the new HUD-1. Once the new software is functioning, the recurring costs of training new employees in its use and the costs associated with periodic upgrades simply replace those costs that would have been incurred doing the same thing with software for the old rule.

Similarly, there will be a one-time adjustment cost for legal advice on how to deal with the changes related to the new GFE. The one-time adjustment cost for legal fees is estimated to be \$116 million. Once the adjustment has been made, the ongoing legal costs are a substitute for the ongoing legal costs that would have been incurred under the old rule and do not represent any additional burden. Finally with respect to the GFE, employees will have to be trained in the new GFE beyond the software and legal training already mentioned. This one time adjustment cost is estimated to be \$194 million.<sup>17</sup>

### **Costs of the HUD-1**

The HUD-1 has been adjusted to ensure that the new GFE and the HUD-1 (a final settlement document issued at closing) work well together. The layout of the revised HUD-1 has new labeling of some lines so that each entry from the GFE can be found on the revised HUD-1 with the exact wording as on the GFE. This will make it much easier to determine if the fees actually paid at settlement are consistent with the GFE, whether the borrower does it alone or with the assistance of the settlement agent. The reduced number of HUD-1 entries that will result, as well as use of the same terminology on both forms, should reduce the time spent by the

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<sup>16</sup>The estimate is based on the costs of updating software (see Section VII.B.1 of Chapter 6 the Regulatory Impact Analysis).

<sup>17</sup> See Sections VII.B.2 and VII.B.3 of Chapter 6 of the Regulatory Impact Analysis.

borrower and settlement agents comparing and checking the numbers. Generating the new HUD-1 should not pose any problem for firms closing loans -- in fact, the closing process will be much simpler given that borrowers and closing agents can precisely link the information on the initial GFE to the information on the final HUD-1.

One revision to the HUD-1 that could generate an additional cost is the addition of a comparison page. The burden of an additional page could be very small: loan originators will not have to collect additional data beyond what is required for the GFE. In certain cases, the burden may be noticeable so we assume that the *average* burden is ten minutes per loan for loan originators. Settlement agents may face a recurring cost, although this is not likely either since loan originators are responsible for providing the data. But the settlement agent will have to add final charges not known by the originator, and may have to fill out the entire form if the lender does not transmit the information on an already completed HUD-1 page 3. The settlement agent may also want to check the information concerning settlement costs, tolerances, and loan terms to make sure they agree with the GFE. In some cases, the settlement agent will have to calculate the tolerances. We assume that it will add five minutes *on average* to the time it takes to prepare a settlement. The actual distribution of the total additional time burden will differ by transaction depending on how much of the work is done by the lender. Taking loan originators into account, the total time burden is 15 minutes per loan, for a cost of \$18 per loan. The recurring compliance cost to the industry would be \$225 million annually.

**Table 4. Compliance Costs of the Final Rule (if 12.5 million loans annually)**

Portion of Rule	One-time Compliance Costs during the first year	Recurring Compliance Costs (annual)			
		in millions annually		\$ cost per loan	
	in millions	Low-Cost	High-Cost	Low-Cost	High-Cost
GFE	\$383	\$364	\$693	\$32.40	\$55.40
HUD-1	\$188	\$107	\$225	\$18.00	\$18.00
<b>Total</b>	<b>\$571</b>	<b>\$471</b>	<b>\$918</b>	<b>\$50.40</b>	<b>\$73.40</b>

There will be one-time adjustment costs of \$188 million in switching to the new HUD-1 form. Once the adjustment has been made, these costs do not represent any additional burden. Settlement firms will have to upgrade their software and train staff in its use in order to accommodate the requirements of the new rule. It is estimated that the software and training cost will be \$80 million. Similarly, there will be a one-time adjustment cost for legal advice on how to deal with the changes related to the new HUD-1. The one-time adjustment cost for legal fees is estimated to be \$37 million. Finally, employees will have to be trained in the new HUD-1 beyond the software and legal training already mentioned. This one time adjustment cost is estimated to be \$71 million.<sup>18</sup> A summary of the compliance costs for the base case of 12.5 million loans annually is presented above in Table 4.

<sup>18</sup> See Section VIII.B of Chapter 6 of the Regulatory Impact Analysis.

## **Economic Benefits of the Final Rule**

While most of the effect of this rule comes in the form of transfers from originators and settlement firms to consumers, there are economic benefits of the rule stemming from an increase in efficiency. The efficiencies come primarily from time saved by both borrowers and originators as a result of forms that are easier to use. There are also positive spillovers of increasing consumers' level of awareness. First, consumers will be less susceptible to predatory lenders and therefore this type of wasteful activity will be discouraged, freeing up resources for more productive purposes. Second, by consumers better understanding the loan product, there will be a decrease in the probability of default leading to foreclosures, which can cause dramatic social costs.

### **Consumer Benefits**

Mortgage applicants and borrowers realize \$1,169 million in savings in time spent shopping for loans and third-party services as a result of the new GFE. This amount is derived from a time savings worth \$55 per applicant (75 minutes at \$44 per hour) over 21.25 million applications. For example, if each borrower saves an average of 15 minutes in shopping for third-party services, then the total savings to borrowers would be \$234 million. The new form and the tolerances will enable borrowers to save time shopping for loans and for third-party settlement service providers. If the new forms save the average applicant one hour in evaluating offers and asking originators follow-up questions, borrowers save \$935 million.

The benefits are calculated using the ratio of 1.7 applications per loan, which is a measure of the current state of affairs. Although we calculate administrative costs for firms at different ratios (1.7 and 2.7), it would be misleading to calculate consumer benefits at higher ratios. Going from an average of 1.7 to 2.7 applications per loan does not save the average consumer more time. It is clear that the consumer will not be harmed because the increase in applications is voluntary but should not be counted as an economic benefit.

Upon receipt of the GFE, the borrower immediately has good pricing information on third-party services. The borrower could decide to use the originator's third parties, in which case his or her search is over. Or, the borrower could search further with the originator's prices as a good starting point and available as a fall-back. In both cases the borrower searches less, but spending less time searching does not imply less benefit from the search. It is possible that under the final rule that some consumers will want to spend more time searching because the new GFE increases the productivity of search. Although additional time spent searching reduces the time spent on other activities, the reward to search is an increase in consumer savings. Under these circumstances an increase in the time spent shopping does not constitute a burden imposed by the rule since the increase in time searching is voluntary. Consumers are free to remain at previous lower levels of shopping and enjoy a lower increase in saving from the rule.

We do not expect the average consumer to spend more time searching because there are other effects that should dominate the incentive described above. First, the higher productivity in search of the new GFE increases a consumer's savings at all levels of search: consumers will be able to reduce their level of effort and retain the same level of saving previous to the rule. Second, we expect that a large portion of the increase in savings will be independent of an

individual's shopping behavior. As the market becomes more competitive, shoppers who are less sophisticated or less diligent may still benefit from the competitive pressure of others' shopping. This additional saving will allow consumers to spend less time searching. The time that they do spend searching, however, will be more effective and lead to greater savings. The new GFE will allow consumers to spend more time comparing and evaluating offers and less time trying to decipher the loan details.

### **Industry Benefits**

Industry will benefit by spending less time answering borrowers' questions and from the simplicity of average-cost pricing. If half of the borrowers' time saved comes from less time spent with originators and third-party settlement service providers, then originators and settlement agents will spend 37.5 minutes less answering borrowers' follow-up questions. The value of the time saved from dealing with follow-up questions from consumers is \$956 million.<sup>19</sup> Loan originators receive a saving of \$765 million (30 minutes per application) and third-party settlement \$191 million (7.5 minutes per application).<sup>20</sup> The reduction in time explaining the GFE to consumers could outweigh the administrative costs of the rule. While there was some skepticism of this result by industry representatives, there were no alternative estimates offered and there was no denial that customer service is indeed a time-consuming activity.

There will be reductions in compliance costs from average cost pricing. This reduces costs because firms do not have to keep up with an itemized, customized cost accounting for each borrower. This not only saves costs when generating the GFE, it also saves quality control and other costs afterwards. Industry sources have told HUD that this could be the source of significant cost savings. It is estimated that the benefits of average-cost pricing will lead to a reduction in originator costs of 0.5 percent, or \$210 million. The originator only needs to know his or her approximate average cost when coming up with a package price that is acceptable. The cost of tracking the details for each item for each loan is gone. Some or all of industry's total of \$1,166 million in efficiency gains (\$956 million plus \$210 million) have the potential to be passed through to borrowers through competition.

### **Reduction in Non-Productive Behavior**

Many price-discriminating loan originators and settlement firms extract excess fees without significant effort. They are able to estimate a potential customer's willingness to pay a markup beyond the costs of originating a loan based on easily observable characteristics of the consumer.<sup>21</sup> In contrast, some predatory loan originators expend additional resources to seek out borrowers who are less sophisticated financially and more likely to accept loans with excessive

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<sup>19</sup> Calculated as follows: 12,500,000 loans times 1.7 applications per loan times 37.5 minutes per application times \$72 per hour, the average hourly opportunity cost of time of loan originators.

<sup>20</sup> Just as we do for consumers, we estimate the value of time efficiencies using the 1.7 application per loan ratio even when comparing it to costs generated using the higher 2.7 ratio. It would not be logical to claim that we are saving a firm any time by requiring them to process additional applications.

<sup>21</sup> The Fannie Mae Foundation (2001) found that as much as 35 to 50 percent of the borrowers in the subprime market could have qualified for lower-cost prime market loans.

fees. Consumers can be steered into disadvantageous loans by aggressive mail, phone, TV, or door-to-door sales tactics targeting neighborhoods with a high proportion of minorities or elderly. Tactics are becoming advanced: credit bureaus offer a “mortgage trigger” service, which notifies a subscriber when a consumer’s credit history is being checked (Stone, 2008). This allows aggressive and non-conscientious lenders to identify borrowers who are in the market for a loan and lure them into a predatory loan. Whenever producers expend substantial effort to raise prices rather than output, there is a deadweight loss for society.

With an improved disclosure, consumers will be more informed, more likely to reject loans with excessive fees, and less susceptible to predatory lenders. The final rule will raise the predatory lender’s cost of searching for vulnerable borrowers and will thus inhibit predatory behavior. Reducing this predatory activity will lead to a net gain in social welfare equal to the costs of actively searching for less informed borrowers and extracting an abnormally high markup. If, for example, the decline in predatory activity represented one percent of current originator effort, this would result in \$420 million<sup>22</sup> in social surplus. These resources could be devoted elsewhere for more productive purposes. The transfer to consumers is composed of both the lost excess profits from markups and the deadweight loss from the inhibited predatory activity to achieve those markups. Thus, the gain to consumers will outweigh the loss in profits of predatory firms.

### **External Benefits of Preventing Foreclosures**

There are two ways in which this rule will contribute to sustainable homeownership. First, by reducing settlement costs, the rule will provide a small cushion for borrowers in the event of financial distress. Second, by educating consumers, the rule should lead to better decisions by borrowers as to the best loan or even whether homeownership is the optimal choice. Consumers who understand the details of their loans are more likely to avoid default and thus foreclosure. For example, knowing how high your interest rate and monthly payments can go should make the loan applicant hesitant to accept an adjustable-rate mortgage unless the borrower has the income security to do so. Buck and Pence (2008) find that borrowers with adjustable-rate mortgages appear likely to underestimate or to not know how much their interest rate could change. The final GFE would present critical loan terms such as the maximum monthly payment on the first page in order to better inform borrowers.

There are private costs to the borrower and lender as well as substantial negative economic externalities of a foreclosure to neighboring properties and local governments. The Joint Economic Committee of the U.S. Congress estimates the total costs to society at \$78,000 per foreclosure: \$7,200 to the borrower; \$50,000 to the lender; \$1,500 to neighboring property owners; and \$19,200 to local governments. The foreclosed upon household pays moving costs, legal fees, and administrative charges of \$7,200. Lenders can lose as \$50,000 per foreclosure. These costs consist of the loss on loan and property value, property maintenance, appraisal, legal fees, lost revenue, insurance, marketing, and clean-up.

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<sup>22</sup> The total transfer to consumers of \$5.88 billion represents 14 percent of the total revenue of originators, which is projected to be \$42.0 billion. One percent of this is \$420 million.

The lender and borrower are not the only parties to suffer from a foreclosure. It is often argued that there are negative impacts to the value of neighboring properties from a foreclosure. There is an amenity value to having an up kept property next door; foreclosed properties if vacant can attract crime; and there may also be a depressing effect on the local economy. One estimate of the negative externality of a foreclosure on nearby properties is \$1,508. In addition, the local government loses \$19,227 through diminished taxes and fees and a shrinking tax base as home prices decrease. The total benefit of preventing one foreclosure is \$77,935 in averted costs. It is difficult to estimate how many foreclosures a uniform and transparent GFE with settlement fee tolerances would prevent. We do not estimate it for the purpose of this analysis. However, preventing only 1,000 foreclosures nationwide would yield \$78 million of benefits. There are other benefits of informed financial choices that are more difficult to quantify. For example, the average loan amount is 3.5 times a household's income so even minor inefficiencies in this market could have sizeable impacts on the U.S. economy.

### **Effect on Industry Structure and Small Business**

The impact of the rule on small business is significant because a large share of the firms, revenue, and employees, in origination and settlement services are small firms. HUD estimated that 4.13 billion or 49.5 percent of the \$8.35 billion in transfers to consumers would come from small business.<sup>23</sup> Practically all mortgage brokers qualify as a small business; as do two-thirds of the banks and thrift institutions qualify; and four-fifths of the credit unions. Small originators account for 51.2 percent of their industry's revenues and \$3.01 billion of the consumer transfers. Within the small originator group, most of the transfers to consumers come from small brokers (\$2.47 billion, or 82 percent of the \$3.01 billion). Small firms account for most of broker revenues but a small percentage of lender revenues. The title and closing services industry consists of title insurers, title agents, escrow firms, lawyers, and others involved in the settlement process. Small firms account for 38 percent of the revenue in the title and settlement industry and \$680 million of consumer savings. Small firms providing other third party services, such as appraisers, surveyors, credit bureaus and pest inspectors, account for 64.7 percent of the revenue in their industry and \$440 million in consumer transfers. We expect the transfer of excess fees from small business to consumers will be proportional to the share of small business revenue. The rule will affect the firms, large and small, who are charging non-competitive prices.

We do not expect small business to suffer disproportionately from the final rule because we do not have any evidence that there is a greater prevalence of overcharging consumers by small business.<sup>24</sup> One could argue that some facets of the rule, such as tolerances, may have a disproportionate impact on small business, even on those small firms that are not charging excessive prices. Some of the one-time adjustment costs may weigh more heavily on small firms. However, we do not believe that the final rule will affect industry structure. We base this opinion on our observation that the real estate industry is very locally oriented. The value of

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<sup>23</sup> A full description of these estimates can be found in Section VII.E of Chapter 3. Data on small business can be found in Chapter 5.

<sup>24</sup> For a detailed discussion of the effects on industry structure, see Section II.C.5 of Chapter 6 of the Regulatory Impact Analysis.



proximity and local expertise make small firms more efficient in providing services to consumers. RESPA reform will not change this distinguishing and central characteristic of the real estate industry. For example, there is no indication that the customer outreach function that brokers perform for wholesale lenders will change with RESPA reform. We expect that brokers will continue to be competitive with other originators and that wholesale lenders will continue to depend on brokers supplying them with loans.

## **Summary of Transfers, Benefits and Costs**

Industry will incur both adjustment and recurring compliance costs in the transfer of excess fees to consumers. A significant proportion of the compliance costs will be passed on to consumers in the form of higher prices. An obvious question is whether the costs of the rule will overwhelm the consumer savings and other benefits. It is likely that the adjustment costs will be spread out over many years. Suppose, for the sake of illustration, that all adjustment costs are imposed on first-year borrowers. In a normal year of 12.5 million loans,<sup>25</sup> this cost would be \$46 per loan. The recurring compliance cost of the rule is \$74 per loan regardless of the year. In such a scenario, the total compliance cost is \$120 per loan in the first year as compared to \$74 for later years. If all compliance costs were passed onto consumers, then the net consumer savings is \$548 the first year and \$594 in subsequent years. We assume, in this scenario, that all costs are passed on to borrowers and not to the applicants who do not receive loans. However, it would be reasonable to assume that in the high-cost scenario, where there is an increase in preliminary underwriting costs, that the cost of an initial credit report would be charged to all applicants.

There are other potential benefits to the consumer besides savings on settlement costs. First, there are aspects of this rule that will save time for industry. The value of these efficiencies could be \$1,166 million for loan originators and settlement agents, for a per loan efficiency of \$93. In a competitive industry, firms would pass these gains along to borrowers in the form of lower costs, a consumer benefit. Second, borrowers themselves will save time through the new GFE. These time savings are estimated at \$1,169 million but are derived from a time savings worth \$55 per applicant (seventy-five minutes at \$44 per hour). In the calculation of net benefits per borrower, we only include the time savings for borrowers and not for other applicants. We make the cautious assumption that successful borrowers have submitted only one application.

The applications that did not result in a loan consist of: applications approved but not accepted; applications denied by the financial institution; and applications withdrawn by the applicant. Although these individuals also realize time savings, it would be misleading to include them in a “per loan” figure in that the time savings of rejected applicant would not benefit the borrower.

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<sup>25</sup> During the first year of implementation (starting January 1, 2010), mortgage volume may be well below normal if the current economic conditions prevail. We have already witnessed a drop in 2007 HMDA single-family loan originations to 10.4 million mortgages from 13.9 million in 2006 and from 15.6 million during the high-volume year of 2005. Nonetheless, we use a measure of the average year as indicative of what to expect.

Adding the firms' and borrowers' value of time efficiencies to the net of compliance cost consumer savings gives us an estimate of the potential consumer benefits per loan: \$696 in the first year and \$742 afterwards. In the lower-cost scenario, the recurring compliance cost is \$23 lower so that the consumer benefits per loan would be \$719 in the first year and \$765 afterwards.

## Conclusion

The ultimate goal of estimating the economic impacts of a rule is to gain a rough idea of whether a particular policy is the best way of achieving a stated policy objective. The obvious alternative to the final rule was to maintain the status quo. This alternative was rejected for reasons given in the above section entitled "Need for Final Rule." Today's GFE is neither an effective tool for facilitating borrower shopping nor for controlling origination and third-party settlement costs. Thus, not to change the GFE would continue the current system of consumers paying non-competitive prices for mortgage services.

There are a variety of other approaches of reforming the current system. Alternative methods proposed and considered for the final rule were: excluding the yield spread premium calculation in the GFE; including an itemization of costs in the GFE; a 10-day interest-rate guarantee in the GFE; banning of the yield spread premium; and requiring the reading of a closing script by the settlement agent. These alternatives, as well as others, were rejected either because they would not accomplish the goal of making the settlement process more transparent for consumers or because they would impose a significant burden on industry.<sup>26</sup>

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<sup>26</sup> For a description of all of the alternatives considered to the proposed and final rule see Chapter 4 of the Regulatory Impact Analyses of the proposed and final rules.

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