

Impact

A regulatory impact analysis must accompany every economically significant federal rule or regulation. The Office of Policy Development and Research performs this analysis for all U.S. Department of Housing and Urban Development rules. An impact analysis is a forecast of the annual benefits and costs accruing to all parties, including the taxpayers, from a given regulation. Modeling these benefits and costs involves use of past research findings, application of economic principles, empirical investigation, and professional judgment.

The Impact of Mortgage Disclosure Reform Under RESPA

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Abstract

It is expected that the final Real Estate Settlement Procedures Act rule will encourage shopping, increase efficiency, lower housing costs, and promote the purchase of loans that are more suited to a household's 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 not occur without some costs to industry. We estimate a potential \$571 million of one-time adjustment costs. Although it is imaginable that the annual compliance costs of the rule are close to zero, the U.S. Department of Housing and Urban Development has assumed significant costs, ranging from \$50 to \$74 per loan,

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Abstract (continued)

depending on the number of applications per loan (totaling from \$630 million to \$918 million). Significant net consumer benefits are present even in the highest cost case. The rule can also be expected to generate economic efficiencies, such as time savings for consumers and for industry, a reduction of wasteful predatory behavior, and an increase in sustainable homeownership.

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 tradeoffs associated with interest rates, discount points, yield spread premiums (YSPs), and upfront settlement costs. Settlement costs, and especially the multiplicity of lender fees and the title charges, add to the borrower's confusion. Even after the settlement costs have been agreed on, they are subject to change until the day of closing. To exacerbate this situation, typical homebuyers 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 consumers¹ borrow fairly infrequently. This disadvantage 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. Lenders and third-party service providers can exploit this imperfection by charging excessive fees. The goal of the final rule under the Real Estate Settlement Procedures Act (RESPA) is to improve consumer welfare by reducing market imperfections that are a result of information asymmetry in the mortgage loan and settlement process. The final rule is expected to accomplish a reduction of closing costs through a new Good Faith Estimate (GFE) that includes both a one-page summary of the critical mortgage loan characteristics and an accounting of settlement costs that focuses the consumer's attention on the bottom line. A tolerance on the potential increase of settlement costs ensures that the GFE is a reliable shopping document. (See "Overview of the Final Rule" in the following text for more information about the final RESPA rule.)

It is expected that the new mortgage disclosure will encourage consumers to shop for the best mortgage, 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 borrowers 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 some costs to the settlement and lending industries in addition to the transfer of surplus. The authors estimate \$571 million of one-time adjustment costs related to new software, training,

¹ The term *consumer* refers to an individual at any stage in the shopping process from the initial application for a mortgage loan (applicant) to the final settlement (borrower). The term *consumer* also embraces different motives for borrowing, whether the mortgage loan is for a new home purchase or for refinancing an existing mortgage loan.

and legal consulting. After the transition expenses have been incurred, any ongoing costs that are substitutes for the software, training, or legal consulting costs, which would have been incurred anyway, do not represent an additional burden. Annual recurring compliance costs, which could be close to zero, will also occur. The U.S. Department of Housing and Urban Development (HUD), however, has assumed significant costs ranging from \$630 million to \$918 million (\$50 to \$74 per loan), depending on the number of applications per loan. In the high-cost case, significant borrower savings still exist, even if the full costs of the RESPA rule are imposed on borrowers.

The RESPA rule can be expected to generate economic benefits as well as costs. First, the rule may provide time savings for both consumers and industry. Second, the rule may provide two social benefits: a reduction of wasteful predatory behavior and an increase in sustainable homeownership.

Current State of Affairs

HUD issued a final rule under RESPA to improve the process of obtaining home mortgages and to reduce settlement costs for borrowers.² Because the final rule calls for significant changes in the process of originating a mortgage, a wide range of benefits, costs, transfers, and market impacts can occur. The effects on borrowers from improved shopping for mortgage loans will be substantial under this rule.

RESPA is a consumer-protection statute 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 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, a final settlement document issued at closing, which is a standard form that shows the actual charges imposed on borrowers and sellers in connection with the settlement.

Current rules do not ensure that the GFE is a reliable estimate of final settlement costs. There is little guidance and there are no meaningful standards for originators in providing GFEs 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 borrower’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 shopping for a loan and the mortgage settlement process both difficult and confusing, even for the most informed shoppers.³ The current HUD-1, which is the document used at

² The final rule, “Rule To Simplify and Improve the Process of Obtaining Mortgages and Reduce Consumer Settlement Costs” (FR-5180-F-03), was printed on November 17, 2008, and is available at <http://www.hud.gov/offices/hsg/slfh/res/finalrule.pdf>.

³ See pages 156–160 of chapter 3 of the *Regulatory Impact Analysis* (HUD, 2008) for a list of potential fees and charges, which 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. (A regulatory impact analysis provides an estimate of the benefits, costs, and transfers of a regulatory action as well as the impacts on other federal agencies and small business. A regulatory impact analysis is also required to include a discussion of alternatives to the planned regulatory action.)

closing, can include an array of charges with names that may be entirely unrelated to anything in the GFE, making nearly impossible the borrower's task of judging whether their GFE told them anything useful.

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 tradeoffs, such as paying settlement costs up front or paying them over time through a higher interest rate. Loan originators do not always clearly explain this tradeoff to borrowers and it is not evident from current GFEs. The typical 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 deterred 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 recordkeeping because the closing costs reported to the settlement agent need not be transaction specific. Such a practice would be and is thus less burdensome for industry. The settlement process needs a regulatory framework 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 the Final Rule

The final RESPA rule provides a new, simplified GFE that includes tolerances on final settlement costs and a new method for reporting wholesale lender payments in broker transactions.⁴ Borrowers in today's market are frequently overcharged by the combination of a higher interest rate and YSP (Woodward, 2008). 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, such as the 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 tradeoff table so that consumers will learn the relationship between the interest rate, the YSP, and total settlement costs. The third page also includes a table for mortgage applicants to use for notetaking on alternative loan offers, thus providing a visual means for comparison shopping.

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 YSP. The new GFE will disclose the YSP and discount points in brokered loans prominently and accurately and in an informative way so borrowers may use them to their advantage. The prominent placement of the YSP and discount points in the calculations that lead to net settlement costs makes them difficult to miss. That placement should also enhance borrowers' comprehension

⁴ See <http://www.hud.gov/offices/hsg/sfh/res/gfestimate.pdf> for a copy of the GFE.

of how YSPs can be used to reduce upfront settlement costs. The new tradeoff table will help borrowers understand the relationship between higher interest rates and lower settlement costs.

HUD contracted with forms development specialists, the Kleimann Communication Group, Inc., to analyze, test, and improve the GFE and HUD-1 forms, resulting in documents that are consumer friendly and that efficiently convey the terms of the loan and settlement costs (Kleimann Communication Group, 2008). HUD conducted multiple rounds of extensive consumer testing of the GFE over 6 years, from August 2002 until September 2008. The testing included qualitative interviews and quantitative evaluations of nearly 1,600 homebuyers, potential homebuyers, and homeowners who had refinanced in 17 cities across the United States. Testing results show that consumers could 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 finding the additional loan offers to be overwhelming, the consumers found that the larger number of offers helped them focus on the key information.

HUD designed the new GFE form to focus borrowers' attention on the right numbers so that competition is maintained between brokers and lenders. People who participated in the forms testing were highly successful in identifying the cheapest loan, with success rates as high as the 90+ percent range, regardless of whether the broker loan was cheaper, the lender loan was cheaper, or the loans cost the same. Broker bias was not evident.⁵ The forms testing confirmed the advantages of easy-to-understand, professionally developed forms.

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 after 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, providing 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 pricing method will make internal operations for the loan originator simpler and less costly, and competition among lenders will compel them to pass these cost savings to borrowers.

HUD also revised the HUD-1 Settlement Statement form to make the GFE and HUD-1 easier to compare.⁶ The revised HUD-1 describes categories of charges using the same language as the GFE and orders the categories of charges in the same order as the GFE. The final rule introduces a comparison page in the revised HUD-1 that would (1) compare the GFE estimates to the HUD-1

⁵ Bias does show up in comparisons in which broker and lender loans are otherwise completely identical. In such cases, borrowers who do not think of the two loans as identical tend to favor the lender loan. The likelihood, however, of borrowers getting two otherwise identical loans is extremely low.

⁶ See <http://www.hud.gov/offices/hsg/sfh/res/hud1.pdf> for a copy of 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.

The authors 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 borrowers can rely on, and a comparison page on the HUD-1 that enables the borrower to compare the amounts listed for particular settlement costs on the GFE with the costs listed for those charges on the HUD-1. It will also enable borrowers to double check the loan details at settlement.

Need for the Final 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 most third-party fees. The Urban Institute (Woodward, 2008) collected data on 7,560 Federal Housing Administration (FHA) loans. The mean total closing cost for all loans was \$4,917 for an average loan amount of \$108,237. Total charges comprised 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 a high degree of price dispersion. In other words, some borrowers get market-price deals, but other borrowers do not.

Because total loan charges are correlated with the 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 nonsubsidized loans from a data set of closing costs that the Urban Institute provided (see exhibit 1). Slightly less variation occurs when the costs are measured as a percentage, but the variation is still substantial: the ratio of what the 75th percentile pays as a percentage of the loan to what the 25th percentile pays is 1.8 for total loan charges, 2.1 for the YSP, and 2.4 for direct loan fees.

It is apparent that one-half of the borrowers pay loan charges equal to or greater than 3.2 percent of their loan amount, one-fourth pay loan charges of at least 4.2 percent of their loan amount, and 5 percent pay loan charges of at least 6.2 percent of their loan amount. The variation is similar for

Exhibit 1

Distribution of Categories of Closing Costs as a Percentage of Loan Amount*

Series	5th Percentile	25th Percentile	50th Percentile (median)	75th Percentile	95th Percentile
Total closing cost	2.9	4.1	5.1	6.4	8.9
Total loan charges	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
Total title charges	0.6	0.9	1.2	1.6	2.3
Other third-party charges	0.2	0.4	0.6	0.8	1.4

* Calculated by HUD from data provided by the Urban Institute.

title charges and other third-party charges. One-half of the borrowers pay total closing costs equal to or greater than 5.1 percent of their loan, one-fourth pay closing costs of at least 6.4 percent of their loan amount, and 5 percent pay closing costs of at least 8.9 percent of their loan amount.

The data strongly indicate price dispersion and thus price discrimination. This article is not concerned with price discrimination that is based on costs but with discrimination based on 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 is important to note that, if the variation of fees and charges paid is greater than the actual costs of providing the services, then that variation constitutes evidence of a violation of RESPA, which explicitly prohibits markups.⁷

In a competitive market, the price of the good should depend on its quality and not on 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, as mentioned previously. Indeed, strong evidence indicates that individuals pay different prices for reasons other than the cost of providing the service. The Urban Institute (Woodward, 2008) found that African Americans pay \$415 more for their loans and that Hispanics pay \$365 more (after taking into account borrowers' differences, such as credit score and loan amount) than Whites do.⁸ These loans are not subprime loans but standard FHA loans.⁹ Other researchers, reviewed in the *Regulatory Impact Analysis* (HUD, 2008), 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 YSP is one element of a mortgage that a borrower is not likely to understand well. The YSP 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 YSP. This relationship appears to hold in the data analyzed. The burden of the YSP, however, is on the borrower, who pays a higher interest rate for loans with a higher YSP.

If borrowers were well informed, a negative one-to-one relationship would exist between upfront fees and the YSP. The upfront fees and the YSP 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 YSP, which the lender pays, and direct fees, which the borrower pays.

The Urban Institute (Woodward, 2008) found no strong tradeoff between the YSP and upfront cash payments. Ideally, each dollar of YSP generated by a higher interest rate would result in a 1-dollar reduction in upfront fees. In a sample of unsubsidized loans with a rate above 7 percent, which

⁷ 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 many loan originators are ethical. If the entire market mirrored this more efficient segment, then RESPA reform would not have been as urgent.

⁸ For its statistical analysis, the Urban Institute focused on a subsample of 6,366 unsubsidized loans, for which the mean total charges are slightly higher, at \$5,245. Lender charges for unsubsidized loans are \$3,390, of which \$1,450 are direct fees and \$1,940 is the average YSP.

⁹ 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 followup.

is appropriate for investigating YSPs, the Urban Institute found that broker loan origination fees, rather than being lower by 1 dollar for each dollar of YSP, are *higher* by 16 cents.¹⁰ Such a relationship is contrary to what one would expect in a market where only minor imperfections existed.¹¹

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 (that is, get “zero-cost” loans) pay \$1,200 less for their loans than borrowers 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 anticompetitive practices, including price fixing. A large fixed cost of entry results from compiling a database of transaction and lending records. To make matters worse, Eaton and Eaton (2007) successfully argued 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, because the only component that varies substantially is the insurance premium. Eaton and Eaton (2007) found that borrowers pay title fees far greater than what is needed to cover costs and earn a reasonable return. The Urban Institute (Woodward, 2008) found an average \$1,329 title charge in its sample of all loans, with a standard deviation of \$564. The Urban Institute also found a significant variation by state, with title charges in New York, Texas, California, and New Jersey all costing at least \$1,000 more (holding property values constant) than charges in North Carolina, the state with the lowest title costs. It is reasonable to ask what extra benefits people in the states with high-cost title charges get relative to those in the states with low-cost charges, or why costs are so high if people are not receiving extra benefits.

The authors also examined the variation of title costs within states 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 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 more than \$1,000 for nine states. As a result of the extent of price dispersion, significant savings can be expected from the final rule.

Transfers From Industry to Consumers

It is difficult to estimate the extent to which the final rule will improve consumer shopping for mortgages and reduce the costs of closing a mortgage transaction for the borrower. The enormous

¹⁰ In a larger sample of all nonsubsidized brokered loans, the Urban Institute found that paying 1 dollar of YSP to a mortgage broker reduces upfront fees by only 7 cents, for a net loss of 93 cents on the dollar.

¹¹ Jackson and Berry (2002) found that consumers get only 25 cents of value for every dollar of YSPs. They concluded that the problem of price dispersion occurs when YSPs 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.

potential for cost reductions in today's market, however, is indicated by studies showing the wide variation in prices unrelated to costs. Consumer savings were estimated under a variety of scenarios concerning originator and settlement costs.¹² 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 (that is, origination fees, appraisal, credit report, tax service, flood certificate, title insurance, and settlement agent charges).¹³ 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 are better informed.

Industry experts never challenged the authors' estimate that the average consumer 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. Indeed, results from the Urban Institute study (Woodward, 2008) imply that the savings to borrowers may be as much as \$1,200 per loan. The authors conducted a sensitivity analysis with respect to the methodology of estimating the savings projection to provide a range of estimates: the \$6.48 to \$8.38 billion of transfers (\$518 to \$670 per loan) represents the substantial savings that can be achieved with the new GFE.¹⁴

The sources of consumer savings by industry can be disaggregated (see exhibit 2). Originators (brokers and lenders) contribute \$5.88 billion, or 70 percent, of the \$8.35 billion in consumer savings. This \$5.88 billion in savings represents 14.0 percent of the total revenue of originators, which is projected to be \$42.0 billion.¹⁵ The \$5.88 billion is divided between brokers, who contribute \$3.53 billion, and lenders (banks, thrifts, and mortgage banks), who contribute the remaining \$2.35 billion. Third-party settlement service providers contribute \$2.47 billion, or 30 percent,

Exhibit 2

Consumer Savings by Industry*

Source of Savings	Aggregate Consumer Savings (\$ in billions)	Percent of Total (%)	Transfer per Loan (\$)
Origination services	5.88	70.4	470.40**
Brokers	3.53	42.3	
Lenders	2.35	28.1	
Third-party services	2.47	29.6	197.60
Title and closing	1.79	21.4	143.20
Other third-party	0.68	8.1	54.40
Total settlement	8.35	100.0	668.00

*Base case scenario and assuming 12.5 million loans.

**A broker or lender will originate a loan. The authors assume that the savings per loan are equal across types of originator.

¹² Government fees, taxes, and escrow items are not included in this analysis because they are not subject to competitive market pressures.

¹³ We double checked this estimate using an alternative "title" approach and found a similar percentage reduction (12.6 percent).

¹⁴ See the *Regulatory Impact Analysis* (HUD, 2008), section VII.E.4 of chapter 3, for a description of the alternative estimates of consumer savings.

¹⁵ This figure 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).

of the \$8.35 billion in consumer savings. This \$2.47 billion in savings represents 10.0 percent of the total revenue, which is projected to be \$24.74 billion, of third-party providers. The \$2.47 billion is divided among title and settlement agents, who contribute \$1.79 billion, and other third-party providers (appraisers, surveyors, pest inspectors, etc.), who 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 Final Rule

Both one-time adjustment and annually recurring costs are expected to arise from the changes the rule will introduce. 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

Some features in the new GFE in the final rule would increase the cost of providing the loan and some would decrease the cost. Most of the information required on the GFE is readily available to originators, suggesting no additional costs to collect the information. In addition, less itemization of individual fees suggests reduced costs. On the other hand, a small amount of additional costs could be associated with the optional tradeoff table. Although it is difficult to estimate, it appears that a net of zero additional costs is possible. If the GFE adds 10 minutes per application to the time it takes to currently handle the forms, however, 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).¹⁶

The presence of tolerances will lead to some extra costs to originators for making additional arrangements for third parties to provide settlement services. Some originators might occasionally check market prices for third-party services, formulate estimates so that several prices charged by third parties fall within the tolerance, and trust that no third-party services to whom they refer the borrower charge 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 originators to do more than they are doing today. If, while making third-party arrangements to meet the tolerances, the average loan originator incurs an average of 10 minutes per loan, then the total cost to originators making third-party arrangements to meet the tolerance requirements is \$150 million (\$12 per loan).

The potential for additional underwriting costs exists 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 multiple preliminary underwriting

¹⁶ 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 applications-per-loan scenario, full underwriting is started for 33.75 million applications, of which 21.25 million are not originated.

will require no additional compliance cost. In the high-cost scenario, demand by the average applicant for preliminary GFEs increases by one application per loan to 2.7 applications per loan. A preliminary credit report involves only one FICO¹⁷ score from one credit bureau and therefore will cost only \$5 per report, as compared with a more expensive full credit report that would cost \$25. HUD estimates additional labor costs of \$6 (5 minutes at \$72 an hour) for the loan originator to order 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.

The number of additional GFEs the average borrower would receive under the new rule cannot be determined. Some borrowers may continue the informal shopping method that many use today; that is, they gather information and make inquiries to lenders and brokers about products and rates before proceeding with the request for a 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 (for example, a mortgage applicant may be denied during the preliminary underwriting without having been charged for an appraisal). Some applications that are not originated may be disapproved at the preliminary stage rather than at the end of the full underwriting stage (as they could with current procedures). The authors expect an increase in the ratio of *accepted* applications per loan. The resulting savings in appraisal, verification, and other incremental underwriting costs that would be avoided would tend to offset the increase in costs resulting from the extra preliminary underwriting previously noted.

The authors estimate the recurring compliance costs would range from \$32 to \$55 per loan and from \$405 million to \$693 million in aggregate.

Ann Schnare (2008) claimed that HUD made two serious errors in estimating the recurring compliance costs of the GFE. The authors found her first contention to be unsubstantiated but the second one to be worthwhile investigating. Schnare's report stated 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 10 days. Including such hedging costs dramatically increased Schnare's estimates of the recurring compliance costs. No requirement of an interest-rate guarantee exists, however, in the proposed rule. A more accurate estimate of the hedging costs would be zero. Only the prices on noninterest-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 with HUD's, were inflated by a factor of as much as four.

Schnare's second major criticism was that HUD did not consider the possibility that the rule could increase the administrative costs to loan originators because of the greater demand for GFEs. Although

¹⁷ Fair Isaac Corporation. As of March 10, 2009, the company is known as FICO™.

HUD believes that it is just as likely that the number of applications will not increase, HUD responded by including a sensitivity analysis of the application-to-loan ratio (outlined in exhibit 3).

In addition to incurring recurring costs of the GFE, loan originators will incur one-time adjustment costs of \$383 million in switching to the new form. They will need to upgrade their software and train staff in using the form to accommodate the requirements of the new rule. It is estimated that the software will cost \$33 million and the training will cost \$58 million, for a total of \$91 million.¹⁸ 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. After the new software is functioning, the recurring costs of training new employees in its use and the costs associated with periodic upgrades simply replace the costs that would have been incurred had they not upgraded and continued using the software for the old rule.

Similarly, loan originators will incur a one-time adjustment cost for legal advice on dealing with the changes related to the new GFE. The one-time adjustment cost for legal fees is estimated to be \$116 million. After the adjustment cost has been incurred, the ongoing legal costs are a substitute for the ongoing legal costs that would have been incurred under the old rule and do not represent any additional burden. Finally, employees will need to be trained in other aspects of the new GFE beyond the software and legal training already mentioned. This one-time adjustment cost is estimated to be \$194 million.¹⁹

Exhibit 3

Recurring Compliance Costs of the New GFE by Applications per Loan

Source of Additional Cost	Per Loan Cost		Total Cost to All Firms (in millions)		Total Cost to Small Firms (in 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
Total cost of GFE	\$32.40	\$55.40	\$405	\$693	\$213	\$364

GFE = Good Faith Estimate.

Costs of the HUD-1 Settlement Statement Form

The HUD-1 Settlement Statement form has been adjusted to ensure that the new GFE and the HUD-1 work well together. The layout of the revised HUD-1 has new labeling of some lines so that the borrower can easily match each entry on the GFE with the exact wording on the revised HUD-1. This adjustment will make it much easier to determine if the fees actually paid at settlement are consistent with the GFE, whether the borrower compares the forms alone or with the assistance of the settlement agent. The reduced number of HUD-1 entries that will result, as well as

¹⁸ See section VII.B.1 of chapter 6 of the *Regulatory Impact Analysis* (HUD, 2008). The estimate is based on the costs of updating software.

¹⁹ See sections VII.B.2 and VII.B.3 of chapter 6 of the *Regulatory Impact Analysis* (HUD, 2008).

the use of the same terminology on both forms, should reduce the amount of time borrowers and settlement agents spend 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. Recognizing, in certain cases, that the burden may be noticeable, the authors assume that the *average* burden would be 10 minutes per loan for loan originators. Settlement agents may face a recurring cost, although that is not likely because loan originators are responsible for providing the data. The settlement agent, however, will have to add final charges unknown to the originator and may have to complete the entire form if the lender does not transmit the information from page 3 of an already completed HUD-1. The settlement agent may also want to check the information concerning settlement costs, tolerances, and loan terms to ensure they agree with the GFE. In some cases, the settlement agent will have to calculate the tolerances. The authors assume that this step will add 5 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 the lender does. 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.

Settlement firms will incur one-time adjustment costs of \$188 million in switching to the new HUD-1 form. After the adjustment has been made, these costs do not represent any additional burden. Settlement firms will need to upgrade their software and train staff in its use to accommodate the requirements of the new rule. It is estimated that the software and training will cost \$80 million combined. Similarly, settlement firms will incur 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 need to be trained in aspects of the new HUD-1 beyond the software and legal training already mentioned. This one-time adjustment cost is estimated to be \$71 million.²⁰ A summary of the compliance costs for the base case of 12.5 million loans annually is presented in exhibit 4.

Exhibit 4

Compliance Costs of the Final Rule*

Portion of Rule	One-Time Compliance Costs During the First Year (\$ in millions)	Recurring Compliance Costs			
		(\$ in millions annually)		(\$ cost per loan annually)	
		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
Total	571	471	918	50.40	73.40

GFE = Good Faith Estimate.

* If 12.5 million loans annually.

²⁰ See section VIII.B of chapter 6 of the *Regulatory Impact Analysis* (HUD, 2008).

Economic Benefits of the Final Rule

Although most of the effect of this rule comes in the form of transfers from originators and settlement firms to borrowers, economic benefits of the rule stem from an increase in efficiency. The efficiencies, which come primarily from time saved as a result of forms that are easier to use, benefit both borrowers and originators. Positive spillovers include 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, when consumers have a better understanding of the loan product, the probability of default will decrease. The resulting decrease in defaults would reduce the dramatic social costs that accompany foreclosures.

Consumers' Benefits

As a result of the new GFE, mortgage applicants and borrowers will realize \$1,169 million in savings in time spent shopping for loans and third-party services. This amount is derived from a time savings worth \$55 per applicant (75 minutes at \$44 per hour) over 21.25 million applications. For example, if each borrower saves an average of 15 minutes in shopping for third-party services, 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 1 hour in evaluating offers and asking originators followup questions, borrowers will 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. It would be misleading to calculate consumers' benefits of time savings during search at higher ratios because going from an average of 1.7 to 2.7 applications per loan does not save the average consumer more time. It is clear, however, that the consumers will not be harmed because this increase in applications would be voluntary on the part of the consumer.

Upon receiving 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. The borrower could also decide to search further using the originator's prices as a good starting point and have them available as a fallback. In both cases, the borrower spends less time searching; however, spending less time searching does not imply receiving less benefit from the search. It is possible that under the final rule some mortgage applicants will want to spend more time searching because the new GFE increases the productivity of their search. Although additional time spent searching reduces the time spent on other activities, the reward in searching 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 because the increase in time searching is voluntary. Some consumers may choose 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 other considerations will dominate the incentive previously described. First, the higher productivity in searching 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 savings previous to the rule. Second, it is expected that a large portion of the increase in savings will be independent of a consumer's shopping behav-

ior. 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 savings will enable mortgage applicants to spend less time searching. The time that they do spend searching, however, will be more effective and will lead to greater savings. The new GFE will enable applicants to spend more time comparing and evaluating offers and less time trying to decipher the loan details.

Industry Benefits

Industry will benefit from 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' followup questions. The value of the time saved from dealing with followup questions from consumers is \$956 million.²¹ Loan originators will save \$765 million (30 minutes per application), and third-party settlement agents will save \$191 million (7.5 minutes per application).²² The reduction in time explaining the GFE to consumers could outweigh the administrative costs of the rule. Although industry representatives expressed some skepticism of this result, they offered no alternative estimates and did not deny that customer service is indeed a time-consuming activity.

Reductions in compliance costs from average-cost pricing will occur. Average-cost pricing reduces costs because firms do not have to keep up with an itemized, customized cost accounting for each borrower. Average-cost pricing not only saves costs when generating the GFE, it also saves the costs of quality control and other costs afterwards. Industry sources have told HUD that average-cost pricing 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 will need to know only 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 Nonproductive Behavior

Many price-discriminating loan originators and settlement firms extract excess fees without significant effort. They are able to estimate a potential borrower's willingness to pay a markup beyond the costs of originating a loan based on easily observable characteristics of the applicant.²³ 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 fees. Consumers can be

²¹ The average hourly opportunity cost of time of loan originators is calculated as follows: 12,500,000 loans times 1.7 applications per loan times 37.5 minutes per application times \$72 per hour.

²² 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.

²³ 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.

steered into disadvantageous loans by aggressive mail, phone, TV, or door-to-door sales tactics targeting neighborhoods with a high proportion of minority or elderly people. 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 nonconscientious 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 mortgage and settlement disclosure, borrowers 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 1 percent of current originator effort, this would result in \$420 million²⁴ 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

The final rule will contribute to sustainable homeownership in two ways. 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 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. Bucks and Pence (2008) found 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 to better inform borrowers.

Foreclosure generates private costs to the borrower and lender and substantial negative economic externalities 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 much 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 cleanup.

Negative impacts to the value of neighboring properties from a foreclosure include an amenity value to having an upkept property next door, the attraction of crime to vacant foreclosed properties, and

²⁴ 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 the originators’ revenue is \$420 million.

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 in benefits. Other benefits of informed financial choices 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 final 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.²⁵ Practically all mortgage brokers qualify as a small business, as do two-thirds of the banks and thrift institutions 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 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 consist of appraisers, surveyors, credit bureaus, and pest inspectors; they 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 noncompetitive prices.

Small businesses are not expected to suffer disproportionately from the final rule because no evidence indicates a greater prevalence of small businesses overcharging consumers.²⁶ 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. The authors do not believe, however, that the final rule will affect industry structure. They base this opinion on their observation that the real estate industry is very locally oriented. The value of proximity and local expertise makes 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, nothing indicates that the customer outreach function that brokers perform for wholesale lenders will change with

²⁵ These estimates are fully described in section VII.E of chapter 3 of the *Regulatory Impact Analysis* (HUD, 2008). Data on small business appear in chapter 5.

²⁶ For a detailed discussion of the effects on industry structure, see section II.C.5 of chapter 6 of the *Regulatory Impact Analysis* (HUD, 2008).

RESPA reform. We expect that brokers will continue to be competitive with other originators and that wholesale lenders will continue to depend on brokers to supply 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 borrowers. A significant proportion of the compliance costs will be passed on to borrowers in the form of higher prices. An obvious question is whether the costs of the final 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,²⁷ 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 with \$74 for later years. If all compliance costs were passed on to borrowers, then the net consumer savings is \$548 the first year and \$594 in subsequent years. In this scenario, we assume that all costs are passed on to borrowers and not to the applicants who do not receive loans. It would be reasonable to assume that in the high-cost scenario, however, in which preliminary underwriting costs increase, the cost of an initial credit report would be charged to all applicants.

The consumer realizes other potential benefits in addition to savings on settlement costs. First, aspects of this rule will save the industry time. 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 (75 minutes at \$44 per hour). The calculation of net benefits per borrower only included the time savings for borrowers and not for other applicants. The authors cautiously assume 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 because the time savings of rejected applicants would not benefit the borrower.

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

²⁷ 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 Home Mortgage Disclosure Act 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.

Conclusion

The ultimate goal of estimating the economic impact of the final 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 section entitled “Need for the Final Rule.” The current GFE is not an effective tool for facilitating borrower shopping or for controlling origination and third-party settlement costs. Thus, not to change the GFE would continue the current system of having consumers pay noncompetitive prices for mortgage services.

A variety of other approaches could reform the current system. Alternative methods proposed and considered for the final rule were excluding the YSP calculation in the GFE, including an itemization of costs in the GFE, including a 10-day interest-rate guarantee in the GFE, banning the YSP, 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 the industry.²⁸

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²⁸ For a description of all the alternatives considered to the proposed and final rule, see chapter 4 of the *Regulatory Impact Analysis* (HUD, 2008).

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