NAR White Paper: RESPA Reform
Prepared By
NATIONAL ASSOCIATION OF REALTORS
Government Affairs / Economic Research
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I. Background

Introduction

In 1996-1998, there was tremendous interest in the mortgage and settlement services industry and on Capitol Hill to seek comprehensive RESPA/TILA reform legislation. NAR was actively engaged in this effort through the Mortgage Reform Working Group. This is the coalition of industry and consumer groups, which has worked since May of 1997 to develop a consensus reform proposal.

The legislative and regulatory environment has changed dramatically for 1999 and 2000. The industry and consumer groups were unable to reach consensus on a reform proposal, the FED/HUD report (released in July of 1998) was unfavorable to many of the industry positions, and Congress has expressed very little appetite to move this very complicated and controversial issue without consensus.

Absent a fast track reform effort and wishing to be very deliberate in its policy development, NAR decided to use this opportunity to reassess our current RESPA policy. On May 20, 1999, at the NAR Midyear meetings, the RESPA Presidential Advisory Group (PAG) met to review efforts toward enacting meaningful RESPA reform. Input was solicited from members on alternative packaging proposals and the potential opportunities or conflicts they present. Perceiving strong sentiments but no consensus to change our current policy, the PAG directed NAR staff to pursue research and analysis ascertaining the benefits of alternative RESPA reform proposals. The RESPA PAG requested staff to prepare a white paper of future policy options to be delivered at the 1999 Annual Meeting in Orlando. This report fulfills this request.

On July 9, 1999, NAR hosted a planning meeting in Washington comprised of brokers from small independent to large conglomerate firms to discuss future RESPA reform proposals. At this meeting it became apparent that input needed to be solicited from a broader segment of the membership. It was decided that the best option was through focus groups at targeted state conventions. States selected were Texas, Louisiana, Massachusetts, New Mexico, Illinois, and California. NAR staff conducted these meetings from August through October 1999.

In addition to these focus group meetings, NAR contracted Hart-Riehle-Harwig Research to conduct consumer polling to ascertain consumer attitudes toward referral fees in the real estate transaction. These telephone surveys were conducted between July 25 to 30, 1999. Also, NAR's Economics Research has conducted separate surveys that tracked the trends impacting the real estate industry. These studies find direct and indirect impacts of technology and innovation on real estate professionals. The ***1999 National Association of REALTORS® Membership Profile***finds NAR's membership getting older but becoming more technologically adept. The ***1999 National Association of REALTORS® Profile of Real Estate Firms*** measures the use of on-line services by real estate firms, as well as the increased impact of affinity arrangements and ancillary services on the operation of real estate firms. The last research component was to commission an economic analysis of the use of referral fees in residential real estate. Professors' Colwell and Kahn of the University of Illinois created a paper that considered theoretical economic arguments for and against referral fees, the legal status of referral fees in several contexts, and the practices regarding referral fees in a variety of professions other than residential real estate.

Organization of Report

This report consists of three sections. Section One presents a background of the issue and includes a time line of significant events with respect to RESPA policy development at the NATIONAL ASSOCIATION OF REALTORS. Section Two provides the consumer polling results and a discussion of academic studies of the economic functions of referrals and referral fees. Section Three presents a synopsis of members' views expressed at the focus groups conducted at state conventions this summer and fall, and presents five Section 8 reform options.

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RESPA Legislative and Regulatory Timeline

1974
The Real Estate Settlement Services Procedures Act (RESPA) was passed by Congress to ensure the provision of greater and more timely information on the nature and costs of the settlement process to consumers. RESPA also sought to protect those consumers from unnecessarily high settlement charges caused by certain abusive practices that had developed sporadically throughout the country.

RESPA's stated purpose is to "effect certain changes in the settlement process for residential real estate that will result in:
1. more effective advance disclosure to homebuyers and sellers of settlement costs;
2. the elimination of kickback or referral fees that tend to increase the cost of certain settlement services;
3. a reduction in the amounts home buyers are required to place in escrow accounts established to insure the payment of real estate taxes and insurance; and
4. significant reform and modernization of local record keeping of land title information."

RESPA, as enacted in 1974, prohibited compensation from referring a homebuyer to a settlement service provider.

Section 8(a): "No person shall give and no person shall accept any fee, kickback, or thing of value pursuant to any agreement or understanding, oral or otherwise, that business incident to a part of a real estate settlement service involving a federally related mortgage loan shall be referred to any person."

The statute goes on to say that, while a person cannot be paid for a referral, the person making a referral may be paid for goods or services, leaving it to HUD to determine when a payment is for a referral and when it is for the goods or services.

Section 8(c)(2): "Nothing in this section shall be construed as prohibiting...(2) the payment to any person of a bona fide salary or compensation or other payment for goods or facilities actually furnished or for services actually performed..."

1983
Congress amended RESPA to say that controlled business arrangements (CBAs -- now referred to as affiliated business arrangements) did not, in and of themselves, violate RESPA, if certain disclosure and other requirements were met.

Section 8(c)(4): "Nothing in this section shall be construed as prohibiting...(4) controlled business arrangements so long as (A) at or prior to the time of the referral a disclosure is made of the existence of such an arrangement... (B) Such person is not required to use any particular provider of settlement services, and (C) the only thing of value that is received from the arrangement, other than payments permitted under this subsection, is a return on the ownership interest or franchise relationship..."

1992
On November 2, 1992, HUD published a final rule amending Regulation X (the regulations implementing RESPA). The rule created two exemptions from Section 8 requirements for (1) payments by employers to employees for referrals; and (2) payments by borrowers for CLO services.

Section 3500.14(g)(2)(ii) and (iii): "Section 8 of RESPA does not prohibit... (ii) an employer's payment to its own employees for any referral activities; or (iii) any payment by a borrower for computer loan origination services, so long as the disclosure set forth in appendix E of this part is provided the borrower."

1994
On July 21, 1994, HUD issues proposed RESPA rules that would prohibit referral payments to employees from employers for referrals to affiliated companies, reversing HUD's 1992 final rule. As proposed, HUD creates an exception to the prohibition by permitting managerial employees, who do not have routine contact with consumers, to be compensated for the overall profitability of the affiliate.

1996
On June 7, 1996, HUD issues final rule to withdraw employee compensation rules and replaces it with a narrower exemption for managers. These regulations restrict incentive payments paid to employees of real estate firms for marketing or providing other settlement services. In general, if the employee (manager, customer representative, financial services representative) has significant contact with the consumer, the employer could not compensate the employee. This provision severely encumbers employers from paying employees for marketing the services of affiliated companies. HUD also issued statements of policy in three areas:

Statement of Policy 1996-1 Computerized Loan Origination Systems -- The policy interpretation permits consumers to pay for CLO services and be reimbursed for these fees by the lender. Settlement service providers such as mortgage firms may pay for goods or facilities actually furnished or for services actually performed by the CLO operator. Settlement provider names on a CLO system must be presented in a neutral display format.

Statement of Policy 1996-2 Sham Controlled Business Arrangements -- The interpretation sets forth a list of factors HUD looks to in determining whether a CBA is bona fide, including: how adequately it is capitalized, whether it has its own employees and whether it contracts out all or most of the work back to a parent company. The guidance specifies that no single factor determines whether or not a specific business arrangement is a sham.

Statement of Policy 1996-3 Retaliation -- HUD has concluded that RESPA does not give HUD authority to prohibit retaliation against employees or agents who fail to make referrals to affiliated entities. **Lender Lockout** -- HUD has no authority to regulate lender access to the offices of real estate brokers. **Office Space Rental** -- Real estate offices that lease space to lenders or other settlement service providers must charge the general market value of the office space leased; rent cannot be based on the number or value of business generated from the location. Real estate firms would be prohibited from charging lenders (or other settlement providers) more than the market rate for office space located in the real estate firm.

The regulation was to become effective October 7, 1996; however, Congress delayed the section placing restrictions on employer payments to employees until July 31, 1997. It is important to note that the three policy statements were not delayed and were effective on October 7, 1996. However, any reference in the statements of policy concerning payments from employers to employees was not applicable. HUD, in November, issued regulations halting the June 7, 1996 final rule. Additionally, Congress mandates HUD/FED to determine if they, through regulation, can "harmonize" disclosure requirements between RESPA and Truth-in- Lending Act (TILA). If not, HUD and FED are required to provide to Congress a legislative proposal on how to accomplish this goal. In December, HUD issues additional Affiliated Business Arrangement disclosure statement clarifications with a January 14, 1997 effective date.

1997
On May 9, 1997, HUD issues a proposed rule with clarifying language to restrict further the new manager exemption of June 1996 final rule. Also in May, Rep. Lazio (R-NY) held an industry and consumer group meeting to build a consensus solution in reforming RESPA, creating the Mortgage Reform Working Group (MRWG). Participants included NAR, MBA, NAMB, CMC, RESPRO, CFA, the National Consumer Law Center, the Consumers Union, ABA, ALTA, ACB, AARP, NAHB and several other industry and consumer groups. In June, NAR and MBA sent a joint letter to HUD asking that they hold off on implementing the June 1996 final rule. To date, HUD has not issued a final rule, thus preserving the 1992 rule.

1998
In July 1998, the FED/HUD report was submitted to Congress, with both HUD and the FED testifying before Congress. In September, NAR and other industry groups were invited to testify. In September, the last MRWG meeting was held, with no industry consensus reached.

1999
In January, Senator Gramm (R-TX), Chair of Senate Banking Committee states that RESPA reform will not be a priority in the 106th Congress. In May, NAR PAG directs staff to research additional reform options and present a White Paper for member consideration in November.

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NAR Policy Development

NAR policy on RESPA has evolved over the 26 years since its enactment in 1974 and major amendments during this time. NAR's policy supports the right of real estate licensees to receive fees for a full range of real estate related services as long as basic RESPA requirements are met (written disclosure, no required use). NAR supports the development of "Controlled Business Arrangements" or affiliated settlement service arrangements. These affiliated companies should be permitted to operate free of undue entanglement by HUD in the compensation arrangements of real estate brokerage companies.

1994
The official NAR RESPA policy position was as follows:

NAR believes that real estate brokers/agents providing services in addition to or different to those they are obligated to provide by their agency agreement, are entitled to remuneration for these services, provided that full and written disclosure is made to and accepted by all clients and customers to the transaction in advance of undertaking to perform such services.

We are opposed to the acceptance of fees by real estate brokers/agents, and other staff for the simple referral of customers or clients to mortgage lender and providers of other settlement related services.

In controlled business arrangements, as defined by the RESPA statue, we believe brokers/agents, and other staff are entitled to remuneration for the delivery of real estate-related services provided that written disclosure is made to and accepted by all clients and customers to the transaction, and there is no required use of these services.

We are opposed to legislative or regulatory efforts to limit the payment of remuneration for these additional services. **NAR Statement of Policy, August 4, 1994**

1997
At the 1997 NAR Annual Convention, a Presidential Advisory Group on RESPA Reform was appointed and made policy recommendations that were reviewed by the Public Policy Coordinating Committee and approved by the NAR Board of Directors. NAR's proposal for reform is twofold: (1) to support the preservation of the current favorable employee compensation provisions, and (2) to advance the ability of firms to offer one stop shopping by creating an environment where a real estate firm can offer directly to the consumer a package of fully disclosed settlement services at a guaranteed price. The specific language approved and amended by the Board of Directors follows:

1. That the National Association of REALTORS® support efforts to increase regulatory clarity for both the Real Estate Settlement Procedures Act (RESPA) and the Truth in Lending Act (TILA), by recommending the following:

- RESPA and TILA be merged onto one disclosure statute.
- If they cannot be merged, RESPA and TILA should be written to complement each other.
- Enforcement authority should be placed with the Department of Housing and Urban Development (HUD) if RESPA and TILA are merged.
- If merged, maintain the real estate broker exemption from the 3 day right of recision. (Currently contained in the TILA regulations)

2. That NAR codify the exemptions in the 1992 Rule for Section 8 as they relate to employer-employee compensation. The exemptions sought would include:

- A payment by an employer to its own bona fide employee for generating business for the employer; and
- In an affiliated business arrangement, a payment by an employer of a bonus to a managerial employee based on criteria relating to performance (such as profitability, capture rate, or other thresholds) of a business entity in the affiliated business arrangement.
- A payment by an employer to its bona fide employee for the referral of settlement service business to a settlement service provider that has an affiliate relationship with the employer, provided written disclosure is made to and accepted by all clients and customers to the transaction, and there is no required use of these services.

3. That NAR affirm its current position on affiliated business arrangements as defined by the RESPA statute, we believe brokers/agents and other staff are entitled to remuneration for the delivery of real estate related services provided that written disclosure is made to and accepted by all clients and customers to the transaction, and there is no required use of these services.

4. That NAR support disclosure requirements for referrals to affiliated businesses made over the telephone as written in HUD's May 9, 1997 Proposed rule.

5. Clarify that HUD does not have authority to regulate the rental of office space.

6. That NAR support maintaining RESPA enforcement authority at HUD.

7. That NAR seek to remove or limit criminal penalties under RESPA.

8. NAR opposes the current draft federal legislative language that would exempt payments to an "affinity group" from Section 8 of RESPA.

9. That NAR oppose blind bundling* of settlement services as outlined in the Consumer Mortgage Coalition (CMC) proposal. We do support the consumer's right to compare and select from fully optional and disclosed packages of settlement services, provided the following:

Anyone, not just lenders, could offer a package of settlement services.

The consumer would be permitted a choice of whether to buy the package or purchase services separately. In other words, no required use of package the lender cannot require the use of their package to obtain the loan and cannot charge a rate or point differential if the consumer chooses a competitor's package.

Lenders should be prohibited from rejecting the use of a competitor’s package if providers in the package are approved by the secondary market, the Financial Institutions Reform, Recovery and Enforcement Act (FIRREA), or any other law governing loan products.

If consumer is offered an open package at a guaranteed price, there should be no government restrictions or prohibitions on how settlement service providers price their product.

When consumers choose to use a package, package providers could require use of those services and service providers contained within the package even if they are from affiliated businesses.

A basic package of settlement services is defined as all settlement services associated with closing the mortgage loan and required by the secondary market, FIRREA, or any other law governing loan products.

Fully disclose services, the service providers and the price of services within the package, however in a basic package there is no need to disclose the service providers. In supplemental packages, those requested by the consumer in addition to the basic package, the services and service providers must be disclosed.

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II. Research

NATIONAL ASSOCIATION OF REALTORS® Research Studies

Throughout 1999, the Economic Research Group of the National Association of REALTORS® has conducted separate surveys that tracked the trends impacting the real estate industry. These studies find direct and indirect impacts of technology and innovation on real estate professionals. The ***1999 National Association of REALTORS® Membership Profile*** finds NAR’s membership getting older but becoming more technologically adept. The ***1999 National Association of REALTORS® Profile of Real Estate Firms*** measures the use of on-line services by real estate firms, as well as the increased impact of affinity arrangements and ancillary services on the operation of real estate firms.

Membership Profile

The membership of the National Association of REALTORS® is becoming older, more successful, and is more experienced. Contrary to the belief that an aging workforce will not respond to the challenge of emerging technologies, most REALTORS® use computers and the Internet for the business needs

- **Today's REALTOR® is older and more likely to be female than in the past:** In 1999, the typical REALTOR® is a 52 year-old female sales agent who earned $43,500 from her real estate activities.

- **REALTORS® work hard and bring great experience to her customers:** The typical REALTOR® works 45 hours a week, has been in the real estate business for 13 years, has been with her firm for six years and has worked for only one other firm.

- **Today's REALTOR® is better educated than her predecessors:** Nearly nine out of every ten REALTORS have taken at least some college courses, with 43 percent having completed a Bachelor's degree.

- **REALTORS® are responding to a diversifying America:** Sixteen percent of REALTORS® have conducted business in a language other than English. Spanish is the most widely used language in those transactions.

- **Computer ownership is nearly universal:** Nearly nine out of 10 REALTORS own or lease a computer while more than 60 percent of REALTORS use E-mail and the Internet for business purposes.

- **REALTORS® are using the Internet to increase their marketing presence:** Nearly three out of 10 REALTORS have a Web page for business purposes while three-quarters of REALTORS® represent real estate firms that have Web pages. Successful REALTORS® have Web pages-the median gross personal income of REALTORS® with Web pages is $66,900.

- **At this time real estate professionals are generating a relatively small portion of their business from the Internet:** Fifty-seven percent of REALTORS report that at least one percent of their business is generated from on-line services.

- **REALTORS® are using the Internet to gather more information about their profession and to improve their lives:** Fifty-eight percent of REALTORS® use the Internet to find industry information, 16 percent participate in business-related on-line discussions, and 26 percent have shopped on-line.

Firm Profile:

Given the wide diversity of real estate industry, it is nearly impossible to describe the "typical" real estate firm. There are many small firms who have just a handful of sales agents, while the conglomerates are changing the face of the industry. While most firms are small, more REALTORS® represent the larger firms. Most firms are making a presence on the Internet and are using computer software to improve their productivity.

- **Most real estate firms are small, but REALTORS® tend to represent larger firms:** More than four out of five real estate firms have just one office. Further, sixty percent of real estate firms have five or fewer sales agents, while 4 percent of firms have more than 50 sales agents. Even though most firms are small, 38 percent of real estate agents represent firms with a sales force of more than 50 agents.

- **The "typical" firm specializes in residential brokerage and has been in business for longer than its predecessors:** Real estate firms have been in business for a median of 13 years. Residential brokerages with more than 50 agents have been in business for a median of 20 years, compared to 11 years for the typical residential firm with ten or fewer agents.

- **Real estate firms have increased their presence on the Internet:** Fifty-seven percent have a Web page on the Internet and 56 percent post their listings on REALTOR.COM™

- **The Internet is generating business:** More than seven out of ten firms report generating at least one percent of their business from on-line services. Eight percent of firms generate more than ten percent of the business from the Internet.

- **Other technologies are playing a substantial role inside firms:** Cellular phone use is nearly universal, more than 70 percent of firms use scanners, and nearly three out of five firms use digital cameras.

- **Real estate firms use computer software to improve productivity:** Firms report widespread use of software for comparative market analysis, document preparation, and presentation. The use of property management software is nearly universal among firms that specialize in that field.

Firm size is a determinant for the use of technology in the firm. Larger residential firms, which are firms that generate more than half of their revenue from residential brokerage and have sales forces larger than 50, report greater technology use than smaller residential brokerages.

- **Larger residential firms (with a sales force of more than 50 agents) are more likely to have a Web site than smaller residential firms (with a sales for of ten or fewer):** Ninety-three percent of larger residential firms have Web sites compared to "just" 53 percent of smaller firms.

- **Larger firms are more likely to generate business from the Internet:** Ninety-three percent of residential firms with a sales force larger than 50 generate at least one percent of their business on-line compared to 36 percent for residential firms with ten or fewer sales agents.

- **Larger firms are more likely to embrace technologies beyond the Internet:** Ninety-two percent of larger residential brokerages use digital cameras (compared to 52 percent for smaller residential brokerages) and 98 percent of residential brokerages with more than 50 agents use scanners (compared to 66 percent of residential brokerages with 10 or fewer agents).

Beyond technology, firms are innovating through their participation in affinity arrangements and through offering ancillary services, such as mortgage finance and business brokerage. Similar to technology, larger brokerages are more likely to use these new revenue sources.

- **Affinity arrangements are most common among larger residential brokerages:** Fourteen percent of all real estate firms participate in affinity arrangements, including more than half of residential brokerages with more than 50 agents.

- **Affinity arrangements tend to occur between real estate firms and other corporations (such as Costco), professional associations, and employers:** Sixty-four percent of firms that participate in affinity arrangements have "corporations that provide services to customers." More than two out of five participating firms have arrangements with professional association while nearly three out of four such firms deal with employers.

- **Business brokerages, where real estate firms help sell businesses, is the most widely cited ancillary business activity:** Seventeen percent of firms participate in this business.

- **Among residential brokerages with more than 50 agents, mortgage finance is the most popular ancillary business activity:** Fifty-six percent of these firms report their participation in this field.

Both the membership and firm profile reports, as well as other NAR Economic Research products are available online at**NAR.Realtor.com/Research.**

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NAR Commissioned Research

NAR also conducted extensive research during the months of July and August of 1999 to develop credible, third party research to ascertain consumer attitudes toward referral fees in the real estate transaction. NAR complemented the survey results by commissioning an economic analysis of the use of referral fees in residential real estate. Professors' Colwell and Kahn of the University of Illinois created a paper that considered theoretical economic arguments for and against referral fees, the legal status of referral fees in several contexts, and the practices regarding referral fees in a variety of professions other than residential real estate.

Consumer research results confirmed once again that one-stop shopping offers the benefits of increased convenience, better service and potentially lower costs. Homebuyers want one-stop shopping from their real estate company. Results of the survey follow.

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Hart-Riehle-Hartwig Research: Consumer Polling

From July 25 to 30, 1999, Hart-Riehle-Hartwig Research interviewed a representative cross section of 801 home buyers nationwide who purchased their homes within the past two years. Key findings include:

- Most people find the concept of one-stop shopping for settlement services to be appealing. Three in four recent homebuyers (76 %) say that getting all or some of their home-buying services handled through one company is appealing.

- Recent home buyers may have been satisfied with the process that led them to a successful home purchase, but they still see the need for many improvements in that process. Two in three (65 %) recent homebuyers feel that a change in current rules in order to give companies a financial incentive to put together a one-stop shopping package for homebuyers would be an improvement in the home-buying process.

- The current pool of recent homebuyers is highly cost-conscious. Because of the past few years' strong housing market, more non-traditional homebuyers are in the market, and these buyers often are stretching their family finances in order to buy a home. Today's homebuyers are much more likely than they were in 1997 to say that the idea of saving money through discount-priced one-stop shopping services has a great deal of merit. Four in five (81 %) recent homebuyers believe that this idea has some merit.

- When recent homebuyers consider where to go for one-stop shopping, only REALTORS, banks, and mortgage companies make sense to them. Overall, half (49 %) of all recent homebuyers would prefer to use a one-stop shopping company if they could go through the home-buying process again.

The executive summary and national survey results are provided in Appendix I of this report.

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Academic Research:*Economic Functions of Referrals and Referral Fees*,
Peter F. Colwell and Charles M. Kahn, August 24, 1999.

Professors' Colwell and Kahn of the University of Illinois prepared for NAR an economic analysis of the use of referral fees in residential real estate. They considered theoretical economic arguments for and against referral fees, the legal status of referral fees in several contexts, and the practices regarding referral fees in a variety of professions other than residential real estate. The highlights of their analysis include:

- As professional services become ever more complex, so do the institutional arrangements for the provision of these services to consumers. The complexity of financial arrangements has led to the appearance of intermediaries or middlemen; specialist in arranging complex transactions. Referrals by middlemen and referral fees paid to middlemen emerge in markets in which there is less than full information about diverse customers and service providers. In some markets, referral fees are an accepted and uncontroversial part of the institutional landscape. In other markets and institutional settings they may be illegal, unethical, and/or economically inefficient.

- The roles taken on by a middleman in markets for professional services fall into five functional categories: marketing, screening, matching, monitoring and guaranteeing. The value added from using a middleman as an information specialist stems from the economy of scale in transmitting information from service providers to multiple customers, and the economy of scope in transmitting information from customers to service providers. We would expect the middleman to attempt to extract compensation for all of the services provided.

- Regulatory restrictions on the ability of middlemen to receive private referral payments can have real effects. In particular such restrictions will discourage the entry of specialists with high set-up costs and low variable costs. The response of government agencies to referral fees have varied across the occupations, with the FTC consistently arguing for eliminating mandatory restrictions of referral fees, and other agencies and legislation pushing for greater restrictions.

- The role of middlemen is becoming ever more central to the efficient operation of real estate markets. The real costs incurred by middlemen are not included in the regulatory authorities' calculations of permitted costs, and become, under RESPA, prohibited as referral fees. By prohibiting referral fees, RESPA does help to maintain confidence that real estate professionals work at the exclusive agent of the client, but it does so at a price: It discourages development of innovative packages of products by alliances of small independent service providers and prevents these firms from taking advantage of the economies of scope that these alliances would provide, placing them at a disadvantage relative to large consolidated service providers.

- As it stands, RESPA includes two sets of provisions that limit the ability of middlemen to provide settlement services. The restrictions on referral fees restrict the ability/willingness of middlemen to make referrals to certain types of service providers, limiting the usefulness of the independent arrangement and skewing the industry towards large consolidated organizations. On the other hand, the requirement that packages be serverable discourages consolidated organizations from reaping the full advantage of scale economies by providing low-cost comprehensive "plain vanilla" packages. If both sets of restrictions were dropped it is likely that the new forms of organization would co-exist with existing forms, becoming dominant in specialized niches of the market, while existing arrangements would continue to dominate other niches. With a variety of arrangements available it would become important for customers to be clear as to which sort of arrangement each provider was working under; therefore there would continue to be a useful role for disclosure provisions under RESPA.

The complete paper by Professors' Colwell and Kahn is provided in Appendix II of this study.

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Other Academic Research

The American Land Title Association (ALTA), in response to the July 1998 joint Federal Reserve Board and HUD recommendations for legislative changes in the Real Estate Settlement Procedure Act (RESPA) and the Truth in Lending Act (TILA), commissioned Professor Robert M. Feinberg, Chair of the Department of Economics at American University to conduct a study of the economic implications of implementing the FED/HUD report. This study, entitled **Economic Implications of Real Estate Settlement Packaging,** was released December 18, 1998. The entire paper is provided in Appendix III.

Professor Feinberg believes that the recommendations presented in the FED/HUD joint report will have very negative consequences for consumers and for current settlement service providers. Specifically, he believes that the benefits of allowing packaging of settlement services as proposed will produce minimal benefits at best, while imposing potentially significant costs on consumers and smaller settlement service provides, and risk to the real estate settlement industry. He states that the FED/HUD packaging proposal assumes, without providing evidence in support, that vigorous competition exists among mortgage lenders and will assure that any cost savings realized by lenders in arranging for the various services will be passed on to consumers. Professor Feinberg believes that both of these premises are debatable. Moreover, he states that any benefits that might result from packaging would likely be distributed unevenly across regions and individuals. In contrast, he states that the possible costs are easier to identify. These include higher prices to certain groups of customers, elimination of settlement service providers that could have long-term competitive implications, conflicts of interest, and risk of harming small businesses and disrupting a system that generally works well at present.

Professor Feinberg presented an extensive discussion of what he believes are the direct and indirect costs of packaging. The costs of packaging are of the following types: (1) raising prices on settlement services to selected groups of home-buyers; (2) the threat of long-term availability problems, especially by smaller providers of certain settlement services, which may have implications for future levels of competition in the real estate settlement market; (3) reduced purchases of consumer-benefiting services associated with the home purchase; and (4) moral hazard issues which may reduce the quality of some settlement services that primarily benefit consumers but which are included in lender-provided packages.

Feinberg concluded his paper by stating:

- It is difficult to see significant benefits accruing from the suggested changes in settlement procedures outlined in the Fed/HUD report. As detailed above, any cost savings arising from packaging should not be assumed to necessarily pass through to consumers. There is at least as great a chance that packaging (especially in the form envisioned in the Fed/HUD report) will lead to higher prices to some groups of consumers. The stated goals of making comparison shopping between lenders easier and of giving consumers more certainty in the true cost of real estate transactions are unlikely to be achieved by the changes.

- Significant costs are likely in the form of price discrimination, harm to small business, and in a reduction in purchases of consumer-benefiting services not included in the package. When viewed in the light of increasing lender consolidation, there is also the potential cost of placing more control over the settlement system in the hands of an industry that may be becoming less competitive (especially in certain regions and to certain customers).

- Even in the best case scenario, consumers will have much less than full information in the settlement process. Any benefits from packaging would require strong competition among lenders, and will likely be distributed unevenly across regions and individuals. And the economic benefits -- in terms of reduced search costs and lower settlement costs -- are quite questionable. While the net impact may in fact be to induce reduced search by consumers, that does not necessarily indicate a societal gain through lower search *costs*; there is economic value to time spent evaluating alternatives. In terms of settlement costs, for certain classes of consumers limited sources of credit may exist and for these customers the effect of packaging may be to raise the total cost of closing.

- While better information and greater certainty about rates and points would be desirable, the current system has generally served US consumers well. Furthermore, a limited amount of packaging is occurring even without a regulatory mandate. Some vertical integration is occurring and leading to internal company packages; however, without mandate, changes occurring are market-driven and still leaves room for non-integrated firms, small businesses, and consumer choice among settlement providers.

It is important to note that Professor Feinberg's analysis specifically addresses the packaging of settlement services as proposed in FED/HUD report. This proposal is at odds with many of the packaging proposals put forward in the Mortgage Reform Working Group and, more specifically, is not the proposed packaging scheme proposed by NAR. While one can generalize from Professor Feinberg's analysis to other packaging proposals, his specific concerns do not necessarily apply to NAR's proposed bundling proposal.

- Significant costs are likely in the form of price discrimination, harm to small business, and in a reduction in purchases of consumer-benefiting services not included in the package. When viewed in the light of increasing lender consolidation, there is also the potential cost of placing more control over the settlement system in the hands of an industry that may be becoming less competitive (especially in certain regions and to certain customers).

- Even in the best case scenario, consumers will have much less than full information in the settlement process. Any benefits from packaging would require strong competition among lenders, and will likely be distributed unevenly across regions and individuals. And the economic benefits -- in terms of reduced search costs and lower settlement costs -- are quite questionable. While the net impact may in fact be to induce reduced search by consumers, that does not necessarily indicate a societal gain through lower search *costs*; there is economic value to time spent evaluating alternatives. In terms of settlement costs, for certain classes of consumers limited sources of credit may exist and for these customers the effect of packaging may be to raise the total cost of closing.

- While better information and greater certainty about rates and points would be desirable, the current system has generally served US consumers well. Furthermore, a limited amount of packaging is occurring even without a regulatory mandate. Some vertical integration is occurring and leading to internal company packages; however, without mandate, changes occurring are market-driven and still leaves room for non-integrated firms, small businesses, and consumer choice among settlement providers.

It is important to note that Professor Feinberg's analysis specifically addresses the packaging of settlement services as proposed in FED/HUD report. This proposal is at odds with many of the packaging proposals put forward in the Mortgage Reform Working Group and, more specifically, is not the proposed packaging scheme proposed by NAR. While one can generalize from Professor Feinberg's analysis to other packaging proposals, his specific concerns do not necessarily apply to NAR's proposed bundling proposal.

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III. NAR Focus Groups

Observations

In the period of August-October, 1999, NAR staff held 5 focus group meetings to ascertain the benefits or disadvantages of reform proposals discussed to date. To gauge member attitude toward reforming RESPA, it was first important to identify the current problems associated with RESPA compliance. The following is an attempt to do this. The information was gathered from a variety of sources, but mostly from these small focus group discussions. This information is a collection of the observations from these discussions and not a legal interpretation of the law.

The rules are too vague

The most common problem cited by REALTORS is the uncertainty of the current law. RESPA states that no one shall pay and no one shall accept a fee for the referral of settlement service business. It is not clear what payments are permissible under RESPA and which are prohibited. The following includes some areas of uncertainty:

- ***Payments for Services Performed****:* RESPA does not prohibit the payment of a thing of value for services actually rendered. The challenge is to discern whether work was actually performed and if the payment received was reasonable. A common application of this provision is in mortgage origination area. Mortgage lenders and mortgage brokers frequently solicit real estate agents/brokers to originate loans in return for compensation. Many in the industry rely on the guidance provided by then FHA Commissioner Nick Retsinas in a 1995 unofficial interpretation letter defining the services that must be performed in order to justify the payment of compensation. Industry interpretation and compliance varies. Some look at this as an additional opportunity to provide one stop shopping and others view this as operating potentially close to the edge of violating section 8.

- ***Affiliated Business Arrangements*****:** An Affiliated Business Arrangement does not violate section 8 of RESPA if certain conditions are satisfied. Of specific concern is the provision that the only thing of value that can be derived from this relationship is a return on ownership interest or franchise relationship. RESPA's restrictions on referral payments prohibit a firm from realizing the full benefit of an investor's work in capturing affiliated business. The return on ownership does not always fairly correspond to the investment of time and effort a person contributes to ensure the firm's affiliated businesses are successful. To limit compensation to a return on investment when multiple owners are involved does not accurately reflect individual effort to make the business profitable.

- ***Employer Payments to employees*****:** There is an exemption in Section 8 for affiliated business arrangements that permits employers to compensate their employees, not agents, who refer clients to the employer's affiliated business. However this fairly straightforward exemption has become cloudy given HUD's 1994, 1996 and 1997 attempts to amend, withdraw and further amend this exemption. None of these changes became law, but many in the industry are not clear about this.

- ***Internet Applicability:*** As Internet marketing increases, questions arise regarding the applicability of RESPA to this new environment. Do the rules that were written prior to these technological advances work? When lenders advertise on the web site of a real estate firm, is the compensation provided to the real estate firm a flat advertising fee or is it based on the number of hits or actual referrals that resulted from the site? How about links to other service providers? The Internet is making possible these new relationships and cross marketing that provide additional resources to consumers and additional profits to the real estate firms. As the transaction moves closer to an electronic platform, these questions will need to be addressed.

It is expected that the future real estate transaction will be fully integrated and facilitated by electronic commerce. RESPA rules need to adapt to these changes so as not to be an inhibiting factor in the natural evolution of the marketplace. It is equally important not to make changes to accommodate electronic commerce to the law to permits a specific marketing practice today that effectively may prohibit additional innovative business strategies tomorrow.

Enforcement

Many in the industry have come to accept the notion that RESPA is not enforced. *It is important to note that this is the perception and should not be interpreted as an accurate account of HUD enforcement activity.* This is troubling for a couple of reasons. First, a perceived lack of enforcement creates a false sense of security for those firms that question their own compliance. Vague rules coupled with this perception is a bad combination that leaves a firm with little recourse other than to proceed with an affiliated business arrangement model, and hope it holds up to future potential scrutiny. Second, some believe this creates an unlevel playing field between those providers that are working within the rules and those that ignore them. Some are paying and accepting fees while others are not. The former gain in terms of increased profitability from fees and referral business while the latter forfeit these benefits. Unfortunately, this can be said of any regulated business environment. Those who violate the rules appear to profit, at least until they get caught.

Members also question how the government is measuring the success of this consumer statute in the absence of enforcement. Anecdotal evidence indicates that most Section 8 RESPA complaints are typically from competitors and not consumers. This raises the issue of the need for Section 8.

While many argue that the lack of enforcement presents certain problems, to advocate for strong enforcement when criminal penalties are attached is not a position many would support. Others admit that the strict criminal penalties may serve as the appropriate deterrent for those who otherwise might risk a violation by paying or receiving fees. However, it was generally accepted that fines should be more in line with the offense. To incarcerate someone because they accepted or paid a $50 fee does not make sense to anyone.

Ignorance of the law

While most practitioners recognize that RESPA is a federal law that requires certain disclosures and prohibits kickbacks, definitions of what constitutes a kickback varies. This is especially true at the very basic level. While it is pretty well understood that a mortgage lender cannot give a real estate agent a cash payment for the referral of a borrower, some believe other things of value are permissible. This lack of industry awareness of rules results in a corresponding lack of industry compliance. It is apparent that there is a segment of the industry that is operating outside of the law. This is not out of blatant disregard for the rules, but merely from a lack of understanding of the full meaning of "thing of value". There exists a great need for education at the agent level on the RESPA rules. This need is increasing given the changing environment and its application to the Internet and other one stop shopping models.

Level Playing Field

A common cry from the Realtor community is that the current law favors large firms over small firms. The rationale being that large firms have the resources to structure the complicated business model required by the rules in order to provide ancillary services. Small firms do not have the same ability to offer one stop shopping. This position is supported by the academic study written by Peter Colwell and Charles Kahn (See Appendix II). The viewpoint expressed is that if rules were changed to permit fees at the firm level, small firms could develop relationships with service providers in their marketplace. As a result both large and small firms would thrive in this environment.

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Potential Options to Reform RESPA's Section 8

The following is a summary of the various options to reform Section 8 if such reform is deemed necessary. The intent is to create a laundry list of options, **not recommendations**, to consider in any future NAR policy making effort. The prohibition against referral fees and kickbacks is the most controversial and of most concern to REALTORS . This is the area that regulates business and compensation structures.

I. Repeal Section 8

This represents the most radical approach to RESPA reform. This appeals most to those who feel the current rules create an unlevel playing field for small to mid- sized firms who have difficulty navigating the cumbersome rules of RESPA to ensure compliance. They believe the consumer is far more educated today than when RESPA was first enacted in 1974. The potential for abuse in the market place is small given the level of information and competition that has driven and will continue to drive prices down. The conviction is that professional REALTORS , those that are in the business for the long term, will not jeopardize the transaction and commission for a referral fee to a settlement service provider. They are REALTORS first and take their fiduciary responsibility to their client seriously. If rules were changed to permit the payment of referral fees, real estate agents would continue to recommend only those service providers that are reliable and provide quality service. To deviate from this standard of care would jeopardize not only the transaction at hand but all future business from the client. Repeat business is the name of the game and worth preserving at all costs.

On the other hand, there is recognition that if Section 8 is repealed, some agents and brokers may take advantage of consumers for the referral fee. Given the nature of the business, many people enter the real estate field for the short term, usually between other jobs or in a part time fashion. These folks usually do not take the time and effort necessary to learn the rules or consider the future of their business relationships. If rules were changed to permit the payment and acceptance of fees, a segment of these practitioners would take advantage of this with little regard for the quality of service or reputation of the provider. This could potentially result in consumers paying higher fees for poor services, the very environment RESPA was intended to address.

Adopting this route to reform would also be an uphill battle. There is no one to date seeking repeal of Section 8. NAR would have to objectively quantify the consumer and industry benefits of repeal if we are to gain support from these entities, a required ingredient to congressional approval.

II Maintain Current NAR Policy on Reform (See Section I)

NAR's current policy is twofold: 1) to support the preservation of the current favorable employee compensation provisions and, 2) to advance the ability of firms to offer one stop shopping by creating an environment where a real estate firm can offer directly to the consumer a package of fully disclosed settlement services at a guaranteed price.

This approach to reform recognizes that certain provisions of RESPA's Section 8 are favorable to the real estate community and should be maintained in any reform effort. It also recognizes consumers are demanding more certainty in the transaction with respect to the costs and services required to close the deal. Providing an option of a guaranteed cost package of settlement services is one way to meet this demand. NAR's policy on packaging would ensure that healthy competition for these services would exist in the marketplace specifically by permitting anyone, including REALTORS , the ability to package and market these services directly to the consumer. The services within the package should be itemized and the total cost of these services disclosed to the consumer. Finally the consumer should have the option to purchase these services separately, as they do today.

Advantages to this approach include the ability for REALTORS to offer packaged ancillary services either through an affiliated lender or as a stand-alone directly to the consumer. This could provide additional revenue streams for the firm and provide certainty to those affiliated businesses that wish to provide this service. Most importantly, the packaging proposal as defined by NAR will help to ensure the REALTOR maintains the position as the first point of contact for the consumer. Packaging as defined by other industry players is interpreted as a grab for this position.

Concerns about this approach center on the future of the transaction and how any future changes in the regulatory environment might have the unintended consequence of favoring one industry over another. Opponents of the packaging ideas feel that large banks are currently positioned to capitalize on this model by creating packages with such efficiency that competitors will be driven out of the market. This environment would facilitate a shift from the REALTOR to the lender as the first point of contact.

Other industry and consumer groups have drafted their own proposals to define packaging. The FED/HUD report also includes a recommendation to permit this marketing scheme. However, the Federal Reserve Board's economic analysis does not make a convincing argument that this kind of reform will result in healthy competition and consumer benefits .

NAR's current proposal appears to be the most rational approach to reform. If reform is necessary, it supports maintaining some of the current rules as we know them while opening up Section 8 just enough to permit additional marketing practices that could result in additional consumer benefits while increasing firm profitability for those who wish to participate.

III. Relax Section 8 to permit payment of fees at the firm level-broker only

This approach to reform generates varying degrees of support or opposition. An immediate reaction from supporters is the shrinking bottom line of the real estate brokerage firm. As overhead and agent splits increase, the bottom line of the firm is shrinking. As a consequence, many brokers are expanding their business beyond real estate brokerage to remain competitive. More firms are looking to ancillary services as a profit center. To permit fees at the broker level for marketing the services of settlement providers is an appealing concept. To them, accepting compensation for the marketing of another provider is something they should have been able to do long ago. Today, this is done free of charge because of RESPA. REALTORS enjoy the first point of contact with the consumer and in this role are depended upon for the referral of other service providers to complete the transaction.

As reported in the Colwell/Kahn study, this function has a value attached to it. REALTORS have invested time and effort to educate themselves on who the reliable service providers are in their market. These referrals are made today without any incentives other than the assurance that the transaction will proceed smoothly. There is an implied liability associated with these referrals because of the agency relationship between the REALTOR and the consumer. In today's world, when something goes wrong in the transaction, the REALTOR is usually the first person the consumer contacts. The consumer expects quality and those who provide less do not last long in the business. Therefore, in today's marketplace, where the REALTOR is already making referrals and therefore indirectly responsible for the profitability of another provider, it makes sense to permit some compensation for these qualified leads.

Another advantage to this approach is the replacement of cumbersome rules for affiliated business arrangements with a scheme that makes sense and offers opportunities to smaller firms who do not have the resources to establish a more complicated business structure. Proponents believe this would open up the floodgates to new marketing schemes and transaction models. The packaging of settlement services would most certainly be one result if the restrictions were loosened to this degree. Defined packages would not be necessary. The use of affinity marketing would also increase in this environment.

An interesting benefit of this relaxation of Section 8 is the choice a firm can make **not** to accept or pay referral fees for business. A firm can choose not to participate in these marketing practices and sell this decision as a marketing strategy for the firm, much like congressional candidates who choose not to accept Political Action Committee (PAC) contributions. This has not surfaced as a primary reason for supporting this type of approach to reform but an observation of a possible opportunity it may present.

This option restricts the firm from passing on any fees or compensation to the agent for generating this new business. Support for this approach is based on the fact that the real estate broker is liable for the actions of the agents. Regardless of increased consumer awareness and confidence in REALTOR professionalism, there is still a percentage of folks in the industry who will be motivated by the fee rather than the service. Rules should be in place to prevent this potentially damaging practice.

IV. Relax Section 8 at firm level; permit the payment of fees by the broker to the agent.

This represents an extension of the above option. Under this scenario a broker may compensate agents for making referrals to the firm's marketing partners. Agents would still be restricted from receiving compensation directly from settlement service providers. This resembles the current exemption for employers who compensate their employees for refering customers to their affiliated partners. Under today's rules, agents are not considered employees for this purpose. For example, a mortgage lender could not pay an agent who refers a borrower. However, in the same scenario a mortgage lender could pay the agent's broker for any referral that comes from the brokerage. The broker could then compensate the agent.

Those in favor of this approach feel that a broker needs some ability to offer incentives to agents to keep business within the firm. Otherwise, agents will take business outside of the firm. This is not due to the quality of service offered by the firm but rather due to the pre-existing relationship agents have established with other providers. Unfortunately, firm loyalty is not strong among some agents. Brokers need this added incentive to capture that ancillary business.

Those in opposition express great concern over the dangerous precedent this practice would create. Brokers today are feeling the pressure of increased commission splits and shrinking profitability of the firm. To change the law to permit the payment of fees to agents would create additional pressure on the firm's bottom line. They feel this incentive is not necessary. In an affiliated business arrangement, the firm provides the agent a means to simplify the transaction for her consumer. This arrangement provides value to the agent in terms of time that does not have to be spent on coordinating these services directly. This gives the agent more time to list and sell, the core activities of the sales agent.

V. Maintain Current Law-No reform

Given the uncertainty of how a change in the law will impact the real estate brokerage community, maintaining current law remains an attractive option. Supporters of the current law claim that is not perfect and the rules are difficult to navigate, however many firms have committed the resources and time to develop a business structure according to these rules. To change the rules of the game now in exchange for an uncertain environment might interfere with business and introduce unfair competition into the marketplace. Business models have been developed to operate under the constraints of the current law. Perhaps the industry needs more education on how they can structure their business within the law to increase their bottom line.

Even those who express frustration with the current law are more apt to support the status quo than a replacement fraught with uncertainty. They understand that RESPA is more than a consumer protection statute. Until the industry can be assured that changes to RESPA will benefit and not disadvantage the REALTOR community, the current law will suffice.

Summary

To advocate any changes to RESPA that include one of the above options will most certainly change the way the real estate transaction is conducted. The question is not only how will it change, but can the

REALTOR community prosper in the new environment. As reflected in this paper, opinions vary. The purpose of reforming RESPA and TILA is to provide more certainty for consumers and the industry, to promote healthy competition in the industry and hopefully to lower the costs of the transaction. Many of the proposals submitted by the industry, consumer advocates and the federal government purport to do this through some variation of guaranteed cost settlement service packages. However, the effects of such proposals are difficult to quantify. Even the Federal Reserve Board's economic analysis of packaging does not make a compelling argument for the benefits of packaging.

Given the complexity of the marketplace and the uncertainty of future technological advances relative to the home purchase transaction, it appears that any effort to reform the regulatory regime should be conducted in a slow and deliberative process. Before moving quickly to enact change in this uncertain environment, more thought should be directed at quantifying the benefits of such change to consumers as well as the real estate and mortgage industry. The information contained in this report should help facilitate this process.

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Appendix I

M E M O R A N D U M

TO: National Association of REALTORS

FROM: Hart-Riehle-Hartwig Research

DATE: August 23, 1999

SUBJECT: Findings of a Survey among Recent Home Buyers

From July 25 to 30, 1999, Hart-Riehle-Hartwig Research interviewed a representative cross section of 801 home buyers nationwide who purchased their homes within the past two years. This report presents the key findings of this research, for the internal strategic purposes of the National Association of REALTORS.

Key Findings

1. **Most people find the concept of one-stop shopping to be appealing.** The intensity of support for the idea, however, is not as strong as it was in 1997.

- **Three in four recent homebuyers (76%) say that getting all or some of their home-buying services handled through one company is appealing.**

- **Only one in three (31%), however, find this idea to be very appealing.**

The shift in the recent-home-buyer audience may explain the decline in intense support. In 1997, the market was comprised largely of core homebuyers, who were willing to buy even in a poor housing market and who were service- and hassle-conscious. In 1999, recent homebuyers represent an expanded pool that includes many non-traditional homebuyers, for whom the home purchase is a financial stretch, and who are, therefore, more price-conscious when it comes to services.

2. Recent home buyers may have been satisfied with the process that led them to a successful home purchase, but they still see the need for many improvements in that process. One would expect these people to be strong defenders of the status quo, but they endorse changes that would make the home-buying process quicker, cheaper -- particularly regarding upfront costs -- more convenient, and more objective. Changes that would allow companies (specifically real-estate companies) to receive referral fees for homebuyers' using services that they recommend, however, are not seen as measures that would significantly improve the home-buying process.

- **Two in three (65%) recent home buyers feel that a change in current rules in order to give companies a financial incentive to put together a one-stop shopping package for home buyers would be an improvement in the home-buying process** -- 33% feel that it would be a big improvement.

- **Two in three (68%) recent home buyers say that banning the practice of mortgage lenders' requiring a large, upfront payment from mortgage applicants would be an improvement** -- 48% say that it would be a big improvement.

- **Two in three recent home buyers (67%) believe that increasing the use of Internet applications to reduce the time it takes for a home buyer to get full mortgage approval would be an improvement** -- 39% believe that this would be a big improvement.

- **And nearly two in three (62%) recent home buyers say that increasing the use of computer credit scoring to make mortgage approval decisions more objective would be an improvement** -- 33% say that this would be a big improvement.

Support for one-stop shopping is on par with support for such popular changes as eliminating upfront mortgage application costs. **Clearly, however, fewer new homebuyers endorse one-stop shopping when it is described from the point of view of real-estate companies or companies in general. The one-stop shopping idea works much better when described in terms of what is in it for the home buyer -- price reduction and a quicker, more objective process.**

3. The current pool of recent home buyers is highly cost-conscious. Because of the past few years' strong housing market, more non-traditional homebuyers are in the market, and these buyers often are stretching their family finances in order to buy a home. When asked to evaluate several reasons for supporting the idea of one-stop shopping, home buyers today put saving money, along with making the process easier, at the top of their list. Neither brand-name service nor speed of process prove as compelling as *lower cost* and *simpler process* in framing the concept of one-stop shopping for home-buying services.

- **Today's home buyers are much more likely than they were in 1997 to say that the idea of saving money through discount-priced one-stop services has a great deal of merit.** In fact, four in five (81%) recent home buyers believe that this idea has at least some merit,including 50% who say that the idea has a great deal of merit -- representing a 17-point increase since 1997, when 33% said that the idea had a great deal of merit.

- **Home buyers are as likely now as they were two years ago to support the concept of one-stop shopping if it means dealing with only one person in order to achieve a more simplified home-buying process.** Four in five (81%) recent home buyers say that there is merit in this idea, including 50% who say that the idea has a great deal of merit -- nearly the same proportion as in 1997 (52%).

- **Many homebuyers see merit in the idea of one-stop shopping if it would speed up the home-buying process.** More than three in four (78%) recent home buyers believe that this idea has merit, including 44% who believe that it has a great deal of merit.

- **Receiving a standard level of service does not prove as important as other reasons for having one-stop shopping.** Although two in three (63%) new home buyers believe that the idea of brand-name service has merit, only one in four (23%) say that it has a great deal of merit.

- **Repeat buyers are more loyal to the status quo.** First-time home buyers range from six to 10 percentage points more likely than repeat buyers to endorse each change as having a great deal of merit.

- **Core home buyers -- the kind of people who buy a home even in a bad housing market -- are perhaps the best targets for one-stop shopping.** Today, in a hot market that attracts many non-traditional buyers, nearly half (49%) of all recent homebuyers say that if they had to go through the whole process again, they would use a company that offers one-stop shopping. In 1997, however, when the housing market was much less vibrant than it is today, two in three (66%) new homebuyers said that they would use a company that provides one-stop shopping.

That nearly half of today's home buyers would consider using a company that offers one-stop shopping may be due to core home buyers' interest in relieving the hassles of home buying, although it also may reflect non-traditional home buyers' cost-consciousness.

4. When recent home buyers consider where to go for one-stop shopping, only realtors, banks, and mortgage companies make sense to them. About two in three recent homebuyers say that they would consider each of these types of companies for one-stop shopping, with about one in four strongly considering each one. Companies that are not given widespread consideration include insurance firms (39% strongly/ somewhat consider), religious or fraternal organizations (36%), stock and mutual fund brokerage firms (33%), Internet Web sites (28%), tax preparation companies (24%), shopping clubs or price clubs (15%), and credit card companies (10%). About half (51%) of recent homebuyers would consider using a professional organization of which they are a member to provide one-stop shopping for home-buying services. **In the one-stop shopping world, realtors are royalty.**

5. A majority (58%) of new home buyers say that they would consider using a company that offers a simplified, one-stop shopping process of referrals or recommendations for service providers. Only one in three recent homebuyers express serious concern about referral fees. Fewer than one in five (18%) homebuyers, however, say that they would strongly consider using such a service. And as further evidence of the tenuous support of such a service, only one in five (20%) recent home buyers indicate that they would be willing to pay more for one-stop shopping through a real estate company, down from one in three (32%) home buyers willing to do so two years ago.
Recent homebuyers have several concerns about the one-stop shopping concept. Their biggest worries include the idea that this would give one company a financial incentive to recommend only home-buying service providers who pay them a commission or referral fee -- a majority (54%) of home buyers say that this would give them a great deal of concern -- and the expectation that home buyers would pay a higher price for the convenience of handling the services through one company (53%, up from 37% in 1997). Another major concern among recent homebuyers is that one-stop shopping would give one company too much control over the home-buying process – half (49%) say that this is a great concern to them.**These findings suggest that the new, non-traditional homebuyers have pocketbook concerns -- namely, whether they are getting the best price for each service.**

6. Overall, half (49%) of all recent home buyers would prefer to use a one-stop shopping company if they could go through the home-buying process again. Certain demographic groups are more likely than others to prefer using a one-stop shopping company rather than shopping around for each service.

- **Recent homebuyers who live in large cities are more likely to prefer a one-stop shopping company (55%) than are those who live in the suburbs (45%) or in a medium/small city (49%).**

- **Recent homebuyers in the traditional homebuyer market (those under age 50) are much more likely to prefer one-stop shopping (52%) than are their older counterparts (41%).**

- **White new home buyers (50%) are more likely than are blacks (43%) to say that they prefer one-stop shopping for home-buying services.**

- **Recent home buyers with less than a college degree (52%) are more likely than their neighbors who have at least a bachelor's degree (46%) to prefer one-stop shopping.**

7. A majority (55%) of recent home buyers report that the home-buying process was either excellent or very good. Slightly less than half (44%) say that the process was either just okay (32%), not very good (7%), or poor (5%).

- **Among the groups most satisfied with their recent home-buying process are 18- to 29-year-olds (68% excellent/very good), new home buyers age 50 and over (61%), those with an annual income less than $65,000 (60%), and those who live in a suburb (58%) or a medium/small city (57%).**

- **Among those least satisfied with their home-buying process are 30- to 49-year-olds (48% just okay, not very good, poor), those with an annual income less than $65,000 (47%), and residents of large cities (49%).**

That nearly half of all recent homebuyers say that they were not happy with their home-buying experience shows that there is room for improvement and change.

8. Most home buyers are not adverse, per se, to using service providers recommended by real estate agents. In fact, in most cases in which the real estate agent recommended a service provider (with the exception of homeowners insurance providers), home buyers were at least two-and-a-half times more likely to use the provider recommended than not.

- **Recent home buyers were four times more likely to use a home inspector recommended by a real estate agent (43%) than to use a home inspector other than the one recommended by the agent (10%).**

- **Recent home buyers were four times more likely to use a title insurance company recommended by a real estate agent (42%) than to use one other than was recommended (10%).**

- **Recent homebuyers were four times more likely to use an appraiser recommended by a real estate agent (37%) than to use a different appraiser (9%).**

- **Recent home buyers were more than two times more likely to use a mortgage company recommended by a real estate agent (35%) than to use another mortgage company (14%).**

- **Recent home buyers were five times more likely to use a termite inspector recommended by a real estate agent (34%) than to use one other than was recommended (7%).**

- **Recent homebuyers were four times more likely to use a settlement attorney recommended by a real estate agent (25%) than to use a different one (6%).**

Hart-Riehle-Hartwig Research FINAL
1724 Connecticut Avenue, NW Interviews: 801 recent homebuyers
Washington, DC 20009 Dates: July 25-30, 1999
(202) 234-5570

Study #5522 N.A.R. July 1999

Please note: all results are shown as percentages unless otherwise stated.

1a. Which of the following phrases best describes your involvement in the home-buying process?

You were the sole decisionmaker	20		**[139]**
You were one of the primary decisionmakers	78	**CONTINUE**	
You played a major role in researching and recommending, but the decision was made by somebody else	2		
You played little or no role in the decision, and the decision was made by someone else	-	**TERMINATE**	
Refused	-		
Not sure	-		

1b. Is this the first home you have purchased? **(IF "NO", ASK:)** How many homes in total have you bought in your life, including the one you just bought?

Yes, this is the first home purchased	34	**[140]**
No, two homes, including current purchase	26	
No, three homes	19	
No, four homes	9	
No, five or more homes	12	
Not sure/refused	-	

1c. Did you get a mortgage loan to purchase your home?

Yes, got mortgage loan	90	**[141]**
No, did not get mortgage loan	10	
Not sure/refused	-	

2a. You have just been through the home-buying process. From a homebuyer's point of view, how would you rate the process overall--is the overall home-buying process for homebuyers excellent, very good, just okay, not very good, or poor?

Excellent	13	**[142]**
Very good	42	
Just okay	32	
Not very good	7	
Poor	5	
Not sure	1	

2b. Thinking about the real estate agent who was the most involved with you in your recent home purchase, would you rate the job that the real estate agent did for you as excellent, very good, just okay, not very good, or poor?

	7/99	5/97	
Excellent	31	43	**[143]**
Very good	30	25	
Just okay	15	15	
Not very good	4	2	
Poor	4	5	
Not sure	16	10	

(READ ITEM) -- did the real estate agent who helped you buy your home recommend a list of possible service providers or assist you in finding someone to provide this service? **(IF "YES," ASK:)** Did you use someone recommended by the real estate agent, or did you use someone other than the ones recommended by the agent?

THIS TABLE HAS BEEN RANKED BY THE PERCENTAGE WHO SAY THEY USED SOMEONE THE AGENT RECOMMENDED

	Agent Recommended				
	Used Someone Agent Recommended	Used Someone Other Than Ones Agent Recommended	Agent Did NOT Offer Recommendation Or Assistance In Finding This Service	Not Sure	
Home inspector	43	10	37	10	**[145]**
Title insurance company	42	10	36	12	**[148]**
Appraiser	37	9	41	13	**[149]**
Mortgage company	35	14	44	7	**[147]**
Termite inspector	34	7	46	13	**[146]**
Settlement attorney	25	6	54	15	**[144]**
Homeowners insurance	16	15	60	9	**[150]**

As you have just been through the traditional home-buying process, let me describe a new home-buying process that is being discussed. Under current law, it is illegal for anyone, based on a recommendation or endorsement, to receive a commission, a finder's fee, or a referral fee when a home buyer chooses to use one of the services we just mentioned, such as a settlement attorney, home inspector, mortgage, or insurance company. As a result, there is no financial incentive for any company to offer a one-stop shopping program for home buyers that includes referrals to other companies that might provide these services. Under this new law, referral fees could be paid if a homebuyer used the recommended service provider, and those referral fees or commissions would have to be disclosed to the homebuyer in advance. The home buyer would be under no obligation to use any of the services recommended and could shop for their own services if they wanted to, just as they can now.

3a. Suppose you were buying a home. If a company offered to set up a simplified, one-stop shopping process for you, in which they would offer referrals or recommendations for service providers that the home buyer could use, is that something you would consider strongly, consider somewhat, consider a little, or would you not consider using it at all?

Consider strongly	18	**[151]**
Consider somewhat............................	40	
Consider a little..................................	17	
Would not consider at all	22	
Not sure...	3	

3b. Many different kinds of companies might offer this kind of one-stop shopping for homebuyers. For each one I name, tell me whether you would consider using THAT KIND OF COMPANY for one-stop shopping for a home.

THIS TABLE HAS BEEN RANKED BY THE PERCENTAGE WHO SAY CONSIDER STRONGLY OR SOMEWHAT

	Consider Strongly	Consider Somewhat	Consider A Little	Would Not Consider At All	Not Sure	
A mortgage lender or mortgage provider.....	22	44	14	19	1	**[158]**
A bank or credit union................................	26	38	13	22	1	**[157]**
A real estate company	23	40	14	22	1	**[162]**
A professional organization that you are a member of	18	33	13	34	2	**[155]**
An insurance company	9	30	18	42	1	**[161]**
A religious or fraternal organization that you are a member of	11	25	11	51	2	**[156]**
A stock and mutual fund brokerage firm.....	6	27	16	49	2	**[154]**
An Internet Web site	7	21	17	52	3	**[160]**
A tax-preparation company, such as H&R Block..	4	20	13	62	1	**[152]**
A shopping club or price club	3	12	14	70	1	**[159]**
A credit card company	2	8	10	79	1	**[153]**

3c. Let me read you a list of changes that some people have suggested could be made in the home-buying process. For each item, tell me whether you feel that it would be a big improvement, a small improvement, or whether it would not make any difference to you as a homebuyer.

THIS TABLE HAS BEEN RANKED BY THE PERCENTAGE WHO SAY BIG IMPROVEMENT

	Improvement Big	Small	Would Make No Difference	Would Make Things Worse (VOL)	Not Sure	
Ban the current practice of mortgage lenders requiring a large, upfront payment from mortgage applicants, to cover the cost of credit checks, and requiring the mortgage company to pay for checking an applicant's credit……	48	20	24	4	4	**[166]**
Increase the use of Internet applications to reduce the time that it takes for a home buyer to get full mortgage approval……	39	28	27	4	2	**[167]**
Change current rules in order to give companies a financial incentive to put together a one-stop shopping package for home buyers, including inspections, title insurance, and mortgage approval……	33	32	25	7	3	**[163]**
Increase the use of computer credit scoring to make mortgage approval decisions more objective and less subject to human bias….	33	29	26	7	5	**[164]**
Allow companies to receive a referral fee for home buyers who use home-buying services from partners they recommend, in order to encourage closer cooperation between companies involved in the home-buying process……	13	30	39	11	7	**[165]**
Change current rules in order to allow real estate companies to accept referral fees from their partners when they offer home buyers a brand-name inspection, title insurance, or mortgage services……	10	29	42	13	6	**[168]**

3d. Suppose you could do it all over again, but this time you had the choice of handling some or all of the steps involved in buying a home--from real estate listings, to the mortgage application, inspections, appraisals, title insurance, legal work, and settlement attorney--directly through one company. If you had that choice, which would you personally prefer?

Option A: Shopping around for each settlement service yourself, OR

Option B: Using a company that offers many settlement services or "one-stop shopping."

	7/99	5/97	
Option A: Shopping around for each settlement service yourself……	40	27	**[169]**
Option B: Using a company that offers many settlement services or "one-stop shopping"……	49	66	
Neither (VOL)……	1	2	
Depends/both (VOL)……	7	3	
Not sure……	3	2	

4a. Overall, how appealing would it be to have the choice of getting some, or all, of your home-buying services handled through one company, instead of individually hiring all of them yourself--very appealing, somewhat appealing, not very appealing, or not appealing at all?

	7/99	5/97		
Very appealing	31	42	**CONTINUE**	**[170]**
Somewhat appealing	45	36		
Not very appealing	9	8		
Not appealing at all	13	11	**Skip to Q.5a**	
Not sure	2	3		

(ASK ONLY OF RESPONDENTS WHO SAY IT WOULD BE "VERY" OR "SOMEWHAT" APPEALING IN Q.4a.)
4b. Would you have been willing to pay more for these services for the convenience of having some or all of the services handled through the real estate company?

	7/99	5/97	
Willing to pay more	20	32	**[171]**
Not willing to pay more	49	37	
Not sure	7	9	
Not Very/Not Appealing At All/Not Sure (Q.4a)	24	22	

5a. I'd like to read you various reasons why some homebuyers say that they would like to handle some or all of their home-buying services through one company. For each one I read, please tell me how much merit you feel that reason has.

THIS TABLE HAS BEEN RANKED BY THE PERCENTAGE WHO SAY A GREAT DEAL OF MERIT

	A Great Deal Of Merit	Some Merit	Only A Little Merit	No Merit At All	Not Sure	
It would mean just one person to contact, making the process easier to manage for the buyer						**[173]**
July 1999	50	31	9	9	1	
May 1997	52	30	8	9	1	
The home buyer could save money if companies offer these services at discount prices						**[175]**
July 1999	50	31	8	9	2	
May 1997[1]	33	41	11	14	1	
It would speed up the home-buying process						**[172]**
July 1999	44	34	8	13	1	
It means getting one standard level of brand-name service from all the individual home-buying service providers						**[174]**
July 1999	23	40	17	18	2	

[1] In May 1997, the question was phrased "The home buyer could save money if real estate companies..."

5b. Now I'd like to read you some concerns that people have about getting some or all of their home-buying services through one company. For each one I read, please tell me how much that would concern you.

THIS TABLE HAS BEEN RANKED BY THE PERCENTAGE WHO SAY A GREAT DEAL OF CONCERN

	A Great Deal Of Concern	Some Concern	Only A Little Concern	No Concern At All	Not Sure	
It gives the one company a financial incentive to recommend only those home-buying service providers that pay them a commission or referral fee						**[178]**
July 1999	54	31	8	6	1	
It would mean that the home buyer pays a higher price for the convenience of handling the services through one company						**[176]**
July 1999	53	30	9	7	1	
May 1997[1]	37	43	12	7	1	
It would give one company too much control over the home-buying process						**[177]**
July 1999	49	31	9	10	1	
May 1997[1]	38	34	14	13	1	
It would mean that a company would get referral fees or commissions when home buyers use services that the company recommends						**[179]**
July 1999	33	34	15	17	1	

[1] In May 1997, the phrasing "real estate company" was used in place of "one company".

6. Suppose you could use this kind of one-stop home-buying process to identify some or all of the individual home-buying services you might use, with the recommended companies cooperating with each other to simplify the home-buying process. Thinking about it again, how appealing would it be to have the choice of getting some or all of your home-buying services handled through one company, instead of individually hiring all of them yourself--very appealing, somewhat appealing, not very appealing, or not appealing at all?

Very appealing	27	**[180]**
Somewhat appealing	48	
Not very appealing	8	
Not appealing at all	14	
Not sure	3	

7. If you were dissatisfied with one of the services provided, who would you hold most accountable--the one-stop shopping company you used, or the individual service provider recommended by that company?

The one-stop shopping service	51	**[208]**
The individual service provider	32	
Both equally (VOL)	12	
Not sure	5	

8. Suppose a real estate company offered you one-stop shopping for home-buying services and a law required that company to give you complete disclosure on the amount of any referral fee it would receive if you used a service recommended by them. In that case, how much confidence would you have about handling some or all of those services through that real estate company, instead of hiring each one yourself--a great deal of confidence, quite a bit of confidence, only some confidence, or very little confidence?

Great deal of confidence……………	16	**[209]**
Quite a bit of confidence……………	29	
Only some confidence ………………	35	
Very little confidence…………………	18	
Not sure…………………………………	2	

9. Finally, thinking about all the issues we have discussed, do you feel that the government should make it easier for any kind of company to offer one-stop shopping services, should it leave the rules as they are now, or should the government put more restrictions on companies' ability to offer one-stop shopping services?

	7/99	5/97[1]	
Make it easier…………………………	34	46	**[210]**
Leave rules the same………………	41	30	
More restrictions………………………	13	12	
None of them (VOL) ………………	5	4	
Not sure………………………………	7	8	

[1] In May 1997, the phrasing "real estate company" was used in place of "any kind of company".

<u>FACTUALS</u>: Now I have some questions for statistical purposes only.

F1. In what age groups are you?

18-24……………………………	2	**[211-212]**
25-29……………………………	12	
30-34……………………………	16	
35-39……………………………	21	
40-44……………………………	13	
45-49……………………………	11	
50-54……………………………	9	
55-59……………………………	5	
60-64……………………………	3	
65 and over ……………………	6	
Refused…………………………	2	

F2. Are you currently employed?

(IF CURRENTLY EMPLOYED:) What type of work do you do?

(IF NOT CURRENTLY EMPLOYED:) Are you a student, a homemaker, retired, or unemployed and looking for work?

Currently Employed		
Professional/ manager	38	**[213-214]**
White collar worker	21	
Blue collar worker	18	
Farmer, rancher	-	
Not Currently Employed		
Student	-	
Homemaker	10	
Retired	10	
Unemployed, looking for work	1	
Other	-	
Not sure	2	

F3. What is the last grade you completed in school?

Eighth grade or less	-	**[221-222]**
Some high school	2	
High school graduate	19	
Some college, no degree	15	
Technical degree	3	
2-year college graduate	11	
4-year college graduate	27	
Postgraduate work, master's degree	19	
Doctoral/law degree	2	
Not sure/refused	2	

F4. Are you currently single, married, separated, widowed, or divorced?

Single	7	**[223]**
Married	84	
Separated	1	
Widowed	2	
Divorced	5	
Other	-	
Not sure/refused	1	

F5. Would you describe the area where you live as a large city, a suburb near a large city, a medium to small city, a small town not near a city, or a rural area?

A large city	12	**[224]**
A suburb near a large city	37	
A medium to small city	24	
A small town not near a city	14	
A rural area	11	
Not sure	2	

F6. For statistical purposes only, we need to know your total household income for 1998. Please tell me which category best represents the total income of all the people in this household in 1998 before taxes were taken out.

Under $5,000	1	**[225-226]**
$5,000-$9,999	-	
$10,000-$14,999	-	
$15,000-$19,999	1	
$20,000-$24,999	2	
$25,000-$34,999	5	
$35,000-$49,999	15	
$50,000-$64,999	20	
$65,000-$79,999	12	
$80,000-$99,999	10	
$100,000 and over	15	
Not sure/refused	19	

F7. Are you from a Hispanic or Spanish-speaking background? **(IF "NO," ASK:)** What is your race -- white, black, Asian, or something else?

Hispanic	3	
White	86	**[227]**
Black	4	
Asian	2	
Other	2	
Not sure/refused	3	

F8. How long ago did you buy your home?

Less than a month ago	3	**[228]**
1 to 3 months ago	8	
4 to 6 months ago	1	
7 months to 1 year ago	18	
1 to 2 years ago	65	
2 to 3 years ago	4	
More than 3 years ago	-	
Not sure	1	

F9. Is the amount of your mortgage above or below $150,000?

(IF BELOW $150,000, ASK:) Is it above or below $125,000? **(IF BELOW $125,000, ASK:)** Is it above or below $100,000?

(IF ABOVE $150,000, ASK:) Is it above or below $200,000? **(IF ABOVE $200,000, ASK:)** Is it above or below $250,000?

Below $100.000	30	**[229]**
$100.000 to $125.000	18	
$125.000 to $150.000	13	
$150.000 to $200.000	15	
$200.000 to $250.000	6	
Above $250.000	4	
Refused	14	

F10. Was the purchase price of your home when you bought it above or below $150,000?

(IF BELOW $150,000, ASK:) Was it above or below $125,000? **(IF BELOW $125,000, ASK:)** Was it above or below $100,000?

(IF ABOVE $150,000, ASK:) Was it above or below $200,000? **(IF ABOVE $200,000, ASK:)** Was it above or below $250,000?

Below $100.000	24	**[230]**
$100.000 to $125.000	16	
$125.000 to $150.000	14	
$150.000 to $200.000	17	
$200.000 to $250.000	8	
Above $250.000	9	
Refused	12	

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Appendix II

Economic Functions of Referrals and Referral Fees

A report submitted to the national association of realtors

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Economic Functions of Referrals and Referral Fees
A report submitted to the national association of realtors

EXECUTIVE SUMMARY

As professional services become ever more complex, so do the institutional arrangements for the provision of these services to consumers. The complexity of financial arrangements has led to the appearance of intermediaries or *middlemen:* specialists in arranging complex transactions. Referrals by middlemen and referral fees paid to middlemen emerge in markets in which there is less than full information about diverse customers and service providers. In some markets, referral fees are an accepted and uncontroversial part of the institutional landscape. In other markets and institutional settings they may be illegal, unethical, and/or economically inefficient. We consider the theoretical economic arguments for and against referral fees, the legal status of referral fees in several contexts, and the practices regarding referral fees in a variety of professions.

The roles taken on by a middleman in markets for professional services fall into five functional categories: marketing, screening, matching, monitoring and guaranteeing. The value added from using a middleman as an information specialist stems from the economy of scale in transmitting information from service providers to multiple customers, and the economy of scope in transmitting information from customers to service providers. We would expect the middleman to attempt to extract compensation for all of the services provided.

Specialist service providers prefer to deal with middlemen who do not reveal to the customer the size of the referral payment and more specialists enter such markets. Surprisingly, customers may *prefer* to purchase in a market in which middlemen as a matter of practice do not reveal the size of the referral payments. Regulatory restrictions on the ability of middlemen to receive private referral payments can have real effects. In particular such restrictions will discourage the entry of specialists with high set-up costs and low variable costs. The responses of government agencies to referral fees have varied across the occupations, with the FTC consistently arguing for eliminating mandatory restrictions of referral fees, and other agencies and legislation pushing for greater restrictions.

Besides real estate brokerage, we focused on three professions in the U.S. whose codes and regulations are traditionally among the most restrictive with regard to payment of referral fees. In each case, among the concerns leading the professional association to resist referral fees was a sense that they would damage the reputation of the professional as an independent and reliable advisor. In some cases these concerns may have been mingled with less justified concerns, such as the desire to maintain market power, or unsound theories of value and price. In the cases we have examined in detail, competitive forces have pushed professionals into more intermediated arrangements and these arrangements have led to an increased reliance on referral fees.

In the real estate market at the present, regulatory restrictions against referral fees are severe. The Real Estate Settlement Procedures Act (RESPA) prohibits fees for referrals among independent providers of services ancillary to consumers purchasing individual housing. This restriction hinders integrated provision of settlement services, and disproportionately burdens small service providers. In the absence of the prohibition both large and small would coexist. Explicit referral fees would be more prevalent where middlemen create bundles of services from many small service providers. These bundles of services would tend to be nonstandard. Large enterprises would tend to produce the more standard bundles.

The role of middlemen is becoming ever more central to the efficient operation of real estate markets. The real costs incurred by middlemen are not included in the regulatory authorities' calculations of permitted costs, and become, under RESPA, prohibited as referral fees. By prohibiting referral fees, RESPA does help to maintain confidence that real estate professionals work as the exclusive agent of the client, but it does so at a price: It discourages development of innovative packages of products by alliances of small independent service providers and prevents these firms from taking advantage of the economies of scope that these alliances would provide, placing them at a disadvantage relative to large consolidated service providers.

Small firms have an interest in adopting the organizational forms favored under RESPA. In order to foreclose on this possibility, recent policy statements by HUD have been designed to limit attempts of providers to establish "sham controlled business arrangements" or "office rental arrangements" in order to benefit from the more flexible treatment of referrals.

There are better ways of providing guarantees of exclusive agency to those customers who value it. Regulation specifying the standards for disclosure of referral fees can serve a useful purpose. Some individual firms may find it in their interest to not accept referral fees and to advertise that stand as a way of carving out a differentiated market niche. Either of these solutions still leaves it possible for customers to choose the most useful combination of services and prices for their own situation.

Economic Functions of Referrals and Referral Fees

I. INTRODUCTION

As professional services become ever more complex, so do the institutional arrangements for the provision of these services to consumers. No longer does a single doctor, or even a small group practice care for a patient. Instead, a medical services are provided by a complicated, layered set of institutions: hospitals, HMO's, doctors in group practices, both general practitioners and specialists, plus a large set of institutions providing ancillary services—home care, stand-alone emergency rooms, hospices, nursing homes and group living arrangements.

Parallel developments can be seen in a variety of professions, most recently real estate, where even the simplest home purchase involves a variety of service providers at the time of settlement: mortgage, mortgage insurance, title insurance and brokerage, of course—but also pest and more general inspections, warranties of major structural and mechanical systems, and legal representation. In each profession, the process repeats the developments that occurred long ago in banking, where increases in complexity of financial arrangements led to the appearance of intermediaries or *middlemen:* specialists in arranging complex transactions.

A middleman provides a number of functions in the context of referring customers or clients to the ultimate providers of services. The middleman incurs both fixed and variable costs in providing these information functions. If a middleman is to continue to provide his services, he must be compensated for these various costs. At times compensation takes the form of *referral fees* from the service providers: payment made by the service provider in return for the middleman's service of linking the provider with a customer. Referrals and referral fees emerge in markets in which there is less than full information about diverse customers and service providers.

In some markets, referral fees are an accepted and uncontroversial part of the institutional landscape. In other markets and institutional settings they may be illegal, unethical, and/or economically inefficient. When emphasizing the damaging aspects of such an arrangement, these payments are called "kickbacks." In some contexts these payments are clearly undesirable: Employee contracts are generally set up in such a way as to prohibit an employee's receiving payments from the employer's business associates. If an employee in a purchasing department receives referral fees from vendors, he is in violation of his contract. In construction work, a general contractor under a cost-plus contract would clearly be in violation of that contract were he to receive kickbacks from subcontractors.

In this report, we will consider the theoretical economic arguments for and against referral fees, the legal status of referral fees in several contexts, and the practices regarding referral fees in a variety of professions. A key test of whether a referral fee is socially useful or not is whether the arrangement persists when disclosure is required: Arrangements which only survive in violation of explicit contractual prohibitions, or which disappear once it is required that customers be informed of them, are unlikely to be socially desirable. On the other hand, there are unlikely to be problems in utilizing referral fees as long as the fact of the fees are revealed to the customer or client and there may be substantial benefits. Provided the fact of the referral fee's existence is revealed we find that there are even situations in which it is socially desirable not to reveal the size of the referral fee to the customer. In these situations benefits can accrue both to customers, in the aggregate, and to service providers.

In the real estate market at the present, regulatory restrictions against referral fees are severe. One of the most controversial aspects of the Real Estate Settlement Procedures Act (RESPA) is the prohibition of fees for referrals among independent providers of services ancillary to consumers purchasing individual housing. This restriction hinders integrated provision of settlement services, and disproportionately burdens small service providers. We examine some of the possible consequences from relaxing this regulatory restriction. We conclude that in the absence of the prohibition both large and small would coexist. Explicit referral fees would be more prevalent where middlemen create bundles of services from many small service providers. These bundles of services would tend to be nonstandard. Large enterprises would tend to produce the more standard bundles. Regulations that ban referral fees favor the large consolidated service providers and discourage the creation of non-standard bundles. On the other side of the coin, there are related regulations within RESPA that currently work against the large firms, and we consider the effects of dropping these as well.

This report is organized as follows For simplicity and ease of exposition all analysis in this paper is carried out through informal, verbal models. For more formal models dealing with some of the same issues see, among others, Pauly (1979), Bagnoli and Khanna (1991), Gravelle (1994), Bloch and Ryder (1994), van Raalte and Webers (1998). : The first section examines the multiple functions undertaken by the middleman who refers service providers to customers or clients. Next, multiple dimensions of compensation for the referral are considered. Then we consider the effects of competition and regulation in the market. Next, issues of agency and the alternative modes of developing reputations for quality. In all of these sections, the real estate market serves as our primary example. The final section uses the framework established to examine examples of other professions, where referrals and referral fees have become contentious.

II. ROLES OF A MIDDLEMAN AS INFORMATION SPECIALIST

The middleman in a market for services plays a number of roles. The purpose of this section is to clarify and distinguish among the major roles. It is important to do so because the basic models of markets assume that there is no cost to the participants in the task of finding one another. It is the nature of these costs and the ways in which middlemen can reduce them, which determines the value created by them.

1. Marketing. A provider of real estate settlement services knows that there is a market somewhere out there for his product. But it is not easy for buyers of the services to find him. Buyers will generally not be familiar with the names or addresses of service providers—indeed they may not know the need for the various items of service that are available.

When this problem arises in other markets, the providers of services expend resources on *marketing*—notably advertising, but also other related techniques designed to inform potential buyers of services of the firm's existence and of the nature of the services provided and to attempt to convince potential buyers of their value.
In the case of providers of settlement services, there are several key features of marketing. First of all, the target audience is extremely specialized. Most people, most of the time, are not interested in the services provided by these specialists, and so advertisements in general-interest outlets are likely to be forgotten well before the members of the target audience are likely to be interested in the services. Thus advertising for some settlement services goes into specialized outlets, such as brochures listing houses or the pages of the newspaper devoted to real estate offerings.

But for many settlement services, such techniques are inadequate. These are the services (for example, title insurance) whose nature is sufficiently arcane that much of the marketing effort would have to be devoted to an explanation of the nature of the service and its desirability—an explanation that would not likely fit into an advertisement. Marketing such services, like marketing life insurance or other complex financial services, would naturally require direct interviews with salesmen to explain the details and benefits of the service.

One might imagine a bevy of eager sales reps clustered in the unfinished roadways of new housing developments, ready to descend on any likely purchaser in a quest for time and opportunity to present the sales pitch for the particular service his firm provides. Instead, a considerable cost saving accrues to all parties if marketing is focused not on the ultimate purchaser but instead on a middleman in the market. For the purposes of the discussion at the moment, assume that a broker or salesperson takes on the middleman role. If the broker is truly the agent of the purchaser of the ancillary services (i.e., a buyer's broker), then there is a reduction in costs of marketing, due to the fact that all potential services need to be explained only once by the service provider, and to a sophisticated representative (i.e., the agent), rather than repeatedly and slowly to each potential customer. The broker then acts in such a way as to benefit the purchaser, possibly without ever explaining the details.

But the most important reduction in cost occurs even if there is no agency relationship between the ultimate purchaser and the middleman. It arises instead from the simple fact that the services provided are *complementary:* a purchaser of one of these services is much more likely to be in the market for the other services than is the average person on the street. Thus the very knowledge that this person is in the process of engaging in a real estate transaction is an extremely valuable commodity. When a variety of providers of ancillary services channel their efforts through a broker, they save on the elimination of duplication of marketing costs that would be necessary if each of these providers were forced independently to find the customer. In other words, cost savings through the so-called *"economies of scope"* of multiple providers working with a single channel for marketing services to potential customers is the most basic source of benefits from existence of middlemen in these markets.

Note that a decision to market through the channel of a middleman does not preclude the use of direct marketing as well. Some service providers may find it advantageous to pursue both channels of marketing. In this case the activities of pharmaceutical companies are illustrative. The manufacturers of drugs expend considerable resources in an effort first of all to make physicians aware of their existence and then to convince physicians of their effectiveness. There is a considerable economy of scope in this process: in general, it makes much more sense to tell the physician about all the options available and then have him pass the information along to the patient than it would to attempt to provide all the information to the public at large in the hopes that someone in the public would find the information useful. However, there are notable exceptions. Certain therapies may be relatively easy for the public to understand; sufferers of certain diseases or conditions may be sufficiently widespread, sufficiently aware of the problem, or sufficiently easy to target in marketing; (or conversely, some medical needs may be sufficiently difficult to communicate about between physician and patient) so as to make direct marketing ("ask your doctor about…") an attractive adjunct to the traditional channels. Rogaine and Viagra are two recent, but by no means unique, examples of prescription pharmaceuticals that were marketed in both channels for the reasons enumerated.

Similarly, efforts by providers of settlement services to market their products to middlemen will not completely eliminate the interest of these providers in direct marketing. Indeed, innovations in services are likely to be marketed in both channels, as the admonition to "ask your lender about…" some new form of service is likely to be a means for the provider to convince middlemen (i.e., lenders in this case) about the value that typical customers will place on the service.

2. Screening. Not everyone who comes into the office of a real estate broker is fully prepared to buy / sell a house. Part of the job of the middleman is to determine who should and who should not complete (or even attempt to complete) a transaction. Among customers contemplating buying a house, some may not have the requisite wealth or sufficiently assured income. Among customers considering selling their home, there may be problems with the house, which render it unsaleable at any price the customers are willing to contemplate. In each case the middleman's role is to *screen* out ineligible customers.

Recently much work on screening in economic theory has focused on situations in which the customer has superior information. The problem then is one of customer incentives: designing arrangements to make the customer reveal his superior information when he may be engaging in strategic behavior in order to avoid doing so (for an introduction see Laffont (1989)). In the case of residential real estate, however, it is probably fairer to say, as a first approximation, that customers do *not* possess superior information about their suitability to the transaction, and do not engage in strategic behavior in order to avoid revealing that information. Instead, if anyone, it is the broker or lender who possesses the superior information, armed as he is with the knowledge of market conditions and of standards necessary to qualify for various programs or to satisfy various service providers. Thus the process of screening is actually a service to the customer who, before the initial interview with the middleman, may not in fact know whether he is eligible for the transaction.

Although screening is a service to the customer, it is a service for which it is usually infeasible for the customer to pay directly. If customers typically paid for the process of the initial screening to determine whether they were qualified to proceed further with a transaction, there would be the incentive for middlemen to set up operations in such a way as to entice individuals who were clearly unqualified nonetheless to pay for the screening and then subsequently to reject them. Similarly, since rejecting an applicant is a less costly process than accepting one and going through the further work necessary, there would be a temptation for middlemen to accept up front payments and then reject without adequate screening. In other words it is rational for customers to be wary of incentives for *"moral hazard"* (unobserved actions detrimental to the customer's interest—here, neglecting adequate screening to determine the customer's real prospects The phenomenon of moral hazard was initially described in insurance markets. For an introduction to the issues see Dixit and Nalebuff (1991).).

To forestall such fears on the part of uninformed customers, professionals—notably personal injury lawyers, medical specialists, private investigators—frequently arrange their business in such a way that initial consultations are free. At the initial consultation, a determination is made as to whether it makes sense to proceed with the services. The professional thus absorbs the cost of the initial consultation—that is to say, in the long run it is folded into the payment for subsequent provision of services. Thus those customers who pass the initial screening must end up bearing the all the screening costs, including those who were rejected in the screening.

When there is a middleman standing between the customer and several service providers, the initial screening by the middleman is of value to both sides. Frequently, in order for the customer to take advantage of the services of one of the service providers, he must qualify by the standards of several of the service providers: unless the house passes the termite inspection, the services of the title insurance company will not be used. By having one middleman responsible for the screening on several dimensions, the costs of duplication in screening are avoided, as well as some of the costs associated with sunk costs of screening on one dimension only to have the transaction fail due to subsequent screening on another dimension.

3. Matching. For those customers who do qualify, the next task of a middleman is to determine the appropriate mixture of services. Are there complications in the arrangements so that specialists (lawyers, surveyors, and credit consultants) will be necessary or will the “plain vanilla” package suffice? In other words it is the job of the middleman to *match* a client with the right package of service providers.

In many environments, this is the essence of professional expertise: the job of an independent insurance agent is to find the right policy; the job of the travel agent is to find the right vacation package, the job of the financial advisor is to find the right investments and the job of the general practitioner is to find the right medical specialist.

In each case, the value of the middleman again depends on the existence of economies of scale and scope. These economies occur on both sides of the middleman. On the client side, a single interview can provide information on several dimensions, enabling the middleman to put the appropriate package together more cheaply. On the service provider side, a middleman can learn once about the various services available from various providers, evaluate them, and then use this information repeatedly when dealing with clients.

These economies do not always dominate the situation. There are occasions in which customers will bypass the middlemen to deal directly with the specialist service providers: customers in some settings may make their own appointment with a specialist, medical or otherwise; they may buy an insurance policy, a cruise package or securities on their own. Bypassing the middleman is most likely to occur when the customer is confident of his own expertise with respect to the available packages—in this case the middleman provides no comparative economies in establishing a match.

Finally, it should be noted that, although the middleman’s source of profit is the informational advantage he possesses over the client and service providers, this advantage is dissipated in the process of providing the service: once the match has occurred, it is in most markets impossible for the two parties to remain ignorant of each other’s identity. Because of this, repeated transactions between the pair can regularly occur directly. For example, once a homeowner/borrower has found an appropriate lender, refinancing the mortgage can and will take place without the middleman’s involvement. This fact severely limits the ability of the middleman to obtain a return for his services beyond the time of the initial matching. For example, a real estate broker must be careful to ensure that, once buyer and seller have been brought together, they do not find a way of freezing the broker out of the deal. Contractual arrangements between broker and seller are designed to prevent this from taking place.

Nonetheless they are imperfect: if the arrangement is not exclusive, then buyer may find a proxy to effect the purchase without using the broker. Even if the arrangement is exclusive, then buyer and seller might delay trading until the expiration of the broker’s contract or even some months beyond that time. Either way, this possibility places a ceiling on obtainable commissions. (In commercial real estate transactions it is sometimes possible to keep the parties’ identities hidden. When that is possible, the middleman jealously guards that information.)

4. Monitoring. The services of experts are themselves complicated goods. It is not always possible for a purchaser to determine whether the service is being provided properly and whether the quality is as promised. Another role for a middleman is to serve as monitor of the service providers included in the customer's package.

There are several reasons that it is natural for a middleman to take on this role. First of course is general expertise. The experience and information developed over the course of the other roles that a middleman carries out make him the natural party to carry out the monitoring function. Thus the general practitioner is better qualified to determine that the surgeon adequately treated the patient's condition; the travel or insurance or real estate agent is better qualified to determine that the cruise line or life insurer or title insurer has dealt properly with all the necessary paperwork.

In the absence of a middleman a customer can always bring in a third party expert to review professional work: another medical specialist can be called in for a second opinion, a lawyer can be hired to review the paperwork. Nonetheless, when expertise is otherwise equal, a middleman has a crucial natural advantage in the role as monitor. This advantage arises from the specialist's foreknowledge that the middleman may be the source of future business. This gives the specialist a greater incentive to carry out the current activities in a satisfactory manner.

Note therefore that this advantage goes beyond the standard consideration of "reputation." In many contexts reputation is established by repeated interactions. A lawyer might be interested in gaining a reputation as an aggressive monitor and reviewer of the work of other professionals. In order to gain and maintain such a reputation, the lawyer will find it valuable to expend effort on this activity, and customers will begin to rely on the reputation in searching him out as a monitor. Nonetheless, even though such a third party may be the equal of a middleman in detecting non compliance by a specialist, such a third party will still not be as effective as an enforcer of compliance. True, he does possess the "stick" that can be used to ensure that a specialist provider behaves as promised: the threat of various sanctions: lawsuits, publicity, and the like. Still, a middleman also possesses these sticks. In addition, however, the middleman uniquely possesses the "carrot" of future business.

There is a second way that a middleman's repeat business makes monitoring more effective. In the previous section we argued that a middleman's advantage at matching customers came from the economy of scale in using a one-time evaluation of services to repeatedly serve new customers. Nonetheless, this is an overstatement. After all, the services themselves change over time, and a middleman must regularly update his evaluation of them. Not only the terms of the available arrangements, but the personnel involved and their skills change over time, requiring continued investment by the middleman. An important source for such updating is customer feedback. The typical middleman's admonition to a customer to "let me know if you have any problems," is not simply courtesy, but a method to obtain assistance in monitoring, allowing a middleman to perform the function at a lower cost than can third parties without their own clienteles.

5. Guaranteeing. The middleman who refers a client to a service provider may be guaranteeing the quality of the service, especially if the middleman has accepted a fee from the service provider and especially if the middleman is the agent of the client. The middleman may be held liable for deficiencies in the service. This contingent liability of the referring middleman is a variable cost that may be very valuable to the client. So a final role for the middleman is as a guarantor of quality bearing contingent liability.

Harking back 20 years or so brings us to a time in which "creative finance" was the way real estate deals were done. Real estate agents often recommended terms to their clients, the sellers, such as seller second mortgages that did not always work out well. Sometimes they were held liable for the poor results of their advice.

This contingent liability is particularly clear in the case of lawyers making referrals to other lawyers.

“Negligent referral” is grounds for a claim of legal malpractice (Mooney and Bloom, 1988). The referring attorney bears joint responsibility for the services, similar to those borne by a partner (Garwin 1993).

Summary

In this section we have examined the roles taken on by a middleman in markets for professional services. Although the roles are varied, we have been able to categorize them generally into five functional categories: marketing, screening, matching, monitoring and guaranteeing. Several conclusions follow from this survey:

1. The informational advantage held by middlemen is key both to the profitability of the position and to its usefulness to other parties.
2. The better informed are customers, or the less expensive it is to gather information on their own, the less value there is in the services of a middleman and the more likely the customer is to deal directly with specialist service providers.

Information is an unusual commodity. Among its unique characteristics, two stand out: 1) once produced, it can be disseminated repeatedly without decay and essentially costlessly. (In other words, photocopying is inexpensive). 2) once disseminated, there is no way of recapturing or repossessing information; it remains available to a recipient in perpetuity. (In other words, there is no way to force someone to forget.) From these two characteristics, the remaining conclusions follow:

3. The value added from using a middleman as an information specialist stems from the economy of scale in transmitting information from service providers to multiple customers, and the economy of scope in transmitting information from customers to service providers. *In other words, relative to dealing with any single customer, the costs of a middleman are largely fixed costs.* Many of these costs are incurred before the prospective customer enters the door.

4. Timing is crucial in obtaining payment from customers. It is difficult to obtain payment at the outset of the consultation (because of moral hazard on the part of the middleman) or much after the initial matching has occurred (because of the danger of being frozen out).

III. IV. COMPENSATION AND LARGE VS. SMALL ENTERPRISES

As the previous section showed, in markets for professional services, middlemen perform a variety of information-related services for both the customer and the specialized service provider. We would expect the middleman to attempt to extract compensation for all of the services provided.

From the customer, payments would be associated with the reduction in costs for finding service providers, reduction of the costs for being screened by them, improved quality of match with a bundle of services selected by the middleman, implicit guarantees by the middleman of the services provided, and improved performance of the service providers as a result of discipline exerted on them by the middleman. (In principle these compensations would then be reduced slightly by the value to the middleman of information provided by the customer on ongoing performance of the service providers). From the specialist service providers the payments would be associated with reduced marketing costs, reduced screening costs, and reduced costs of matching the individual customer to the correct product.

RESPA makes the unusual restriction on middlemen in real estate markets of permitting compensation from service providers only for “services actually performed” by the middlemen on behalf of the service provider—with the stipulation that referrals are not a form of services. In other words, compensation is permitted for the direct value of collecting the information (e.g., value of filling out forms or costs of photocopies and faxes actually transmitted to service providers). Rent for space allocated for Computerized Lending equipment in brokerage offices may be paid if it reflects the market for space.

The general sense of these restrictions is to permit compensation only for short run variable costs attributable to service providers. The more important, fixed cost components are mostly excluded. Variable costs like contingent liability would also not be acceptable for compensation under RESPA. In other words, it is likely that compensation would be permitted from a service provider to a middleman for the time spent by the middleman to gather information and help the customer fill out an application for a service from the service provider. It is conceivable that compensation would be permitted for the time it took to explain the particular features of the service to the customer, provided that this could be satisfactorily distinguished from compensation for recommending the customer to choose that package (in itself a formidable hurdle). It is inconceivable that compensation would be permitted for the fixed costs incurred by the middleman in learning the features of the various packages available from the service provider.

In fact, RESPA is much less restrictive in its control on permitted compensations involving a single large company. In particular, if service provider A has an ownership stake in service provider B (the so-called "Controlled Business Arrangement" or "Affiliated Business Arrangement"), referrals between them are permissible, Explicit referral fees, however are not permissible unless to an employee; see the next paragraph. even though the business thus generated provides profits to the referring entity via its ownership stake. For such a referral to be valid, it is subject to additional restrictions beyond the basic rules of RESPA: there must be a disclosure to the purchaser of the relationship between the entities, and, the purchaser cannot be required to use the particular service provider.

The regulations issued in 1992 and currently in effect permit affiliated firms to compensate their employees for referrals, as long as the fact of this arrangement is disclosed. Since there are at the moment no restrictions on which referral activities employees can be compensated for, this provides a major relaxation of the restrictiveness of the limitations on referrals. In particular, employees can at the moment be paid for referrals to affiliated firms, although they may not be compensated on any one for one basis (i.e., proportional to the dollar magnitude or number of referrals). The 1996 version of Regulation X, scheduled for implementation in July 1997 but never actually implemented in total, would significantly tighten restrictions on employee compensation for referrals to affiliated firms. They would continue to permit managers to receive general performance bonuses, but not if they are calculated as proportionate to the number or value of referrals. However, if managerial employees are involved in more than three settlement service transactions per year, they cannot be compensated. Non-managerial employees can be compensated if they do not provide settlement services. Specialist employees who market the services of more than one of the affiliated companies can be compensated by commission, but they cannot actually be involved in the production of any services with the exception of taking applications and making applications available to the affiliated companies.

Since the employee exceptions clearly give a benefit to the employer-employee relationship in referrals, large firms have an inherent advantage in the current setup. Small firms have an interest in adopting the favored organizational forms. Accordingly, recent policy statements by HUD have been designed to limit attempts of providers to establish "sham controlled business arrangements" or "office rental arrangements" in order to benefit from the more flexible treatment of referrals.

It is possible that the differences according to regulation in the treatment of consolidated and independent firms in fact causes no disadvantage to the small firms. Since both the customer and the service providers can provide compensation to the middleman, the service provider need not directly pay compensation that is ultimately attributable to the service provider. A similar phenomenon occurs in the elementary economic analysis of the incidence of a sales tax. In legal and accounting terms, the seller of the taxed good pays the sales tax. However the imposition of a sales tax may will generally drive the pre-tax price of the good down, so that the post-tax price increases by less than the full amount of the tax. The extent of the change in pre-tax price is determined by elasticities of supply and demand in the market, and so the true incidence of the sales tax is unrelated to the legal identity of the payor. Individuals who are familiar with real estate brokerage will also be familiar with this general concept. It is often argued that buyers of real estate actually pay the brokerage commission because properties that sell through a broker sell for more. That is, the commission that is explicitly paid by the seller is shifted, in some degree, to the buyer.

The sales tax is simply a wedge between the buyer's and seller's price for a good. The middleman's return is simply a wedge between the customer's payment and the service provider's receipts. It is therefore conceivable that any prohibition on certain compensations from the service provider to the middleman is completely without economic effect: Such a prohibition could merely translate into a dollar for dollar decrease in the price paid by the customer to the service provider, coupled with a dollar for dollar increase in the price paid by the customer as commission to the middleman. If this is really the case, then a law against referral fees, although it is completely ineffective, cannot be argued to cause any damage either. In the subsection that follows, we will examine some conditions under which the prohibition against referral fees has real consequences.

Real Consequences from Restricting Fees

We will start from the following key assumptions.

1. Different specialized service providers have different costs for entering the market. Thus as prospective profits in the market vary, so do the number of firms willing to enter.

2. Different customers are best matched to different service providers. Thus the more service providers are potentially in the market, the better the match each individual customer will be able to find.

3. Different specialized service providers have different costs for servicing individual clients. The cost to the middleman of dealing with different service providers also varies. In general these costs will be inversely correlated: if the service provider's client costs are low, the middleman's costs of dealing with that provider are high.

4. After being matched initially by the middleman, a certain fraction of the customers in the market will go on to make additional trades with the same service provider. The middleman will not participate in subsequent trades and cannot predict which customers will participate in additional trades.

5. The less costly it is for the service provider to service a particular customer, the more the service provider pays a middleman for the referral. (In a more completely specified model, this would be a conclusion; not an assumption. There are a variety of more basic market structures that would lead to this conclusion.)

6. The more accurately the customer knows the costs of the service provider, the more price concessions he will be able extract in subsequent dealings with him. (As before, a variety of more basic structures would turn this assumption into a conclusion).

These assumptions lead to the following results:

1. Specialist providers prefer to deal with middlemen who do not reveal to the customer the size of the referral payment and more specialists enter such markets.

2. Customers *prefer* to purchase in a market in which middlemen as a matter of practice do not reveal the size of the referral payments. Of course, each customer individually would also prefer that the middleman quietly make an exception to this practice in his case.

3. Regulatory restrictions on the ability of middlemen to receive private referral payments have real effects. In particular such restrictions will discourage the entry of specialists with high set-up costs and low variable costs.

Since these results are fairly striking, it is worth spending some time examining the robustness of the assumptions that lead to them.

1. As discussed before, restrictions on referral payments need not have significant effects on individual transactions in the short run; service providers will feel their effect largely in discouraging long run entry decisions.

2. Our assumptions have emphasized the costs to a customer from the resultant loss of variety of services, but similar consequences would arise if we emphasized increases in costs from reduced supply of service providers.

3. Heterogeneity of service providers is an important feature of these markets, and it is essential feature in order for middlemen to play an important role in these markets. We are assuming that there is an inverse correlation between the variable costs of a service provider's activities with an individual client and the fixed set-up costs of a middleman establishing a relationship with that service provider. This is a very specific assumption, but it is simply illustrative of the general problem that there will be conflicts between the perspectives of the customer and the middlemen regarding the costs of dealing with various service providers.

4. While some customers who have purchased real estate services do go back to the initial providers later for additional services, this is certainly not a universal practice. On the other hand, the assumption need not be taken literally: all that is necessary is that the initial referral generate an enduring value to the introduced parties; thus having the customer subsequently refer acquaintances to the service provider would also be sufficient. The assumptions about additional trading are simply a natural way of introducing the key fact that the middleman is not in a position entirely to capture the surplus generated by introducing the customer and service provider to each other.

5. It is likely that service providers who have lower costs of dealing with customers (and impose greater burdens on the middlemen in the process) would pay more for the referral, but the results will continue to apply in more general situations. All that is really necessary is that knowledge of details of the arrangement between service supplier and middleman provides useful information to the customer, and the customer will use this information to the detriment of the service provider in any subsequent negotiations with the service provider.

The essential point of the model in this section is therefore that there can be advantages from having a middleman in an information market bound by loyalties to both the customers and the service providers, even if these loyalties are in conflict in the short run. An analogy may be useful: a mediator in a contract negotiation sometimes does his job most effectively by not revealing the entirety of his communications with one party to the other. Filtering the information that passes each way is sometimes in the long-term interest of both of the parties. Similarly, some service providers will be more willing to offer their services through a middleman if they know that not all of the details of their operations will be revealed to customers—and this willingness may be in the long term interest of customers as well.

Summary

RESPA is more restrictive in its treatment of compensation for referrals among small independent service providers than it is in its treatment of equivalent compensations within a consolidated organization. Sometimes regulatory restrictions on payments are devoid of economic effect because economic actors find alternative arrangements that effectively circumvent the restriction. Thus, in some circumstances restrictions on referral payments may be rendered ineffective by routing the payment through a surcharge on the customer's commission to the middleman with a discount on the customer's payment to the service provider. Suppose that the customer pays the same total to the referring middleman and the service provider, but pays more to the middleman and less to the service provider. This has the same effect as the service provider paying a referral fee to the middleman. Nonetheless, restricting the ability of service providers to pay for referrals can have real consequences. One way this can occur is when it is efficient for the middleman to develop information-based relationships with participants on both sides of his market.

V. COMPETITION AND REGULATORY REGIME

We have seen the informational roles that individual middlemen undertake in a market for professional services. The next task is to analyze the effects of competition within such markets. We begin with a baseline examination of the effects of competition between large and small firms: large firms will be assumed to incorporate the in-house provision of services; small firms will link customers with independent providers.

We will begin with the assumption that both of these firms are unrestricted in their ability to specify the terms of their arrangements. As a result, large firms restrict their activities to offering packages of services provided by themselves, while small firms charge referral fees to the service providers they recommend.

Afterwards, we will consider the effects of two regulatory restrictions on the firms: The first restriction forbids firms to offer packages of services without granting the consumer the option of unbundling the services and obtaining parts of the bundle from competitors. This “severability” restriction is written into RESPA as it currently relates to controlled business arrangements. The second restriction we will consider is one forbidding the payment of referral fees. The RESPA provisions permit compensation to the middleman for some work performed for the benefit of the service provider. But, as we have argued, permitted compensation is likely to be a negligible part of the fixed costs involved in building a relationship between middleman and service provider. Thus for simplicity, we will assume that the regulations forbid all compensation from service providers to middlemen and analyze the consequences.

The “severability” requirement is primarily a restriction on large firms; the ban on interfirm compensation is primarily a restriction on small firms. In the final part of the analysis we will briefly consider the effects of allowing competition among all four forms of arrangement, restricted only by a requirement that the middleman disclose to the consumer at the outset the terms of the arrangement.

1. Base line: Integrated firms with exclusive packages and small middlemen with referral arrangements.

The source of the reduced costs to specialist service providers is complementarities between the various acts of information provision. A common response to the existence of such complementarities or “synergies” in production is the merger of the businesses. Such a merger permits the “internalization” of the benefits bestowed by one provider on another; in other words, the benefits are thereby automatically taken into account by management attempting to maximize the profits of the consolidated enterprise. In the real estate market, participants have been well aware of the possible benefits from establishing large firms consolidating several lines of service. Examples include the consolidation of lending and title insurance as well as the consolidation of real estate brokerage and business brokerage.
Nonetheless, in the absence of regulatory preferences, large firms are unlikely to capture the entirety of the real estate settlement market. While they are likely to excel at the provision of standardized packages of services at extremely low costs, they are less likely to be adept at services for specialized niches. Given a level regulatory playing field, large consolidated firms would handle “plain vanilla” settlement services, while non-standard arrangements would be the natural province of independent middlemen making arrangements with a variety of loosely affiliated providers of specialized services.

2. Effect of bans on interfirm compensation

RESPA puts more stringent requirements on the permitted forms of compensation among small independent service providers than for compensation among divisions of a large consolidated firm.

In the short run, the fact that a middleman is not being compensated for fixed costs will have no effect on that middleman's activity. From a short run perspective, it is only the variable costs that count; these are being covered, and it is only the profits (so-called "quasi-rents") from the middleman's informational advantage over other parties which are being appropriated. From the short run perspective, this appropriation is a matter of justice — Who deserves to profit from the existence of this specialized information? — but not a matter amenable to economic investigation, since the appropriation has no effect on economic decisions.

But in the longer run, such appropriations do have economic impact, as they discourage the existence of middlemen in the services market. If the profits from information collection are withdrawn, fewer middlemen remain in the business, and those that do remain move their attention away from the non-compensated forms of activity. If similar appropriations do not occur under a different form of business organization (i.e., large, consolidated firms), then the structure of the market is gradually skewed in the direction of the favored organizational form.
In other words, the prohibition of referral fees acts as a tax on specialized service providers. It discourages innovation in provision of specialty services by making it more difficult for newcomer firms to encourage middlemen to investigate and incorporate their services into the menu of possibilities on offer to customers.

3. Effects of severability requirement

While the burden of the previously analyzed restriction disproportionately falls on small middlemen, the burden of the restriction considered in this section—requiring firms to offer customers the option of severing the bundle of offered services—disproportionately falls on large providers.

The main argument in favor of requiring severability is that it is a regulation designed to discourage -monopolistic behavior. In antitrust law, tied sales are restricted in order to restrain monopoly power. Suppose a firm has two lines of business, in one of which he possesses monopoly power. Then tied sales can be a form of predatory pricing designed to drive competitors out of business: a purchaser who wishes to receive the good on which the firm has market power must also accept the good on which the firm does not have market power, depriving the competitor of a market. Thus the restriction of tied sales can be an attempt to reduce predation. The problem with the argument is that restricting the tied sales does not restrict the firm's ability to engage in predatory behavior: the firm will always be able to achieve the same effect by offering the competitive good at predatory terms either by itself or as an optional addition. In any event, this example makes it clear that in order to effectively prohibit tied sales, regulation must clearly (and tediously) specify the rules for pricing the severable portions of the bundle.

On the other hand, there may also be efficiency losses to the requirement of severability. At the most basic level, it restricts a firm's ability to operate in only the plain vanilla market. If the natural niche for a large firm is a standardized selection with limited options, then forcing the firm to provide larger numbers of options reduces its efficiency as a standardized provider. Allowing the customer to choose among options increases the value of the arrangement for the consumer, but it may increase the costs of the operation unacceptably. For a review of the legal and economic arguments regarding tie-in sales and an application to banks see Weinberg, 1996.

Still, in many situations it is likely that it is no more costly for the firm to drop a component entirely from a package than to include it. We might therefore imagine that a large, standardized system might be willing to offer a "fixed price" package: For a set total charge, the customer can choose as many or as few of the items from the menu as he wishes. However such an arrangement is also likely to run up against the RESPA regulations; if the price differential for omitting a part of a package does not conform to the regulatory definition of acceptable costs, it may be regarded as an attempt to avoid severability. In other words, if the regulation places effective restrictions on the prices permitted for components of the company's package, there is an even greater likelihood of the regulations effectively increasing the cost of providing standardized packages of services.

4. Variety with Disclosure:

Thus under current regulations, additional costs are placed on large firms that wish to provide standard packages without allowing customization. Additional costs are also placed on specialized service providers who attempt to enter the market with new varieties of services. If these restrictions were dropped, some middlemen would still continue to provide their services under the current forms of arrangement. However, we would expect that some providers would prefer to make arrangements not currently permitted. We could expect to find competition among a variety of service providers, each focusing on a different market niche:

1. Large firms providing moderate cost services: These firms are permitted under current arrangements. They would allow a limited amount of customization of service packages by offering options including a mixture of in-house services. Customers who desired additional features not provided by the firm would find it possible to approach other service providers on their own. This arrangement is permitted under current regulations.

2 Large firms providing low cost services: These firms would produce the most standard package with enough services to satisfy the most common needs, but with few additional services or options available. The clients interested in these low-cost packages would be unlikely to approach other service providers on their own. This arrangement is not permitted under current regulations in the sense that any economies associated with any bundling must be passed on to consumers regardless of whether the economy is offset by economic costs.

3. Small firms providing moderate cost packages: These firms would put together non-standardized packages through arrangements with a variety of independent service providers, charging both the customer and the service providers for arranging the package. The freedom to deal with service providers in unrestricted fashion would make it likely that these firms were innovators, providing new services and combinations not available from other middlemen. However the fact that these entities accepted compensation from both customer and service providers would mean that their interests were not as closely aligned with customers as is traditional, and therefore the new arrangements might be more preferable to customers with some confidence in their own ability to evaluate alternative packages. This arrangement is not permitted under current regulations.

4. Small firms providing highest quality services at high cost: These small firms would also put together non-standardized packages through arrangements with a variety of independent service providers. Their compensation is arranged exclusively through the customer. Because their links to service providers are weaker, their services will be somewhat more standardized and not as innovative, but they will compete by offering individual, highly personalized relationships with their customers. This arrangement is permitted under current regulations, and will continue to be attractive to customers who are willing to pay a premium for personalized service.

For this variety in service provision to be possible, it will be essential for middlemen to clearly inform customers of the type of arrangement that is being offered. Although the existing codes for commercial transactions and contracts might be sufficient to ensure that this disclosure takes place, it could be useful for the modified RESPA regulations to require that disclosure take place at the outset of any discussion with customers. The disclosure should inform the customer about whether the arrangements allow the customer to pick and choose among available services of the middleman or also to include services provided by independent agents, and whether the middlemen receives any compensation from other service providers whose services are included in the packages.

Summary

As it stands RESPA includes two sets of provisions that limit the ability of middlemen to provide settlement services. The restrictions on referral fees restrict the ability/willingness of middlemen to make referrals to certain types of service providers, limiting the usefulness of the independent arrangement and skewing the industry towards large consolidated organizations. On the other hand, the requirement that packages be severable discourages consolidated organizations from reaping the full advantage of scale economies by providing low-cost comprehensive "plain vanilla" packages. If both sets of restrictions were dropped it is likely that the new forms of organization would co-exist with existing forms, becoming dominant in specialized niches of the market, while existing arrangements would continue to dominate other niches. With a variety of arrangements available it would become important for customers to be clear as to which sort of arrangement each provider was working under; therefore there would continue to be a useful role for disclosure provisions under RESPA.

VI. THE "HONEST BROKER" AND THE COMPLEXITY OF THE AGENCY RELATIONSHIP

As we have seen, there may be situations in which a middleman may be most effective if he is regarded as having some responsibilities for the interests of parties on each side of the trade he is establishing, but having complete loyalty to neither. This is somewhat akin to the facilitator or even disclosed dual agency that exist in some real estate brokerage transactions today and is the result of changes in the subagency system that dominated the market for approximately 70 years. The role bears some relation to that described in common parlance as the "honest broker": an actor whose goal is to bring the negotiating parties to a satisfactory agreement, without being the exclusive agent of either side. While the role may seem to be familiar, it is not frequently the legal position of middlemen in real estate markets. For example, a real estate broker often is explicitly the agent of one of the parties to the transaction—traditionally the seller; although more recently buyers have begun to have their own agents. In fact, part of the reason for the appearance of buyers' brokers may have been the legal barriers to having the seller's broker serve the intermediate role.

Indeed, the legal concept of agency and the associated fiduciary responsibilities entail a high degree of exclusivity. The agent's duty is to represent the interest of his principal. If a professional serves as the agent of two different parties, constant vigilance must be maintained against the possibility of conflicts in their interest. If the agent envisages the possibility of such a conflict, he has a duty to warn his principals, and if the possibility is realized, he will typically have the duty to resign from one of the relationships. A relationship between a professional provider of services and a client is typically presumed to be an agency relationship. In some cases this presumption is so strong that notification to the contrary by the professional is insufficient to void it. One of the main reasons for resistance to referral fees is the sense that accepting payment from another party is inconsistent with the fiduciary duties to the client. In some cases a customer may be sufficiently risk averse, sufficiently fearful of his own naïveté, or sufficiently suspicious of the specialized service provider as to prefer the safety of an exclusive agency relationship. But the price of such a relationship is likely to be high, since it means the middleman will end up foregoing some of the cost savings associated with his economies of scope. An analogy may be helpful: for some legal disputes full representation of each party by an attorney is the preferred method of resolution. In other disputes a single mediator is less expensive and more effective.

On the other hand, when no agency relationship is perceived, there is often little public resistance to these payments. At one extreme, a dealer in stereo or computer equipment is in the business of putting together packages of these goods for clients. The fact that he obtains these units at a variety of wholesale prices, reselling them at a variety of markups, is likely to be understood by the most naïve customer. It is a small step from the dealer to an individual who puts together suggested packages of stereo or computer systems for clients and arranges for the customer to purchase them. As a practical matter, a professional provider of services who does not receive any compensation from the customer often will not be regarded as an agent of the customer. This should be true in real estate in the absence of a written agency contract and in the presence of a disclosure to the contrary. Tenant reps are usually agents of commercial tenants who are compensated by the property owner. This appears to be a referral fee. Similarly, selling agents who are compensated by listing agents with a proportion of the commission appear to have received something like a referral fee. The customer will presume that compensation comes from the supplier. Similarly, if the amount charged by the middleman is clearly small, the presumption will be that the other parties are offering additional funds. But as the amount charged by the middleman increases, the presumption shrinks and the customer will be more and more likely to have a sense of betrayal upon discovering that some sort of compensation was obtained from the supplier as well.

In other words, most of the objection to referral fees as sensed in the opprobrium of the term “kickback” is due to the clandestine nature of the arrangement. If the possibility of receiving fees from participants on the other side of the arrangement is made clear at the beginning of the arrangement, much of the force of the blanket objection to the arrangement is dissolved. In the model examined in the previous section, the value of the secrecy is in not revealing the *size* of the fee. There would be no particular objection to the revelation of the *existence* of such fees.
If disclosure is provided at the beginning then arrangements with appropriate safeguards for the parties can be determined at the outset; contractual terms (such as cost plus pricing) which are incompatible with referral fees can be avoided, and customers who prefer exclusive agency relationships can be free to seek out other providers. It is standard practice for an economist to recommend a- requirement of an upfront disclosure (here, of the nature of the relationship among the parties), as an alternative to a regulatory restriction on freedom to contract. This is not to say that an arrangement in which the middleman accepts payments from both sides will turn out to be the dominant arrangement prevailing in the market. It will certainly be the case that some, perhaps even most, consumers prefer to make arrangements with middlemen who explicitly pledge to accept remuneration only from customers, never from service providers. Such a pledge may be taken as a standard of conduct for certain categories of middlemen, who use the pledge to distinguish themselves and their position as exclusive agent of their clients, from other middlemen who take on the less restrictive relationship of “honest broker.” For example this pledge could be written into the code of conduct of a professional association. These restrictions would be inappropriate for associations which have the legal power to determine who will or will not practice in the field, but they are appropriate when the professional association does not have the power to exclude non members from practicing, or when members of related professions can provide effective competition. The point is not that no client will want to establish a standard prohibiting referral fees to his agent; rather the point is that it is likely to be a mistake to set a blanket prohibition on all middlemen.

It is important to keep in mind that the most important source of security for the customer is not the fact of the customer being the source of payment for the middleman, nor even the legal liabilities imposed by the contractual relationship, but the desire of the middleman to maintain and develop a reputation in order to attract further business. An extreme example is illustrative: financial ratings agencies (Moody’s, Standard and Poor’s) and CPAs are paid by the companies whose financial information they are certifying. In provision of financial information these organizations are in effect middlemen between their clients and the financial public at large. The public at large does not pay for the services, and the legal responsibilities of these ratings agencies to the public at large are minimal. Nonetheless, the public can and does rely with confidence on the conclusions of these ratings agencies, precisely because the agencies have a strong interest in maintaining a reputation for accuracy in order to maintain a paying clientele. In this case that reputation is as effective as any explicit contractual guarantee or legal obligation. Nonetheless, reputations take time and resources to develop. When a reputation is lacking, then other guarantees will form a partial substitute. New firms and new forms of middlemen may find it valuable to commit ahead of time to serving as exclusive agents of their clients and refusing all referral fees, as a way of developing a reputation for quality service. In other words, allowing this form of commitment can also be a spur to innovation. It would be as great a mistake to forbid a middleman to refuse referral fees as it would be to require this refusal.

VII. EXAMPLES

In order to determine the extent to which the legal restrictions do or do not render the position of referral fees in the real estate market anomalous, it is useful to examine in greater detail the restrictions placed on referral fees in other markets for professional services. We will note both legal restrictions and restrictions imposed by professional associations. We will examine three professions: doctors, accountants, and lawyers.

4. Doctors

In health care, federal and state legislation has generally attempted to control the profits from referrals. The Medicare and Medicaid felony referral statute included broadly worded prohibitions against referral fees. (See Hall, 1988 for an analysis of the costs of prohibiting referral fees in the market for physicians' services). An example of similar state legislation is a Florida law seeking to restrain physicians from referring patients to clinics in which the physicians have a financial interest; the concern over the costs of potential conflicts of interest from this practice is widespread (See, for example, Greenwald, 1992).

Nonetheless, a major form of compensation under HMO's, which is generally left untouched by the statutes, is in fact simply the mirror image of referral fees—namely payment by the HMO to a doctor for *not* referring patients (Terry, 1994; "Practice Management" 1995). In other words, as a way of reducing the costs of medical services the HMO finds it beneficial to make part of the pay to primary care physicians vary inversely with the expenses the HMO incurs as a result of the doctor sending patients to expensive specialists.

In effect the primary care physician is a middleman between the patient and a set of service providers (including the HMO). The difficulties that might be expected to rise from a conflict of interest between the specialist providers and customers in the real estate market have their parallels in the conflicts of interest a primary care physician faces in dealing with the patient and the HMO. Nonetheless, the practice is generally viewed as beneficial on balance, as a way to induce the physician, traditionally the agent of the patient only, to take into account the interests of the HMO in cost savings.

2. Accountants

CPA's have found themselves in the position of having their professional society's ban on referral fees blocked by actions of the Federal Trade Commission. The FTC argued that several parts of the code of ethics of the American Institute of Certified Public Accountants (AICPA) constituted unlawful restraint of trade. However, see Allen and Ng 1997 for a critique of the FTC claim Among the objectionable provisions according to the FTC were restrictions on use of referral fees. The changes in the AICPA standards included permitting members to accept commissions or contingent fees, except "where an impairment of independence is incompatible with other accounting services being provided to the same client" (Landes and Drum, 1992)—effectively from clients whom the CPA was auditing. The changes are documented in Sager, 1991, who also notes that rulings by state boards of accountancy will in general have more influence than federal rulings on professional practice. In any event various state associations have considered whether to modify their own rules in response to the federal ruling. Resistance to fees for referrals in general was due to a fear of loss of independence—that is a damage to the reputational capital of CPA's as a profession. Support for referral fees stemmed largely from competitive pressures: the fact that CPAs, when engaged in work which is comparable to that done by non-CPA's, were placed at a competitive disadvantage by their inability to accept fees for referrals.

The FTC action made a distinction between commissions, for referrals in general, and "referral fees" narrowly defined, which are paid specifically for referring to another CPA. In this respect the debate in Ohio over changes in the state society's code in response to the FTC ruling is instructive: the initial proposals were less stringent for referral fees (for referrals to other CPA's) than for commissions (for referrals to non-CPA's); the latter were to be banned entirely, but the former were to be allowed subject to disclosure. (Landes and Drum, 1991). There are several possible explanations for the distinction: 1. As information providers CPA's are more likely to be experts in the suitability of the services of other CPA's than in the suitability of services (e.g., financial advice) provided by outsiders. 2. A CPA society may regard itself as possessing sufficient control over the behavior of CPA's to ensure that recommended CPA's automatically meet certain quality standards. 3. Since both parties to the transaction in the case of the referral fee are members of the society, the political pressure on a society to allow referral fees is greater than the pressure for commissions. In any event the eventual Ohio decision was to allow for both referral fees and for commissions for "non-attest services" such as financial planning given proper disclosure (Rayball, 1994; for comparable rules in Pennsylvania, see Colgan 1999. For comparable professional rules when CPAs pay referral fees, see the brief discussion of rule 503—Commissions and

Referral Fees in *Journal of Accountancy*, 1993)

2. Lawyers

Lawyers have always felt uncomfortable with referral fees. In addition to the discomfort stemming from the fear of a loss of independence, lawyers have been concerned with whether and in what sense referral fees were earned (Garwin, 1993)—if they were not earned, then, the argument would seem to go, it was unjust to accept them. In this case they would be, at best, a necessary evil. Even the titles of typical articles on the subject point to this concern: “Referral fees: everybody does it, but is it OK? No referral fee for no work,” (Frank 1985); “Referral Fees: Legal Kickbacks?…” (Granelli, 1981); “Referral Fees Paid to Attorneys Who Perform No Meaningful Services to the Client…” (Davis and Allison, 1986); “…Referral Fees Prove That You Really Can Earn Money, Not From What You Know, But From Who You Know” (Dubin, 1987).

For lawyers a distinction has been made between referrals within a firm, for which financial inducements are typically given as part of the partnership agreement, and referrals outside of the firm, which have been more controversial. For instance, in 1987, the Boston Bar Association called for tightening the state rules in order to ban fees for referrals to other law firms (Fanning, 1987). While the association argued that the receipt of referral fees would damage the willingness of the referring attorney to find the best specialist, commentators noted that this problem was already solved through the widespread use of contingent fees, which are only paid to the referring lawyer if the case is won.

During the last decades some states have relaxed their rules on referral fees. (For the case of Michigan, see Carty, 1991, and Marcotte 1989; see also Hazard 1987 and Merrick 1986). More recently the question has turned to the acceptability of referral fees between lawyers and non-lawyers. The ethics committees of state bars disagree on when and whether lawyers may accept referral fees from non-lawyers. On the other hand, the American Bar Association’s Model Rules of Professional Conduct bar all lawyers from paying such fees (Garwin, 1995).

Despite this restriction, lawyers are apparently permitted to enter relations with middlemen who effectively provide the same ultimate payment. In an arrangement parallel to the more widespread HMO’s in health care, prepaid legal plans are becoming more common in the United States (Macpherson, 1990). In these arrangements legal services are offered at a discount by arrangements through the provider. The customer may pay a fixed fee to the middleman, or may pay the middleman for arranging the services and then obtain the services directly from the lawyer at a reduced rate. Either way, the parties to the arrangement have ultimately achieved the same results as would be obtained through a referral fee.

Summary

We have focused on three professions in the U.S. whose codes and regulations are traditionally among the most restrictive with regard to payment of referral fees. In each case, among the concerns leading the professional association to resist referral fees was a sense that the existence of a referral fee would damage the reputation of the professional as an independent and reliable advisor. In some cases these concerns may have been mingled with less justified concerns, such as the desire to maintain market power, or unsound theories of value and price. The responses of government agencies to referral fees have varied across the occupations, with the FTC consistently arguing for eliminating mandatory restrictions of referral fees, and other agencies and legislation pushing for greater restrictions.

The move towards referral fees has been embraced by some in each profession and resisted by many. While some observers argue that the loss of independence is too great a price to pay, others in the professions have stoutly advocated the move to referral fees. Illustrative of the attitude in the case of CPAs, one commentator (Rayball, 1994) attempted to dispel what he described as the “myth” that it is impossible for a CPA to be an objective advisor when blinded by fees paid by referred service providers:

“You can be objective—it just requires careful judgement calls, which CPAs make all the time.”

VIII. CONCLUSIONS

As the real estate market becomes more specialized and complex, the role of middlemen becomes ever more central to its efficient operation. Middlemen take on a variety of informational roles. The real costs incurred in many of these roles are not included in the regulatory authorities’ calculations of permitted costs, and become, under RESPA, prohibited as referral fees. By prohibiting referral fees, RESPA does help to maintain confidence that real estate professionals work as the exclusive agent of the client, but it does so at a price: It discourages development of innovative packages of products by alliances of small independent service providers and prevents these firms from taking advantage of the economies of scope that these alliances would provide, placing them at a disadvantage relative to large consolidated service providers. There are better ways of providing guarantees of exclusive agency to those customers who value it. Regulation specifying the standards for disclosure of referral fees can serve a useful purpose. Some individual firms may find it in their interest to not accept referral fees and to advertise that stand as a way of carving out a differentiated market niche. Either of these solutions still leaves it possible for customers to choose the most useful combination of services and prices for their own situation.

The market for real estate settlement services is not unique in facing the problems of changing institutional arrangements and pressures for referrals and associated fees. A variety of professions are currently grappling with the questions imposed by payment for referrals. Depending on regulatory environment and institutional arrangements in an industry the referral fee has been sometimes explicit and sometimes disguised. Nonetheless, in the cases we have examined in detail, competitive forces have pushed professionals into more intermediated arrangements and these arrangements have led to an increased reliance on referral fees.

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Appendix III

Economic Implications of Real Estate Settlement Packaging

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I. Introduction

The recent joint recommendations by the Federal Reserve Board and the Department of Housing and Urban Development for legislative changes in the Real Estate Settlement Procedure Act (RESPA) and the Truth in Lending Act (TILA) include a proposal requiring either absolute guarantees by lenders of settlement costs necessary to close a mortgage loan or an estimate within a range for these services. To encourage lenders to guarantee the costs of the package of settlement services, they would be given an exemption from the prohibitions against referral and unearned fees in RESPA section 8. While the proposal appears to permit firms other than lenders to offer settlement service packages, in fact all packages will need to be sold through lenders, and it is likely that the end result will be packaging of settlement services by all major lenders.

Such packaging will produce minimal benefits at best, while imposing potentially significant costs on consumers and smaller settlement service providers, and risk to the real estate settlement industry. Furthermore, there is little likelihood that the stated goals of RESPA as presented in the joint Fed/HUD proposal, and discussed below would be accomplished.

The packaging proposal assumes, without providing evidence in support, that vigorous competition exists among mortgage lenders and will assure that any cost savings realized by lenders in arranging for the various services will be passed on to consumers. As discussed below, both of these premises are debatable. Stiglitz (1994, p. 20) notes, in general, that market failure is likely to be observed in financial markets. He also states (p. 29) in loan markets borrowers may face a very limited number of suppliers and may find it difficult to switch from one to another.... the fact that there are ten lenders supplying loans in a market does not mean that each customer has a choice of ten suppliers. Even when there are many banks, competition may be limited. Moreover, any benefits that might result from packaging would likely be distributed unevenly across regions and individuals. In contrast, possible costs are easier to identify. These include higher prices to certain groups of customers, elimination of settlement service providers that could have long-term competitive implications, conflicts of interest, and risk of harming small businesses and disrupting a system that generally works well at present.

The next section of this paper provides a brief description of the Fed/HUD packaging proposal and its stated rationale, along with some discussion of the economic analysis provided with that proposal. Following that, a more detailed economic analysis is given of the potential costs and benefits of the proposal.

II. The Fed/HUD proposal

The Fed/HUD report, which was issued in response to Section 2101 of the Economic Growth and Regulatory Paperwork Reduction Act of 1996, contains a number of recommendations for modifications to paperwork, disclosures, and substantive procedures in the real estate settlement process, but the focus of what follows is on the recommendations made for packaging of settlement services. It should be noted that no detailed analysis of costs and benefits is attempted in the joint report (other than generally mentioning the *types* of costs and benefits which may ensue), and the recommendations themselves are described only as a possible "starting point" for congressional consideration of legislative changes. Nevertheless, it is worth considering that report's motivation for changes, and considering whether the goals stated would likely be accomplished under the proposed changes.

The report recommends that creditors be allowed to choose between guaranteeing closing costs or providing more accurate estimates of these costs than is required at present. Both the Fed and HUD recommend granting an exemption from section 8 of RESPA if a package of settlement services is offered at a guaranteed price. The report does not take a firm position on whether, or the extent to which, the consumer should be provided information on the specific services in the package. Nor does it recommend that itemization of service providers or the costs of particular services be provided to homebuyers.

Appendix E of the report, titled **The Board's Economic Analysis of Packaging: Potential Market Structure and Performance Implications of Guaranteeing Closing Costs**, deals with three issues: the impact of vertical relationships (associated with packaging settlement services) on competition, potential conflicts of interest associated with these vertical relationships, and pricing implications. While this analysis is attached to the Fed/HUD report, support given there for the packaging proposal is quite modest. No claim is made for dramatic benefits; rather what is argued is essentially that the costs are uncertain. The appendix notes: (1) small service providers *may* be disadvantaged (although the report points out that this is not a necessary outcome); (2) packaging may allow a creditor with monopoly power to extend this power to an ancillary market, but this is not likely to be a problem as most local mortgage markets are competitive and barriers to entry are also low; (3) packaging may lead to conflicts of interest which might adversely impact borrowers, suggesting that some settlement services should remain subject to section 8 restrictions under RESPA; (4) average-cost pricing may involve some consumers effectively subsidizing others; (5) guaranteeing settlement costs would increase risk to creditors and therefore may imply the need for higher margins and higher prices to consumers, although this may be offset if lower transactions costs result from vertical relationships.

There seem to be two primary objectives for the changes proposed in the Fed/HUD report, which correspond generally to two major goals of TILA and RESPA:

to better assist the consumer in shopping for mortgage loans ("so that consumers can make comparisons between different creditors' cost disclosures and estimates" [report, p.3]), presumably thereby promoting competition; and
to provide more complete information to consumers on the true full cost of a real estate settlement transaction.

For the first of these, what is required is accurate and timely knowledge of rates, points, and lender processing and underwriting fees those items*directly* associated with underwriting and loan processing along with the transmittal of information to the consumer that all the other expenses can be shopped around for (and are independent of the particular lender chosen); services which are *purely* for the benefit of the lender may be exceptions.Even services which are technically purely for the benefit of lenders are often perceived as having benefits for consumers as well; examples would be attorney input into settlements, home inspections and appraisals, pest inspections. Including these services in packages raises some conflict of interest issues discussed below. The settlement cost guarantee discussed in the report does nothing to help consumers in searching for the best financing package (and in fact might hinder this search), since it reduces the transparency of financing comparisons. It is difficult enough for consumers to evaluate the best financing deal (both on purchase and refinancing) when confronted by an array of fixed and variable rate products, each with alternative possibilities of points, amortization periods and other features. Adding in to the mix a lump sum for settlement costs, especially if not itemized and not complete (see more on this below), will make comparisons among lenders even more complicated.

To the extent that packaging is intended to achieve the second goal stated above informing consumers of the full cost of a real estate transaction the proposal is clearly inadequate, as there are too many exclusions from the package.See Appendix A-4, p. 2 of the joint Fed/HUD report. It is true that many of these excluded services would be required in a comparable cash transaction, and some cannot be guaranteed by the lender because of consumer choices or the dependence on other events beyond the lender's control; however, to the extent that a home buyer is to receive a clear idea of the financial obligations he/she is undertaking, these other expenses -- most prominently property hazard insurance and real estate taxes -- are likely to be much more important than the other expenditures included as part of the recommended guaranteed package. In fact, if one were trying to give the potential homeowner a full idea of what he/she was getting into, some disclosure of likely annual maintenance expenditures would probably be more important as well.

The Fed/HUD recommendations seem to merely *assume* that the two goals set out will be well addressed by the changes proposed (and that they will be equally well served). As noted above, this is far from obvious. Or to put it another way, the proposals fail to make the economic case for packaging. Before any legislative changes are made a more careful analysis must be considered; in particular, it may be possible via more modest proposals to aid in addressing both goals.

III. The Best Case Benefits of Packaging Will Be Minimal

Under the current system of real estate settlement, consumers can shop for individual settlement services. While this can be a time-consuming process, it does allow consumers to compare prices, make judgements as to the quality of service, and select a service provider. Any benefits from a move to packaging would require strong competition among lenders, and will likely be distributed unevenly across regions and individuals. But first, let us consider, what is the nature of the *possible* benefits? These are of two types: reduced consumer search costs and lower prices.

Consider the issue of reducing consumer search costs. Unless there is full disclosure of the particular services in the package (itemization) and the option to consumers of substituting providers of particular settlement services (freedom of provider selection) -- the latter requiring information on prices (perhaps in terms of credits given consumers for substitution) of these elements at a useful point in the transaction, less information will be provided to the consumer than at present. The Fed/HUD recommendations state that "consumers want to know what services they are purchasing" [report, p. 33] and so they suggest that a list of services -- but not individual service prices -- might be provided *by the date of settlement.* This late and incomplete information is clearly inadequate to the goal of providing either full information or the enhancement of a consumer’s ability to shop around.

Colwell and Kahn (1998), while sympathetic to the notion of simplifying the home buying process via modifying RESPA to facilitate bundling or packaging of settlement services, stress that it is important for both bundlers and specialists to co-exist in the market for these services. They envision a world in which there would be competition between the two -- [i]f total price rose with the bundling of settlement services, the marginal consumer would move toward unbundled services; if bundling improved convenience, he would buy bundled services.Colwell and Kahn (1998), p. 4. But this requires that both options be available and that consumers are in a position to judge the advantages of a package versus buying the components separately. Colwell and Kahn, therefore, support a disclosure requirement, provided in a _timely, standardized, easily understood format.Colwell and Kahn (1998), p. 8. In particular, they state:Colwell and Kahn (1998), p. 9. Pafenberg (1998) agrees that itemization of individual costs of service providers within a package is essential.

A disclosure statement specifically designed for bundled services should 1) describe the relationship of the affiliated businesses, 2) state who receives side payments when the services of affiliated businesses are used, and 3) disclose the pricing implications of the buyer’s rejecting part of the package in favor of an unbundled service.

Unless itemization of expenses for services which are part of a package and freedom of provider selection are required, consumers who are well-informed about the settlement process or are willing to take the time to shop will be prevented from getting the best deal, which will tend to raise prices on average. And unless service providers are identified by name early in the process, consumers are prevented from being able to judge the quality of these services provided in whole or in part for their benefit that are included in a given package.

Furthermore, searching for alternative settlement providers (not tied in to existing packages) may be made impossible in areas where there are limited sources of mortgage funds; these would include rural areas and under-served poor urban neighborhoods. The net impact may in fact be reduced time spent searching for settlement services by consumers, but this does not necessarily indicate a societal gain through lower search costs. The crucial economic distinction is whether *search costs* are reduced (which, given an optimal amount of search, would be desirable) or *the amount of search* is reduced (which could be undesirable). A long literature on the economics of information beginning with Stigler (1961) makes clear that, given the inherent uncertainty consumers face about prices (and often about availability), there is an optimal amount of search in markets and limiting the amount of search undertaken may reduce social welfare.For example, imposing a rule requiring buyers to purchase the first used car they saw would reduce the amount of search in that market, but would not likely be socially optimal. On determining the optimal amount of search in a market, see Feinberg and Johnson (1977).

As for the effect on prices, the economic literature on bundling (or tying of sales of one product conditional on the purchase of another),See Adams and Yellen (1976), Berman and Dunn (1987), Slade (1998). The terms bundling, tying, and packaging generally refer to the same conduct by firms; the impact on consumers does not depend on whether the different goods or services are actually produced by the same firms or not. while noting that the practice can be profitable, does not generally suggest that lower prices would result, unless there are significant economies of scopeEconomies of scope are cost savings from selling a package as compared to selling components separately. or economies of scale Economies of scale are cost savings from large volume production of a particular component. which can only be realized via large purchases by a lender. Furthermore, any cost savings so realized would only be passed on to consumers if the mortgage lending market is more competitive than are markets for related settlement services.

The clear presumption of the Fed/HUD recommendations seems to be that lenders do operate in a highly competitive market; from this they draw the conclusion that packaging will push prices down by putting all closing costs in lenders hands. However, for certain classes of consumers (rural, poor credit, unusual size and type of loans, those in the inner-city) there may be limited sources of credit, suggesting market power by lenders in those market sectors; for these customers the effect of packaging may be to raise the total cost of closing. Adams and Yellen (1976) discuss how firms with market power may be able to use packaging or bundling to increase profits by extracting consumer surplus from buyers with different reservation prices (or valuations) for different components of the bundle; in other words, packaging may be an effective form of price discrimination.

Slade (1998) studying the Canadian newspaper advertising industry develops a theoretical model suggesting that, under reasonable conditions, tying will generally be profitable to firms with market power in one component of the potential bundle. She then provides evidence in support of that hypothesis. Other theoretical models which have emphasized strategic behavior by firms with market power (an example is Whinston (1990)) imply that bundling or tying can lead to market power being extended to another market.

The Fed's economic analysis (included with the Fed/HUD recommendations) does acknowledge that for particular items within the package -- they specifically mention title insurance -- it may be more efficient to allow consumers to transact directly for these services. But if allowed for one, it is difficult to argue against this for any, and this then destroys the primary rationale for the package in the first place.

Given oligopsony (buyer) power by large lenders over settlement service providers and at least pockets of market power possessed by lenders towards consumers, there is no guarantee that any discounts received on these settlement services will be passed on to consumers as opposed to being reflected in higher markups. The recent Congressional Budget Office report on competition in ATM markets suggests that, despite expected efficiencies of running large ATM networks, big banks and big ATM owners may be charging higher prices for ATM services. In fact, without itemization and freedom of provider selection -- the type of information required by a competitive market -- this pass- through of discounts to consumers is quite unlikely.

Demand for individual settlement services when considered as part of a package will be effectively price-inelastic (since they represent a small part of the cost of the transaction), suggesting a great ability by lenders to markup these components if they are able to avoid itemizing elements of the package (because in that case consumers can't easily compare competing packages). On the other hand, considered separately, an individual provider will face highly elastic demand if - as is likely - its services are viewed as relatively homogeneous by consumers; this suggests that a well-informed consumer will often be able to do better by shopping around.

As noted above, even if prices *are* reduced through packaging, they will likely only be reduced selectively in markets (both geographically and by demographics and credit rating) where there is considerable competition. In addition, state regulatory restrictions on discrimination may limit lender's ability to get discounts on parts of the package such as title insurance. And where prices are reduced this may require squeezing smaller providers which could force some from the market; this could lead to more limited competition by settlement service providers in those areas.

One final issue to raise here concerns the trend of consolidation in the bank and thrift industry. While current levels of competition in local lending markets may limit the ability to increase markups across the board via packaging, there is a real concern about placing primary control of all settlement services in a market that is in the process of concentrating.

IV. Costs of Packaging Are Potentially Significant

The costs of packaging are of the following types: (1) raising prices on settlement services to selected groups of home-buyers; (2) the threat of long-term availability problems, especially by smaller providers of certain settlement services, which may have implications for future levels of competition in the real estate settlement market; (3) reduced purchases of consumer-benefiting services associated with the home purchase; and (4) moral hazard issues which may reduce the quality of some settlement services that primarily benefit consumers but which are included in lender-provided packages.

If we consider which types of consumers are most likely to lose out from packaging these include both savvy buyers (who would prefer to shop around for best deal on all services, and who will be disadvantaged without itemization and freedom of provider selection) and unsophisticated purchasers (who may be unable to evaluate the choice between competing packages, and who may ignore the non-packaged components of settlement services). As discussed above, rural and inner-city homebuyers (where competition among major lenders tends to be scarce) may find little choice among packages available to them.There is a large literature on the issue of whether discrimination exists in mortgage lending practices, with the argument often made that the ability of lenders to engage in discrimination suggests the existence of market power. Hunter and Walker (1996) survey some of this literature and provide some support for higher loan rejection rates for minority applicants, controlling for neighborhood and personal characteristics. More recently, Berkovec et al (1998) also find evidence of non-economic discrimination in mortgage markets. In addition, it is quite common in rural counties for all financial deposits to be accounted for by just two or three banks or thrifts of course, outside lenders may be available (through direct mail, phone or the Internet), but this certainly suggests the likelihood of something less than vigorous competition among lenders in those markets. For these buyers, prices of settlement packages may rise compared to those of unbundled settlement services.

Research on economic effects of vertical integration suggest that large lenders may be able (after either contracting with or acquiring large settlement service providers) to foreclose markets to smaller settlement service providers, or to induce price concessions by them.See the related discussion in Pepall, Richards and Norman (1998), pp. 443-447. While the latter may seem desirable, these may not necessarily be passed on to consumers. Furthermore, if lenders are able to obtain discounts from title insurance companies (and similar comments would apply to other settlement service providers), these may require rates too low to ensure solvency; loss reserves may be threatened which could imply long-term problems of availability of title insurance where rates are unregulated. Another way to look at this issue is to see that reduced profitability (both by settlement providers not included in packages and by those included but squeezed in pricing) may lead to exit from the industry and reduce the level of competition in the future, to the long-term detriment of consumers.

An additional information-related cost of packaging is that it may lead to reduced purchases of consumer-benefiting services. That is, if customers think that package is complete (as it may be *from a lender's perspective*) they may be unaware of the advantages they might receive from settlement services that could supplement the package. They may, for example, be unwilling to purchase an owner's title insurance policy, or to retain their own attorney to represent their interests in the transaction, or to pay (extra perhaps) for an independent home and pest inspection, etc.

Related to the last point is that the potential for conflicts of interest associated with packaging is enormous.As noted earlier, the Board's Economic Analysis of Packaging acknowledges this problem. There is clearly an asymmetry in the nature of information held by a lender and by a home buyer, both in terms of the types of settlement services which may be desirable for the buyer to obtain, and in the quality of services provided. For some of these services, quality has little effect on the lender but potentially major impacts on the buyer -- examples are home inspection, appraisals, and pest inspections. As long as the providers of these services are able to detect and prevent major problems which would reduce the value of the property below the loan value, the lender would be satisfied; buyers however, would like more assurance of likely future maintenance problems and the costs which these will require. Given both different needs and different ability to judge quality, we would expect a sub-optimal level of service (from consumer perspectives) to result from packaged provision. Of course, even without packaging there is an expert problem of asymmetric information in these services;Generally when consumers can not distinguish good from bad quality service, too little quality will be provided in equilibrium. The problem essentially is that a high-quality provider cannot charge a fee appropriate to that quality since consumers will only be willing to pay a price based on obtaining the average level of quality; obviously this provides little incentive for high quality service. See Leland (1979) and using the example of the used car market Akerlof (1970). however, when consumers are directly making the choice they have some incentive to search out quality references (or to rely on brand name reputations to establish quality), and they do not confront the additional problem of asymmetric quality needs as noted above.

V. Additional Risks of Disrupting the System

Packaging could freeze innovation in the marketing or delivery of settlement services, at a time when such innovation is expanding dramatically. For example, home buyers may now begin the process of shopping for title insurance via the Internet, and it is likely that in the near future this will become a significant source of settlement service provider business (involving very little in the way of search costs); one need only look to developments in the past year in the retail book and music industry to see that Internet sales can provide serious competition for traditional sources of sales (the emergence of **amazon.com** and **barnesandnoble.com** has dramatically altered the nature of competition in this industry).Also, see Home on the Net, an article on the way in which the World Wide Web is changing the way Americans shop for real estate, published in *Money.Com* (Fall 1998), p. 23.

Then there is the concern for exercising care in making changes which taken one at a time may initially seem optimal; in the context of real estate settlements, other market imperfections -- especially highly imperfect information -- may lead to less than optimal results from enforced packaging. The classic theoretical argument on this point (known as the theory of the second best) is found in Lipsey and Lancaster (1956), where the authors prove that unavoidable deviations from optimality in one dimension, e.g., imperfect information, natural monopoly, externalities imply that imposing a seemingly promising solution in another dimension may not be the second-best solution (the first-best solution would of course be to eliminate all market imperfections) and may, in theory, lead to further deviations from optimality that is, society may be worse off after the apparently beneficial action. A related point is that regulatory changes that may seem desirable in the current market environment will not necessarily be preferred in changed circumstances.

To add to the discussion earlier on effects of vertical integration (in this case, contracting or merger between a lender putting together a package and a service provider), the impact of possible harm to small unaffiliated businesses through market foreclosure is generally minimized by economists absent any immediate impact on consumers. However, in the context both of future concerns about packaging reducing the availability of independent settlement service providers and increasing consolidation of the lending industry this may merit further consideration.

VI. Conclusion

It is difficult to see significant benefits accruing from the suggested changes in settlement procedures outlined in the Fed/HUD report. As detailed above, any cost savings arising from packaging should not be assumed to necessarily pass through to consumers. There is at least as great a chance that packaging (especially in the form envisioned in the Fed/HUD report) will lead to higher prices to some groups of consumers. The stated goals of making comparison shopping between lenders easier and of giving consumers more certainty in the true cost of real estate transactions are unlikely to be achieved by the changes.

Significant costs are likely in the form of price discrimination, harm to small business, and in a reduction in purchases of consumer-benefiting services not included in the package. When viewed in the light of increasing lender consolidation, there is also the potential cost of placing more control over the settlement system in the hands of an industry that may be becoming less competitive (especially in certain regions and to certain customers).

Even in the best case scenario, consumers will have much less than full information in the settlement process. Any benefits from packaging would require strong competition among lenders, and will likely be distributed unevenly across regions and individuals. And the economic benefits in terms of reduced search costs and lower settlement costs are quite questionable. While the net impact may in fact be to induce reduced search by consumers, that does not necessarily indicate a societal gain through lower search *costs*; there is economic value to time spent evaluating alternatives. In terms of settlement costs, for certain classes of consumers limited sources of credit may exist and for these customers the effect of packaging may be to raise the total cost of closing.

While better information and greater certainty about rates and points would be desirable, the current system has generally served US consumers well. Furthermore, a limited amount of packaging is occurring even without a regulatory mandate. Some vertical integration is occurring and leading to internal company packages; however, without mandate, changes occurring are market-driven and still leaves room for non-integrated firms, small businesses, and consumer choice among settlement providers.

Nevertheless, if a packaging approach is adopted, it is essential that both itemization and freedom of provider selection be required. Only in this way would competition be feasible from non-lenders who could put their own packages together, and compete with lender-supplied packages. Furthermore, consumers will be unable to compare packages to find the best deal without some transparency in the packaged elements. As noted above, not only will packaging *not* make the real estate transaction simpler and more understandable to consumers; it is likely to complicate the purchase decision. This also suggests that if packaging is required, it should first be phased in for non-sale transactions, which involve inherently less complicated combinations of settlement services (and with fewer of these services benefiting consumers).

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Appendix IV
The Board's Economic Analysis of "Packaging":
Potential Market Structure and Performance Implications
Of Guaranteeing Closing Costs

While it is difficult to make firm predictions, it is plausible that given a choice between estimating or guaranteeing closing costs, many creditors will choose to guarantee them. To provide a reliable basis for the guarantee, these banks may enter into vertical relationships with ancillary service providers (assuming that $ 8 of RESPA restrictions on the fees associated with such relationships are eased.) 11 In a vertical relationship the creditor acts as an intermediary, purchasing the services from affiliated or unaffiliated providers for resale to consumers as part of a loan origination package. Instead of entering into vertical relationships with ancillary service providers, a creditor may base its guarantee on prices observed in previous transactions; however, doing so may not provide as reliable a basis for guaranteeing closing costs Creditors may choose to guarantee costs in conjunction with entering into vertical relationships because they believe that they can thus achieve cost savings for their customers, because such relationships may reduce total transaction costs and consumer search costs.22 For particular items within the package, however, for the bank to serve as an intermediary may be less efficient than for the consumer to transact directly with the ancillary service provider. For
example, interacting directly with title insurance providers may be more efficient, particularly because title insurance services are now offered over the Internet, giving consumers low-cost access to a wide range of choices Another reason that creditors may choose to guarantee costs is that they believe it will provide marketing advantages.

1. Implications of Vertical Relationships for Competition. If significant economies of scale are associated with vertical relationships, smaller creditors or ancillary service providers may find competing with larger creditors difficult. In the presence of economies of scale, larger creditors may benefit from volume discounts provided by ancillary service providers, and larger ancillary service firms may benefit from reduced transactions costs resulting from bulk contractual arrangements. Even in such cases, however, smaller creditors and ancillary service providers may be able to form alliances that would enable them to achieve economies of scale and remain competitive. For example, small creditors may be able to contract jointly with a title insurance company to achieve volume discounts. Moreover, in smaller markets or in particular market niches, volume discounts may be unavailable because of the small number of total transactions, and smaller creditors could remain competitive. Thus, it is by no means clear that smaller creditors or ancillary service providers would, in general, be disadvantaged by removing restrictions on creditors' ability to form vertical relationships with ancillary service providers.

A creditor might not permit borrowers to choose another provider for a service that the creditor has incorporated into a loan origination package. Economic theory suggests that tying arrangements where the creditor requires the use of affiliated providers, raise potential anti-competitive issues, in that tying may allow a creditor with monopoly power in one line of business to create or retain a monopoly in a second line of business.33 See Jean Tirole, Theory of Industrial Organization (1989) Thus, for example, in a town with only one mortgage loan creditor, a creditor requirement that title insurance be purchased from an affiliated provider might drive competing title insurance companies out of business. However, such a result would require prior monopoly power on the part of the institution. It would also require that the attempt to expand monopoly power would not induce other creditors to enter the market. Most local mortgage markets are highly competitive, and barriers to entry into local mortgage markets are low because of the existence of many, large creditors who operate on a nationwide scale.44 See, e.g., Norwest Corporation, 82 Federal Reserve Bulletin 621, 683 (1996). Rapid advances in information and computer technology also help to ensure competitive local markets. Hence, even in concentrated markets, attempts to exploit and expand market power are apt to invite entry and, as a result, not succeed. Thus, in general, there is little reason to expect anti-competitive effects from tying arrangements.55 Some industry representatives have argued that mortgage brokers will be unable to compete with direct creditors if creditors form affiliations with appraisers. Mortgage brokers typically obtain a single appraisal for a given loan application and then offer the application to several creditors. Doing so would not be possible if creditors only accepted appraisals by their affiliates.

There is little reason to believe, however, that the services of mortgage brokers would become extraneous if creditors and appraisers were allowed to form affiliate relationships. To the extent that the services of brokers remain valuable to creditors and consumers, creditors would not want to forgo these services and would be willing to accept independent appraisals in conjunction with brokered applications.

2. Potential Conflicts of Interest Associated with Vertical Relationships. Vertical relationships between creditors and providers of pest inspection, property inspection, and perhaps other services may entail conflicts of interest that adversely affect borrowers. For instance, the degree to which a pest inspection company “errs” in the direction of finding infestations may be of little concern to the creditor but can result in significant costs for borrowers. A lending institution may maintain an exclusive arrangement with a pest control company (requiring all borrowers to use that company) because the company offers low-cost inspections even if the company is prone to making such errors. Similarly, the amount of time a property inspector spends on detecting and reporting minor flaws that have no bearing on the creditor’s risk exposure would be of little concern to the creditor but might be a significant issue for the borrower.66 Because of potential conflicts of interest, certain services could remain subject to restrictions under Section 8 of RESPA.

3. Pricing Implications. To guarantee costs, creditors may need to rely on average-cost pricing of settlement services, where prices might otherwise vary with particular situations. For example, currently, in the absence of guarantees, prices charged by title companies typically vary with the complexity of the search.77 For instance, many companies offer discounted “reissue rates” for searches on properties that they had conducted searches on in the recent past. To provide a standard quote for closing costs in order to guarantee the price, a creditor may contract with a title service provider to obtain creditor’s title insurance at a fixed price that would reflect the average cost of a title search. In such cases, lower-cost customers would cross-subsidize higher-cost customers. This effect of guarantees would be mitigated to the extent that creditors develop product-specific guarantees. Further, creditors that guarantee costs may have to allow some margin in case they have to absorb a cost increase before closing. Passing on the cost of the risk may result in higher guaranteed prices, although the marginal effect may be small in many cases.

On the one hand, these pricing consequences could diminish any advantage of guaranteeing costs and could prompt creditors to estimate costs. On the other hand, as noted, vertical relationships between creditors and ancillary service providers could result in lower transactions costs. Lower transactions costs might then lead to lower consumer prices for ancillary services.