Comments to Proposed RESPA Revisions

By Michael J. Rooney

Docket No. FR-5180-P-01

The Department of Housing and Urban Development published new proposed changes to the Real Estate Settlement Procedures Act on March 14, 2008 in 79 Federal Register 51 at pages 14030 through 14124, both inclusive, Docket No. FR-5180-P-01. The following Comments suggest HUD is out of touch with the demonstrably and notoriously shoddy performance of lenders in connection with the current sub-prime mortgage debacle because HUD desires to give lenders more control and influence over consumers. Moreover, there are a number of other serious deficiencies in constitutional analysis and logical thinking requiring the defeat of these proposals. Finally, it is clear HUD does not understand prohibitions against the unauthorized practice of law or the Illinois Rules of Professional Conduct governing Illinois lawyers.

At page 14055 HUD represents there is no federalism issue presented by the proposed regulatory changes. Yet, the proposed regulations require settlement agents in Illinois to "explain" legal consequences of the promissory note to buyers/borrowers. If the settlement agent is a non-lawyer, this requirement means the settlement agent must engage in the unauthorized practice of law. If the settlement agent is a lawyer who happens to represent the seller in the real estate transaction, the requirement means the lawyer may run afoul of the Illinois Supreme Court's Rules of Professional Conduct. In either instance, the proposed regulations ignore clear requirements of Illinois law and create a conflict between state and federal law.

In generally describing the new rules, HUD says, at page 14050, "…today's proposed rule would require the settlement agent or other person conducting the settlement to read the closing script document aloud to the borrower and <u>explain</u>: (1) The comparison between the loan terms and the settlement charges listed on the HUD-1/1A settlement form with the estimate of charges listed on the GFE; (2) whether or not the tolerances have been met; and (3) the loan terms as contained in the mortgage note and related settlement information. Any inconsistencies between the mortgage note, between related settlement information and the GFE, and between the HUD-1/1A settlement charges and the GFE would have to be disclosed and <u>explained to the borrower</u>." (emphasis added) One might certainly argue that <u>explaining</u> items (1) and (2) might not constitute the practice of law in Illinois. However, I believe it is clear under current law that <u>explaining</u> the legal significance of loan terms contained in the note does constitute the practice of law in Illinois. If a settlement agent is a non-lawyer, HUD will require that settlement agent to engage in the unauthorized practice of law in Illinois, subjecting the settlement agent to discipline by the Illinois Supreme Court. The precise regulatory modification is at page 14058, Section 3500.8(d)(2). See also, further explication by HUD at page 14102.

The use of the "closing script" is required at page 14056, adding new terms under Section 3500.2, Definitions. Not only does this procedure require non-lawyer settlement agents in Illinois to engage in the unauthorized practice of law, it requires lawyers who represent sellers and also serve as settlement agents in Illinois to use the script and to <u>explain</u> such terms to buyers/borrowers on the other side of the real estate transaction, raising serious conflict of interest questions under the Illinois Rules of Professional Conduct. If an attorney representing a

seller and serving as a settlement agent explains legal terms and consequences to a buyer/borrower, is the attorney liable to that buyer/borrower for malpractice if the buyer/borrower does not understand (or says he did not understand) the import of what the lawyer said? Is the attorney required to make disclosures to and obtain consents from both the seller and buyer under Rule 1.7(a) or is the attorney governed by Rule 1.7(b) in this instance?

Or is neither Rule applicable because when HUD uses the term, "explain" HUD does not really mean to explain in detail and get into the legal consequences of the document? But if that is not what is required, why make the requirement at all? Perhaps HUD's hidden agenda is to drive practicing attorneys out of the settlement agent business entirely in the hope that more sellers and buyers will be unrepresented by counsel so the lenders can make more money at the expense of consumers. An alternative explanation is to take at face value HUD's recital at page 14055 that "This proposed rule does not … preempt state law…", mandating the conclusion that, at least in Illinois, settlement agents are NOT required to use the closing script.

HUD proposes to give lenders the authority to negotiate volume discounts with settlement service providers and to ease restrictions on lenders requiring that they disclose their ownership interest in settlement service providers under the guise of "protecting" consumers. Remember, lenders are the same people who brought us the current sub-prime mortgage debacle. Lenders are the same people who allege they were duped by mortgage brokers into making unwise loans. Lenders are the same people who invented the process of selling off poorly-underwritten loans to others who took the loss while they made hundreds of millions of dollars in profits. The only thing more stunning than the irrationality of allowing lenders so much control is the timing of HUD's proposal to do it!

HUD professes on page 14030 that the proposed changes are designed to protect consumers by encouraging them to compare prices and shop for settlement services. HUD selectively cites last year's GAO Report on Title Insurance (GAO-07-401), at page 14033 as recommending RESPA modifications and that HUD be given more enforcement authority. Interestingly, the GAO Title Insurance Report also includes a reference to a study indicating consumers cannot and will not shop for settlement services because the total cost of such services is so small compared to the other costs of a real estate transaction (GAO Report at page 22). The study referred to in the GAO Report also concluded consumers would not delay or disrupt a real estate transaction so shop for title insurance based upon price because the cost of title insurance is so small compared to other real estate transaction costs.

Moreover, as HUD itself admits on page 14100, "…consumers may not be the best shoppers for third-party service providers due to their lack of expertise and to the infrequency with which they shop for these services." HUD goes on to say (at page 14106), "Because of their lack of expertise, consumers may not be the best shoppers for third-party services providers, leaving them to rely on recommendations from … lenders." And yet, in a professed attempt to protect consumers, HUD suggests giving lenders even more control. As further evidence HUD's professed desire to protect consumers is merely window-dressing, on page 14105 HUD admits the title industry argued in favor of more specific and detailed disclosures of costs, but HUD's response was, "Itemization encourages a long list of fees that confuse borrowers." HUD's proposals are designed to tilt the playing field in favor of lenders, not consumers, a position that is simply not justifiable.

HUD alleges that "title fees account for over 70 percent of third-party fees" (at page 14101) and that "lender fees and title charges … total on average approximately four percent of the loan amount." If HUD is correct, title charges must comprise 2.8% of the loan amount. But the single biggest transactional cost to consumers for residential real estate transactions by far is the sales commission paid to real estate agents for the parties. Depending upon where one is located in the United States and the price of the home, the commission is likely to be some percentage of the sales price, generally between 4 and 7 percent. By HUD's own admission, total other settlement charges are roughly 4 percent of the loan amount. So on the sale of a $200,000 home with an 80% conventional loan, the real estate commission is between $8,000 and $14,000, while the other costs total only $6,400 and title charges (which HUD says are 2.8% of the loan amount) are only $4,480. In fact, the GAO Title Insurance Report (at page 22) cites a study indicating title insurance costs, on average, comprised a mere 4% of total closing costs (not 4% of the loan amount), including the real estate agent's commission! This is not to suggest real estate agents' commissions are too high. Clearly, however, consumers are far better off shopping among various real estate brokers and agents to generate savings rather than spending time and energy shopping to save such a pittance (remember: total title costs averaged only 4% of <u>total closing costs</u>, according to the study cited in the GAO Report on Title Insurance).

Several specific proposals are obviously designed to favor lenders at the expense of consumers. First, by allowing lenders to negotiate volume discounts, see page 14051, HUD assures consumers that there will be fewer settlement providers, not more, and, as a result, competition among those providers will decrease. When a single huge lender and a single huge settlement provider come to some volume-based discounted price, smaller settlement providers lacking the economies of scale to meet the price, will necessarily be driven out of business. When that happens, the single huge settlement provider, now provided by HUD with a virtual monopoly, will undoubtedly raise its prices. In the absence of competition, because HUD has intentionally driven competitors out of the marketplace, the price to the consumer will go up dramatically.

Second, such arrangements will permit lenders to disguise the fact that they are requiring consumers to use settlement service providers owned by the lender, generating additional profit for those lenders at the expense of the consumer. Contrary to the discussion on page 14052, loosening the definition of "thing of value" so discounts from affiliated companies are permissible will make it easier, not harder, for lenders to effectively "require" the use of one of their owned providers, simply because the discount is available to the lender but not to the consumer. HUD admits as much on page 14038: "HUD's current RESPA regulations require that the GFE include a list of any lender-required providers, including the name, address and telephone number of the provider and the nature of the lender's relationship with the provider. … HUD has determined to <u>eliminate</u> the requirement to identify the name of the required service provider, because it believes that consumers will use the GFE to shop among loan originators based on cost rather than on the identity of individual service providers." (emphasis added) So, despite HUD's acknowledgment that consumers are not the best shoppers for settlement service providers, HUD will let lenders hide the fact that they require the consumer to use a settlement service provider the lender owns! Permitting lenders to hide anything from consumers is a serious mistake. Not surprisingly, the GAO Report on Title Insurance found (at page 15) that the use of affiliated business arrangements (where a lender or other producer of title business owns an interest in the title provider) is growing. HUD's proposals encourage continued growth in

such arrangements.

Third, the entire concept of average cost pricing should be reexamined. On page 14050 HUD says, in effect, some charges may be higher than average and some lower, “provided that borrowers are being charged no more than the average price”. That notion is internally inconsistent, for the very concept of an average is that some people are charged more and some less and the total of all the money paid, divided by the number of transactions, gives the average price. By definition, very few will actually pay the exact average price and it is certain some will pay more. On the same page HUD says lenders will be permitted to negotiate discounts with settlement service providers as long as consumers are not charged more than the discounted price. But two sentences earlier, HUD said some people will pay more and some will pay less! Clearly there is much room for mischief here.

The changes to RESPA proposed by HUD should not be adopted. It may be that there are changes to RESPA that should be made. To the extent such changes are advisable, those changes are not contained in HUD’s proposals. Instead of proposing burdensome and inconsistent new rules, HUD should begin to enforce the rules already in place.

At the heart of the issues with RESPA and HUD’s attempt to regulate mortgage lending is the inability or unwillingness of the federal government to recognize that everything starts and ends with a sale of real estate that is located within the boundaries of a particular state. The transaction is subject to the laws of the particular state where the real property is located. The transaction is handled according to the laws and business customs of the state where the property is located. Even today, real estate may be the most parochial of all the fields of law. The real estate that is the subject of the sales contract has been where it is for millions of years. It will continue to be in that same location, in all likelihood, for a few million more years.

Years ago the land was bought, sold, listed for sale, built upon, occupied, appraised, taxed, financed, remodeled, demolished and rebuilt on all by people who lived within a very few miles of the real estate. Today, some of those participants are not so local and the federal government decided when RESPA was originally passed that such loans were a part of or had an effect on interstate commerce and thus were subject to federal regulation. That conclusion should not mean the underlying real estate transaction itself is also subject to federal regulation. Proposed changes to RESPA, if any, should recognize the constitutional principle of limited federal government, recognizing that those powers not specifically granted to the federal government are reserved to the several states. If interstate commerce is impacted, then regulate lenders in that regard and do not give lenders the unfettered ability to run roughshod over consumers while hiding additional sources of profit, especially when those lenders are the authors of our current economic crisis.

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