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The Real Estate Settlement Procedures Act: Disclosure of Fees to Mortgage Brokers

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Bruce E. Foote
Analyst in Housing
Economics Division

Abstract

This report provides an overview of one of the issues involving the Real Estate Settlement Procedures Act of 1974 (RESPA), which was enacted to prevent abuses in the settlement process for residential real estate. A current issue is whether certain compensation to mortgage brokers violates the anti-kickback provisions of RESPA. The present RESPA regulation is discussed, as well as the unsuccessful attempt to address the issues through a negotiated rulemaking. A summary and analysis of HUD's subsequent proposed rule is provided. Several class-action lawsuits have been filed that allege violations of the anti-kickback and anti-referral provisions of RESPA, and a bill, H.R. 1283, has been introduced in the House that would place a moratorium on certain RESPA class action suits. This report will be updated as regulatory or legislative action occurs.

The Real Estate Settlement Procedures Act: Disclosure of Fees to Mortgage Brokers

Summary

The Real Estate Settlement Procedures Act of 1974 (RESPA) was enacted to effect certain changes in the settlement process for residential real estate. These changes were expected to result in (1) more advance disclosure of settlement costs to home buyers and sellers, (2) the elimination of kickbacks or referral fees that tended to cause unnecessary increases in the costs of certain settlement services, (3) a reduction in the amounts that buyers are required to place in escrow accounts for the payment of property taxes and hazard insurance, and (4) reform and modernization of local recordkeeping of land title information.

The Department of Housing and Urban Development (HUD) was given the authority to prescribe the rules and regulations necessary to achieve the purposes of RESPA. The HUD regulations on RESPA are referred to as Regulation X.

HUD amended Regulation X in 1992, and one of the amendments provided that lenders are required to disclose to consumers all indirect fees that are received. Indirect fees are fees that are paid to the lender that originates a loan from the lender that purchases the loan. At issue is whether certain indirect compensation violates the anti-kickback provisions of RESPA and whether RESPA should be interpreted to require that the amount and nature of indirect compensation be disclosed to consumers.

HUD issued a proposed amendment to Regulation X in 1995. A negotiated rulemaking process was convened under which affected parties tried to reach consensus on the substance of a new rule to be promulgated by HUD. The negotiated rulemaking committee was unable to reach a consensus so the task of providing a new rule remains with HUD. HUD published a proposed rule on October 16, 1997, and the comment period ended on December 16, 1997.

In the meantime, several class-action lawsuits have been filed that allege violations of the anti-kickback and anti-referral provisions of RESPA. A broad class-action ruling against mortgage bankers could be costly.

The critical issue in the proposed regulation is the yet-to-be revealed test that will determine the reasonableness of mortgage broker fees.

Congressional options include letting HUD deal with any changes in the regulations while maintaining oversight of the current regulatory process; or enacting changes to RESPA. A bill, H.R. 1283, has been introduced in the House that would place a moratorium on certain RESPA class action suits.

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The Real Estate Settlement Procedures Act: Disclosure of Fees to Mortgage Brokers

The Real Estate Settlement Procedures Act of 1974 (RESPA) was enacted to effect certain changes in the settlement process for residential real estate. These changes were expected to result in (1) more advance disclosure of settlement costs to home buyers and sellers, (2) the elimination of kickbacks or referral fees that tended to cause unnecessary increases in the costs of certain settlement services, (3) a reduction in the amounts that buyers are required to place in escrow accounts for the payment of property taxes and hazard insurance, and (4) reform and modernization of local recordkeeping of land title information.

Section 8 of RESPA addresses the prohibition against kickbacks and unearned fees. Section 8(a) provides that "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 or a part of a real estate settlement service involving a federally related mortgage loan shall be referred to any person." Section 8(b) of RESPA provides that no person shall give and no person shall accept any portion, split, or percentage of any charge made or received for the rendering of a real estate settlement service in connection with a transaction involving a federally related mortgage loan other than for services actually performed. Section 8 (c)(2) permits the payment of fees if such fees are reasonably related to the goods, facilities, and services provided. Section 8(d) provides that violation of Section 8 of RESPA may result in fines of up to $10,000, imprisonment for up to one year, or both. In addition, affected consumers may be awarded damages of three times the amount paid for settlement services, plus the court costs and reasonable attorneys fees.

Section 17 of RESPA gives the Department of Housing and Urban Development (HUD) the authority to prescribe the rules and regulations necessary to achieve the purposes of RESPA. HUD also has the authority to grant reasonable exemptions from RESPA for classes of transactions, if HUD finds such exemptions are necessary to achieve the purposes of RESPA.

The HUD regulation covering RESPA was issued on June 4, 1976. The regulation is referred to as Regulation X and is found in the Code of Federal Regulations at 24 CFR Part 3500.

On November 2, 1992, HUD published a final rule that revised Regulation X.[1] This was the first amendment to the regulation since a minor revision in 1977, and

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[1] 57 FR 49600

the new rule contained several controversial requirements. One of those involved the disclosure of fees to mortgage brokers.[2]

When RESPA was enacted in 1974, the mortgage lending process was fairly straightforward. Generally, the lender managed the loan process from start to finish. The lender's employees took the loan application, processed the loan, and made the underwriting decisions. The loan was funded by the lender and closed in the lender's name. The loan was held in the lender's portfolio of loans, and the loan was "serviced" (receiving and crediting mortgage payments, handling the escrow accounts, etc.) by the lender.

In today's mortgage lending industry, new and different kinds of business entities have entered the field, and new business relationships have emerged between the entities. A massive secondary market has evolved under which mortgages are purchased from the original lenders, repackaged, and sold as mortgage-backed securities. New intermediaries such as mortgage brokers find people who want to borrow for home purchases and lenders with money to lend for home purchases. The lender that takes the application may not process the loan; the lender that closes the loan may not hold or service the loan. Lenders that originate the mortgages are referred to as "retail" lenders. The lenders that purchase the mortgages are referred to as "wholesale" lenders.

Thus, lenders who act as intermediaries may receive both "direct" and "indirect" compensation. Direct compensation encompasses the fees paid directly by the consumer. Indirect compensation consists of fees paid to retail lenders by wholesale lenders as compensation for the intermediary services performed. As mentioned above, since 1992, Regulation X has required that lenders disclose to consumers all indirect fees that are received. At issue is whether certain indirect compensation may violate the anti-kickback provisions of RESPA and whether RESPA should be interpreted to require that the amount and nature of indirect compensation be disclosed to consumers.

Current Regulations

The current regulation defines what constitutes a secondary market transaction. These transactions are exempt from RESPA, including its disclosure requirements, its prohibitions against kickbacks and referral fees, and its requirement that all compensation be reasonably related to the goods or services provided. Thus, depending upon how the loans are funded at settlement, the current regulations lead to somewhat different treatment of compensation to retail lenders under three settlement situations.

[2] A discussion of the other issues is found in CRS Report 97-241.

Loan Closing and Subsequent Assignment of the Loan

The retail lender processes the loan from start to finish, funds the loan, and closes the loan in its own name. At a later time, the lender sells the loan to a wholesale lender. Currently, Regulation X does not require that the lender disclose to the consumer the terms of the secondary transaction, including the compensation paid by the wholesale lender.

Loan Closing in the Wholesale Lender's Name

The retail lender originates the loan solely as an intermediary. The loan funds are provided by the wholesale lender, and the loan is closed in the wholesale lender's name. The wholesale lender sets the underwriting criteria and makes the underwriting decision. Regulation X requires that all payments to the retail lender, including direct and indirect fees, must be disclosed to the consumer.

Table Funding

The loan is processed by the retail lender and closed in the name of the retail lender. At or about the time of settlement, there is a simultaneous advance of loan funds to the retail lender by the wholesale lender, and an assignment of the loan and servicing rights to the wholesale lender. Regulation X requires that all payments to the retail lender, including direct and indirect fees, must be disclosed to the consumer.

Alternative Disclosure Methods

On September 13, 1995, HUD published a proposed rule that presented six alternative approaches to the disclosure of indirect fees under Regulation X.[3] HUD asked the public to comment on the six alternatives presented, to suggest other approaches, and to comment on whether disclosure of indirect fees is useful to consumers and should continue to be required. HUD also announced the commencement of a process to determine whether to establish a committee for negotiated rulemaking on the proposed rule.

Alternative 1

The first alternative is the status quo. Regulation X would continue to require the disclosure of all direct and indirect fees. A loan sale would continue to be classified as a secondary market transaction only if it occurs after settlement.

Alternative 2

Regulation X would continue to require the disclosure of all direct and indirect fees at settlement. Any loan sale before, contemporaneous with, or after settlement

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[3] 60 FR 47649

would be classified as a secondary market transaction. More loan sales would be treated as secondary market transactions, and exempt from RESPA coverage, than under alternative 1. A table-funded transaction would be treated as a secondary market transaction.

Alternative 3

Regulation X would continue to require the disclosure of all direct and indirect fees at settlement. Only loan sales following the first accrual date (the date the first payment is due from the borrower) would be classified as secondary market transactions. Under this alternative, more transactions would be subject to RESPA than under the current regulation. Table-funded loans and transactions closed in the name of the wholesale lender with no subsequent sale would be subject to RESPA requirements.

Alternative 4

Regulation X would require that only direct fees (no indirect fees) be disclosed at settlement. A loan sale would be classified as a secondary market transaction only if it occurs after settlement. Since no disclosure of indirect fees would be required, the classification of a transaction as a secondary transaction would only be determinative of whether RESPA's requirements and prohibitions (other than disclosure) apply to the transaction. Table-funded loans and loans closed in the name of the wholesale lender would be subject to RESPA.

Alternative 5

Regulation X would require that only direct fees be disclosed at settlement. A loan sale at any time would be classified as a secondary market transaction. As with Alternative 2, more loan sales would be treated as secondary market transactions, and exempt from RESPA coverage, than under alternative 1.

Alternative 6

Regulation X would require that only direct fees be disclosed at settlement. A loan sale would be classified as a secondary market transaction only if it occurs after the first accrual period. As with Alternative 3, more transactions would be subject to RESPA than under the current regulation.

Negotiated Rulemaking

In recent years, negotiated rulemaking has emerged as an alternative to having the regulations drafted unilaterally by the respective federal agency. Agency representatives and representatives of parties affected by the subject matter of the proposed regulation are brought together to negotiate the terms of the proposed rule. Ideally, the parties will examine their priorities and make tradeoffs to reach a consensus on the text of the rule. If a consensus is achieved, the resulting rule may be easier to implement and may be less likely to be the subject of subsequent litigation. If a consensus is not achieved, the process would have made the agency better informed of the issues.

On October 25, 1995, HUD published a notice of intent to establish a Negotiated Rulemaking Advisory Committee to negotiate a rule regarding mortgage broker fees under RESPA.[4] Establishment of the Negotiated Rulemaking Advisory Committee on Mortgage Broker Disclosures (the Committee) was announced on December 8, 1995.[5] The committee met for a two-day session once each month from December 1995 to May 1996.[6] On July 16, 1996, the HUD administrative law judge who presided over the committee issued a summary of the Committee's proceedings and highlighted the committee's accomplishments and failures.[7] The following is based on that summary.

The Committee was to advise HUD on two rulemaking issues: (1) whether the amount and nature of direct and/or indirect payments to mortgage brokers and certain other mortgage originators should be disclosed to consumers; and (2) whether RESPA permits volume-based compensation from wholesale lenders to mortgage brokers and, if so, whether and how the payment should be disclosed. HUD also sought views on whether other forms of indirect fees should be permissible under RESPA, and what the effect of requiring disclosure of such payments would be. In addition, because a secondary market transaction is exempt from RESPA, and because HUD could redefine that term to expand or contract the reach of RESPA's disclosure requirements and its requirement that all compensation be reasonably related to the value of the goods or services provided, the Committee was directed

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[4] 60 FR 54793

[5] 60 FR 63008

[6] In addition to a representative from HUD, representatives from the following 17 groups participated in the negotiations: America's Community Bankers, American Association of Residential Mortgage Regulators, American Bankers Association, American Financial Services Association, Citizen Action, Federal National Mortgage Association, Federal Home Loan Mortgage Corporation, Independent Bankers Association of America, Legal Counsel for the Elderly/American Association of Retired Persons, Mortgage Bankers Association of America, National Association of Federal Credit Unions, National Association of Mortgage Brokers, National Association of Consumer Advocates, National Association of Realtors, Office of the Attorney General of the State of Texas, Real Estate Services Providers Council Inc., and The Mortgage Capital Group.

[7] Alan W. Heifetz. Negotiated Rulemaking on Mortgage Broker Disclosures — Final Report. Memorandum to Nicolas P. Retsinas, Assistant Secretary for Housing, July 19, 1996, 7 p.

to consider whether to recommend any change in the definition of the secondary market.

Though the committee met for six two-day sessions, it was not possible to achieve consensus on a rule for HUD to publish because of the diverse positions taken by the members of the Committee. However, the Committee made progress on reducing the areas of disagreement and it achieved nearly unanimous agreement on a number of issues that should aid HUD in developing a rule for notice and further comment. Now, HUD is left with the task of making decisions on several issues: (1) whether to establish a RESPA Section 8 safe harbor for indirect fees paid by mortgage lenders to mortgage brokers, whether these fees should be disclosed and, if so, how they should be disclosed; (2) where to draw the line between RESPA-covered transactions and secondary market transactions that are exempt from RESPA; and (3) whether to permit wholesale lenders to pay volume-based compensation to retail lenders.

Indirect Fees

As mentioned above, currently Regulation X requires the disclosure of all fees paid to retail lenders, including the payments received from wholesale lenders (indirect fees), when the retail lender is being paid as part of the settlement process. HUD assumed that Congress intended for RESPA to cover only costs related to the initial settlement transactions, therefore disclosure of fees is not required when wholesale lenders subsequently purchase the loans.

With the exception of the National Association of Consumer Advocates (NACA), the Committee supported the development of a safe harbor approach to mortgage broker disclosure requirements.[8] Throughout the negotiations, NACA consistently opposed any rule that would provide that indirect fees paid to mortgage brokers would be exempt from scrutiny under RESPA.

The nearest to consensus any proposal reached with regard to indirect broker fees was a proposal that would establish a RESPA Section 8 safe harbor upon three conditions: (1) that the broker disclose at the time of application the nature of its relationship to the customer (the broker's duties and obligations to the consumer); (2) that the broker not provide any other settlement services to the customer and not be affiliated with any other provider of settlement services to the customer; and (3) that the broker be able to demonstrate in some manner that it is operating within the confines of a competitive marketplace.

There was no agreement, however, as to the treatment of mortgage brokers who did not meet the qualifications of the safe harbor. Three approaches were suggested: (1) consider the payment of any indirect fee to be a per se violation[9] of RESPA; (2)

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[8] A safe harbor may be defined as provisions that give protection from penalty as long as efforts were made to comply with the provisions.

[9] Per se violation is a term that implies that certain types of business agreements are considered inherently anti-competitive and injurious to the public without any need to (continued...)

presume the payment of any indirect fee to be a violation of RESPA; or (3) subject to a test of reasonableness any indirect fee. Under number (2), the presumption of a violation would arise once HUD demonstrated that an indirect fee had been paid. The burden would then shift to the broker to rebut the presumption. Under number (3), HUD would be required to show that an indirect fee had been paid and that it was not reasonably related to the value of the goods or services provided. The broker would then have to show that the fee was, in fact, reasonably related to the value of the goods or services provided.[10]

The Committee was also divided as to whether, for a broker to qualify for the safe harbor, the broker should always disclose the fees it was paid, or whether it should be able to avoid that disclosure where it is able to demonstrate the presence of a competitive market.

Consumer groups generally argue that indirect fees are kickbacks that are illegal under RESPA. The broker is paid by the borrower and the wholesale lender but the borrower does not know about the wholesale lender's part.

Secondary Market Transactions

As mentioned above, because a secondary market transaction is exempt from RESPA, and because HUD could attempt to redefine that term to expand or contract the reach of RESPA's disclosure requirements and its requirement that all compensation be reasonably related to the value of the goods or services provided, the Committee was directed to consider whether to recommend any change in the definition of a secondary market transaction. In other words, where should the line be drawn in distinguishing a primary transaction from a secondary transaction?

No consensus was reached on this issue. Mortgage brokers indicated that they would like the line to be drawn in terms of whose name is on the promissory note. They would define a "secondary market transaction" as any sale or transfer of a mortgage loan by the original lender. Other participants haggled over whether the line should remain as it is but with some additional clarification, or be pushed back to some fixed point after closing, such as 24 hours after funding or 72 hours after closing.

Some members expressed an interest in retaining the current definition. The Mortgage Capital Group proposed that HUD should focus on the definition of a primary transaction. Under this proposal, a primary transaction would occur when (1) the lender's name is on the loan, (2) the lender uses its own funds to make the loan (including a warehouse line of credit), and (3) the lender remains at risk on the loan until it is sold. It would follow then, that a secondary market transaction would occur when the loan is sold. As a counter-proposal, the National Association of Mortgage Brokers (NAMB) suggested that only the first and third elements need be

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[9] (...continued)
determine if the agreement has actually injured market competition.

[10] Heifetz memorandum, p. 4.

included in the definition. Thus, the NAMB definition would include the sale of a table-funded loan as a secondary market transaction.

The National Association of Realtors suggested that a secondary market transaction be deemed to have occurred whenever there has been a transfer of a closed loan. This definition would also include table-funded loans as secondary market transactions.

Volume-Based Compensation

Volume-based compensation is a payment of money or a thing of value that a retail lender receives from a wholesale lender, based on the number or dollar volume of loans that the retail lender sells to the wholesale lender in a given period of time. Volume-based compensation also includes volume discounts where (1) a retail lender is to provide a stated volume of loans to a wholesale lender, (2) the retail lender is given a lower "start rate"[11] than the wholesale lender's advertised rate, and (3) the retail lender keeps a differential between the start rate and the advertised rate as part of its compensation at settlement. HUD has never issued a Policy Statement on whether volume-based compensation is permissible under RESPA.

Suppose Lender A will give the mortgage broker higher fees if the broker completes X volume of loans for the lender within the next 6 months. Suppose Lender B does not provide a bonus for generating loans on its behalf, but Lender B offers better terms for the borrower than Lender A. If the mortgage broker arranges a loan with Lender B, the borrower will save money. If the mortgage broker arranges a loan with Lender A, the mortgage broker will be one loan closer to earning the bonus, and thereby earning more money than if the borrower were sent to Lender B.

Several issues are involved: (1) whether volume-based compensation should be permitted under RESPA, (2) whether volume-based compensation should be disclosed, and (3) whether the broker has a fiduciary responsibility to the borrower, and therefore must arrange the "best" terms for the borrower.

As with indirect fees, three approaches were suggested by the Committee: (1) consider the payment of any volume-based compensation to be a per se violation of RESPA; (2) presume the payment of any volume-based fee to be a violation of RESPA; or (3) subject to a test of reasonableness any volume-based compensation. Under number (2), the presumption of a violation would arise once HUD demonstrated that volume-based compensation had been paid. The burden would then shift to the broker to rebut the presumption. Under number (3), HUD would be

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[11] Assume that a wholesale lender's advertised rate is 8%, Broker A receives volume-based compensation and gets a start rate of 7.75%, Broker B does not receive such compensation, and both Broker A and Broker B deliver 8% loans to the lender. A part of Broker A's compensation would be based on the difference between the two rates. In essence the lender is permitting Broker A to deliver a loan with a lower interest rate than Broker B may deliver, but the lender is rewarding Broker A for delivering a loan at the 8% rate. If Broker B is to earn a bonus, it must deliver a loan with an interest rate higher than 8%. So, a start rate may be defined as the interest rate above that the broker may earn a bonus.

required to show that volume-based compensation had been paid and that it was not reasonably related to the value of the goods or services provided. The broker would then have to show that the compensation was, in fact, reasonably related to the value of the goods or services provided. No agreement was reached on which approach to take.

With the exception of NACA, the Committee agreed that volume-based payments should be permissible if a safe harbor were established for the payment of indirect fees by a lender to a broker, and the broker fulfilled the conditions that would entitle it to take advantage of the safe harbor.

Generally, opponents argue that volume-based compensation may lead to steering. The consumer's interest in being presented a range of loan options may be subverted by the broker's interest in receiving greater compensation from a particular wholesale lender. Additionally, it is argued that when retail lenders close loans above some threshold number, no additional service has been provided. Under this view, the extra compensation is tantamount to an unearned fee, and that is prohibited under RESPA.

The counter argument is that volume-based compensation may be an appropriate payment for services actually performed. Just as insurance companies offer better rates to large groups, wholesale lenders may offer volume-based compensation to retail lenders who demonstrate the ability to deliver a given quantity of high-quality loans. It is argued that assuming the loans are written under consistent standards, it may be less costly for a wholesale lender evaluate and process $50 million in loans purchased from one retail lender, than the cost of evaluating and processing $50 million in loans produced by several lenders. In this view, the single lender provides an economy of scale, and the cost savings are passed to the retail lender.

It is also argued that wholesale lenders operate in a competitive market. To obtain more market share the wholesale lenders may lower their prices to the retail lenders with demonstrated and dependable skills in marketing their product. Lenders argue that these discounts to top producers should not be defined as kickbacks. Brokers and mortgage companies argue that the payments are not tied to any specific loan but are based on volume over time. In this view, disclosure would be meaningless and impractical on an individual loan.

Community groups urge stringent and full disclosure of all fees paid to brokers by both consumers and lenders. They view volume-based compensation as a reward for steering. Though the retail lender may decrease costs for the wholesale lender, to reward the lender is a kickback, and it compromises the broker's duty to the borrower.

Consumer groups argue that brokers have a fiduciary duty to give allegiance to their principal — the borrower. NACA took the position that brokers are always borrowers' agents, and that payment of any indirect fee would violate state and common law agency principles. Mortgage brokers have argued, however, that it is possible for a mortgage broker to offer the loan products of other companies without committing itself to finding the "best" terms for the borrower. Prior to taking a loan application, a mortgage company could have the customer sign a disclosure form that stated (1) that the mortgage company was not the representative of the borrower, (2) that the mortgage company worked on its own behalf, (3) that the company offered the loan products of other lenders, and (4) that those products may not represent the best terms in the market.

Yield Spread Premiums

Retail lenders who provide “above-market” rate loans may receive another type of compensation from wholesale lenders. This compensation, which has become the most controversial, may have a variety of names. The most common are “yield spread premiums,” “yield spread differentials,” and “overage.” Generally, these terms refer to any compensation paid to or retained by a retail lender based upon the difference in the interest rate on the loan and some other benchmark interest rate. It compensates the retail lender for a loan priced at a rate higher than that at which the wholesale lender would have required otherwise. Again, the concerns regarding this form of compensation are whether it violates RESPA and constitutes kickbacks or fee-splitting for delivery of the loans.

In shopping for a mortgage loan, a borrower may compare the price (the range of interest rates and points) of offerings by several lenders. Alternatively, a borrower may obtain the services of a mortgage broker to find the best deal. The presumption is that the mortgage broker has relationships with a multitude of lenders, and will choose the one offering the best price to the borrower. Several class action lawsuits suggest, however, that the some brokers do not always obtain the best prices for the borrowers.[12] In *Culpepper, et al v. Inland Mortgage* the complainants argued that the lender violated Section 8 of RESPA by paying a yield spread premium to a mortgage broker. The Northern District Court of Alabama ruled that the lender did not violate RESPA. That decision was reversed on January 9,1998, by the Court of Appeals for the Eleventh Circuit. The higher court held that the yield spread premium was for a referral and did not qualify for the exemption for the “purchase of good” because “in a table-funded transaction, the lender, not the broker, owns the loan from the outset.” The appellate court also said that the yield spread premium did not qualify as a payment for services. The court ruled that “under the particular facts here, the yield spread premium was a prohibited referral fee under RESPA.”

In *Edwin and Sandra Mentecki and Floyd and Elaine Meyers v. Saxon Mortgage and Crestar Mortgage*, the complainants charge that instead of finding the best terms, the broker sent them to Crestar in exchange for a yield spread premium. A judge in the U.S. District Court in Alexandria has denied a motion to dismiss the class action, but has entered a stay pending an appeal to the 4th District Court of Appeals.

Other suits suggest that the brokers produced loans with interest rates and/or points that were higher than those required by the lenders, and the brokers earned extra fees because of the higher prices. The suits argue that borrowers who obtain

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[12] Groundbreaking RESPA Case Favors Mortgage Banking Industry. Press Release by Briggs and Morgan, P.A.

loans arranged by mortgage brokers should not have to negotiate the loan terms. It is argued that brokers have a fiduciary duty to find the best terms for the borrower. In addition, plaintiffs contend that failure to disclose any extra points amounts to fraud.

Some of the suits have been settled out of court, with the lenders agreeing to pay borrowers, but with no admission of wrongdoing on the part of the lenders. Other suits, however, are still active. The cost of noncompliance with RESPA may be high. Penalties can range up to $1,000 per incident, with a maximum of $500,000 or 1% of a servicer's net worth in class action cases.[13]

The Mortgage Bankers Association estimates that 56% of home loans in 1996 were made by mortgage brokers. The implication is that a prolonged dampening of this part of the mortgage market would be detrimental to potential homebuyers.

At a national mortgage servicing conference sponsored by the Mortgage Bankers Association of America, it was reported that, in an effort to limit their exposure to lawsuits, some lenders are only buying loans from mortgage brokers that have warehouse lines of credit.[14] Some brokers have responded by seeking warehouse lines of credit. If mortgage brokers obtain warehouse lines of credit and close the loans in their own names, the subsequent sale of the loans may be regarded as secondary market transactions that are exempt from the disclosure provisions of RESPA. Lenders and brokers were urged to ensure that the warehouse lines of credit are legitimate.

The Proposed Regulation

The proposed rule, released by HUD on October 16, 1997, would amend Regulation X (part 3500 of title 24 of the Code of Federal Regulations) in three places, and it would add an Appendix F. The first two amendments would revise the definition of "mortgage broker" to include a person who is the "exclusive agent of a lender." The third amendment would provide a "safe harbor" under which payments to a mortgage broker are presumed to be legal if specific requirements are met. One of the requirements would be that the mortgage broker and the prospective borrower complete and execute a mortgage broker contract, in the form specified by the new Appendix F.

Currently, Regulation X defines mortgage broker to specifically exclude a person who is an exclusive agent of a lender. The regulation also provides that a mortgage broker that is the exclusive agent of a lender does not have to provide a loan applicant with a good faith estimate of closing costs. The proposed rule would

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[13] Ted Cornwell. Servicers Need to Watch Out for Harbingers of RESPA Litigation. National Mortgage News, February 17, 1997. P. 10.

[14] Ted Cornwell. Warehouse Lines Protect Lenders. National Mortgage News, February 25, 1997, p. 25.

include such persons in the definition of mortgage broker, and require that they provide loan applicants with good faith estimates of closing costs.

The Safe Harbor

Under the "safe harbor" in the proposed rule, the payment to a mortgage broker (whether from a borrower or from a lender) would be presumed to be legal under Section 8 of RESPA, providing that the following four requirements were met:

(1) Prior to loan application or receipt of any payment, the mortgage broker and prospective applicant execute a mortgage broker contract in the form of Appendix F.

(2) The mortgage broker performs in accordance with the mortgage broker contract and make no representations that are inconsistent with the contract. A mortgage broker who indicates on the mortgage broker contract that "I am your agent and I will get you the most favorable mortgage loan that meets your stated objectives," would be required to get the borrower the most favorable mortgage loan that meets the borrower's stated objectives from among the sources of funds with which the mortgage broker discloses it will shop.

(3) In accordance with instructions for the HUD-1 settlement statement and instructions for the mortgage broker contract, the mortgage broker discloses its maximum total compensation along with the amounts of fees from the borrower and the lender.

(4) The mortgage broker has a valid license or registration, if the mortgaged property is located in a state that licenses or registers mortgage brokers.

The proposed rule provides that the terms of the mortgage broker contract may only be changed by written mutual agreement between the mortgage broker and the borrower. For transactions in which mortgage broker contracts are entered into and adhered to, and under which the other requirements of the rule are satisfied, all compensation to a mortgage broker would be regarded as having been paid within a safe harbor and such fees would be presumed to be legal under RESPA. If one or more of the requirements were not met, then the compensation would not be presumed permissible or legal. Even if all the requirements for the safe harbor were met, however, the presumption of legality may be rebutted if the total compensation received by a mortgage broker did not pass a test to be established by HUD and incorporated into the final rule. So, the proposal has two key components, (1) the mortgage broker contract, and (2) the "test" that would determine the reasonableness of the fees to be paid to the mortgage broker.

The Mortgage Broker Contract

Instead of a simple disclosure, HUD is proposing a binding mortgage broker contract. HUD argues that a "binding contract creates an enforceable remedy for the borrower and ensures that the terms indicated cannot be changed or superceded unilaterally by the mortgage broker.[15]

A one-page "honest lending contract" is proposed. The contract is written in plain English, and it is to be signed by a mortgage broker before a borrower applies for the loan. Mortgage brokers would check one of three boxes on the disclosure form describing their representation:

(1) **I Represent You**. I am your agent and I will get you the most favorable mortgage loan that meets your stated objectives. I will shop for your loan from among (number) lender(s). For my services, I will charge you a fee, but I will not receive any fee for your mortgage loan from a lender.

(2) **I Represent You, But I May Receive a Fee From a Lender**. I am your agent and I will get you the most favorable mortgage loan that meets your stated objectives. I will shop for your loan from among (number) lender(s). For my services, I may charge you a fee and I may also receive an additional fee for your mortgage from a lender.

(3) **I Do Not Represent You**. I am not your agent. I arrange loans from lenders and get paid by lenders and borrowers. I make mortgage loans available from one lender (name of lender); or among (number) lenders.

If a mortgage broker checks the first or second box, then that broker is representing the borrower, and the mortgage broker becomes obligated to find the "most favorable mortgage loan" that meets the borrower's stated objectives.

Other entries on the form would require listing of the maximum compensation that the mortgage broker would collect from both borrower and lender. One line states: "My Total Compensation will be made up of: (Fees You Pay me) and (Fees a Lender Pays me)." The back of the contract would inform consumers of their rights in the mortgage process.

The fees earned by mortgage brokers who use the contract would be presumed to be legal under Section 8 of RESPA unless their fees do not pass a test to be determined by HUD when the rule becomes final. The fees earned by mortgage brokers who do not use the contract would be presumed to be in violation of Section 8 of RESPA. This presumption may be rebutted if such fees are reasonably related to the value of goods and services provided.

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[15] 62 FR 53922

The Test

HUD asked for public comment on all aspects of the proposal, and asked for suggestions on what test or tests may be used to determine if certain fees are permissible under RESPA. The comment period ended on December 16, 1997.

HUD requested that the public suggest a quantifiable or otherwise objective test or tests for examining a mortgage broker's total compensation, because any test established for the final rule must allow mortgage brokers, lenders, and borrowers to determine with certainty whether the total compensation to a mortgage broker is legal.[16]

Suggestions could include defining the outer boundaries of permissible or legal total payments in terms of ranges or amounts, such as a specified dollar amount that could vary based on the size of the loan, or as a fixed percentage of the loan amount. If compensation exceeded a specified range or amount, the excess could rebut the presumption of legality under section 8 of RESPA.

The test could be based on comparing the total compensation received by a mortgage broker to the total compensation received for similar loans to borrowers of similar credit quality. This could be accomplished by establishing a baseline of the average market compensation for comparable loans for an immediately preceding time period. Any compensation for a loan that exceeded the baseline average by more than a specific amount could be used to rebut the presumption of legality.

A test could set criteria to establish the parameters of permissible compensation. For example, a test could provide that a yield spread premium is impermissible unless it is considered owned by, under the control of, and for the benefit of the borrower. The test could provide that a yield spread premium is impermissible based upon other fixed criteria. Any compensation that did not meet the established criteria would rebut the presumption of legality.

As mentioned above, any compensation to a mortgage broker is presumed to violate RESPA if the mortgage broker does not enter into the mortgage broker contract. This presumption may be overcome if the compensation is reasonably related to the value of the goods or services provided. HUD asked for suggestions on any other formulations that would clearly delineate between compensation that may be presumed legal and compensation that would violate RESPA.

Analysis of the Proposal

Though the proposal characterizes use of the mortgage broker contract as voluntary, use of the contract would appear to be virtually mandatory. Brokers who did not use the contracts would have to justify their fees in order to prove that the fees did not violate Section 8 of RESPA. It is unlikely that informed consumers would want to place loans with mortgage brokers who refused to sign the mortgage broker contracts. In addition, such brokers could face the prospect of consumer

[16] 62 FR 53923

lawsuits and would be in a weakened position to rebut a claim of misrepresentation. Therefore, it is likely that most brokers would find that it would be in their best interests to use the contracts.

Would a consumer be willing to take a loan from a mortgage broker that checked the third box — I do not represent you? One of the main reasons for the proposed rule is to provide consumers with some clarity regarding representation. In general, many consumers think that the mortgage brokers represent them, while the brokers feel that they only represent themselves. It might even be argued that many consumers want mortgage brokers to represent them. If a given mortgage broker is unwilling to represent the borrower, would the borrower accept that contract, or would the borrower seek a broker who would agree to representation? Would competition for borrowers force mortgage brokers to accept unwanted fiduciary relationships? Effectively, would mortgage brokers find that checking the third box would not be an option?

Mortgage brokers argue that competition would force them to check one of the first two boxes. It should be noted, however, that a similar situation exists in the real estate brokerage business. In the past, home buyers thought that the realtors were working for them, but the reality was that the agents were legally obligated to the sellers. Most states now require realtors to disclose their representation, and give home buyers the option of choosing "buyer's brokers" who are legally obligated to the home buyers. Initially, the industry was opposed to this approach, but now many realtors market themselves as buyer's brokers. Still, a large number of buyers use the traditional relationship when working with realtors. Conceivably, borrowers might do the same with mortgage brokers.

Currently, part 3500.14(g)(2) of Regulation X permits HUD to investigate high prices to see if they are the result of a referral fee or the split of a fee. The rule notes that high prices standing alone are not proof of a RESPA violation. If the payment bears no reasonable relationship to the market value of the goods or services provided, then the excess may be used as evidence of a violation of Section 8 of RESPA.[17]

Therefore, it could be argued that, since Regulation X already contains a provision authorizing the investigation of high fees, it would be unnecessary to establish a safe harbor test that establishes the boundaries of permissible payments. Similarly, it would be unnecessary to establish a test that compares a particular broker's compensation to that received on loans involving borrowers of similar credit quality.

The lending community, however, assumes that HUD would establish such tests, and accuses the Department of proposing price setting or price control. These are essentially "straw man" arguments since the proposed rule does not advocate any particular test. The preamble to the proposed rule notes that certain tests would be

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[17] Under the proposed rule, this part would not be amended, except that it would be designated as 3500.14(g)(3).

"unworkable and inconsistent with RESPA's legislative history against price-setting."[18]

At what point must prospective borrowers be provided with the mortgage broker contracts? Lenders rate borrowers according to their history of handling credit and their employment history. Borrowers rated at "A" are offered better terms than borrowers rated at "B" or "C". If the contract is signed before the borrower's history has been investigated, the stated fees may become meaningless given the borrower's particular credit and employment history. The contract would have to be nullified if the contract was based upon the assumption that the borrower would have an "A" rating, and it was found was that the borrower had a "C" rating. If the lender wanted to qualify for the safe harbor, a new contract would be required that showed the higher fees that the loan demanded, given the borrower's credit and employment history. In such situations, would lenders risk being accused of employing "bait and switch" tactics?

The lending community was hoping the proposed HUD rule would state that lender-paid mortgage broker fees are legitimate compensation under RESPA, while consumer groups were hoping the rule would state that such fees are illegal under RESPA. A statement in either direction may have obviated the need for further class action suits regarding the issue, and it may have contributed to the settlement of several of the existing cases. Instead, the proposed rule restates HUD's position that the determining factor is whether the total compensation to a broker is reasonably related to the value of the goods furnished or the services provided. So, the proposed rule does not address the questions regarding the legality of lender-paid fees to mortgage brokers.

Reaction to the Proposed Rule

Many lenders, in their letters to HUD regarding the proposed rule, urged that HUD refrain from amending regulation X at this time. They suggest that HUD wait for Congress to enact legislation that overhauls RESPA and the Truth in Lending Act.

Overwhelmingly, mortgage brokers are opposed to the proposed rule. They argue that since they provide more than 50 percent of the mortgages written in a given year, they must be doing something right.

A joint task force of the Mortgage Bankers Association (MBA) and the National Association of Mortgage Brokers (NAMB) have developed a model disclosure agreement. They recommend that HUD adopt their form in lieu of the proposed mortgage broker contract. Under the MBA/NAMB proposal, an applicant would agree to enter into a "Mortgage Loan Origination Agreement" with the broker acting as "an independent contractor to apply for a residential mortgage loan from a participating lender with which the broker from time to time contracts upon such terms and conditions as the applicant requests or a lender may require." Sections 1 and 2 of the MBA/NAMB-recommended form is as follows:

[18] 62 FR 53919

SECTION 1. NATURE OF RELATIONSHIP. In connection with this mortgage loan:

- We are acting as an independent contractor and not as your agent.
- We will enter into separate independent contractor agreements with various lenders.
- While we seek to assist you in meeting your financial needs, we do not distribute the products of all lenders or investors in the market and cannot guarantee the lowest price or best terms available in the market.

SECTION 2. OUR COMPENSATION. The lenders whose loan products we distribute generally provide their loan products to us at a wholesale rate.

- The retail price we offer you — your interest rate, total points and fees — will include our compensation.
- In some cases, we may be paid all of our compensation by either you or the lender.
- Alternatively, we may be paid a portion of our compensation by both you and the lender. For example, in some cases, if you would rather pay a lower interest rate, you may pay higher up-front points and fees.
- Also, in some cases, if you would rather pay less up-front, you may be able to pay some or all of our compensation indirectly through a higher interest rate in which case we will be paid directly by the lender.

We also may be paid by the lender based on (i) the value of the Mortgage Loan or related servicing rights in the market place or (ii) other services, goods or facilities performed or provided by us to the lender.

The MBA and NAMB suggest that HUD adopt their one-page form as the standard form disclosing representation and compensation.

Some consumer groups are opposed to the proposed rule but for different reasons than the mortgage brokers. Such consumer groups consider certain lender payments to mortgage brokers as violations of RESPA prohibitions against kickbacks, regardless of whether such payments are disclosed. Accordingly, the groups view the proposed rule as sanctioning illegal kickbacks. HUD argues, however, that disclosure of fees does not make such fees legal.

An Economic Analysis of the Issues

Mortgage lenders might argue that they operate in a competitive market, and that the market works best when government intervention is limited. One of the tenets of a competitive market, however, is that consumers have adequate information on the availability of goods and services and the prices of such goods and services to make rational decisions on purchases. Finding this information is relatively easy for products that are purchased often, such as bread, eggs, and gasoline. There is little cost in trying different brands until one is found that satisfies the objectives of the purchaser. The "penalty" for a wrong purchase is relatively small. Other products, such as televisions, refrigerators, automobiles, are not purchased very often and the information problem is more difficult. It may not be practical or permissible to try out different brands to find the one that meets the consumer's needs. Another class of goods and services are not purchased very often, but pose greater informational problems because, even when information is available, it may be difficult to understand, interpret, and evaluate.[19] The purchase of money to buy, improve, or refinance a home falls into this category. (Obtaining a loan to finance a home may be regarded as purchasing money.)

Information is regarded by economists as a "public good."[20] A market, by itself, will not produce an optimal amount of information. When markets do not provide the quality of information that consumers need, then purchases may be made based on ignorance and misinformation. The market outcome of these transactions may not be ones that are regarded as in the best interests of the society at large. In the case of mortgage brokers, the information is asymmetric — the brokers have more complete information than the borrowers. The brokers may be able to take advantage of this difference in information by charging the borrowers more than would be charged if the borrowers had complete information. The purpose of RESPA is to ensure that the consumer is provided with information to make an informed choice in a transaction that, for many, will be the only such transaction in their lifetime. Thus, it often falls to government to improve the circumstances under which information is provided, in order to help markets function more efficiently.

In addition, every purchase or sales agreement is a contract with both explicit and implicit terms. Often courts have to determine the implied terms of the contract when, after the fact, the buyer and seller disagree over them. Court determination of these terms, however, can impart uncertainty to the market — buyer and sellers may find that they legally agreed to terms they were unaware of at the time of sale. One remedy is through regulations that clarify the implied terms or that require the terms be specified.

The provisions of Regulation X are designed to address both of the issues described above — the provision of sufficient information and the fuller specification of implied terms. By requiring the mortgage broker contract, HUD hopes to remove any ambiguity about the role of the mortgage broker. The consumer would know in advance something that the consumer had previously assumed — whether the broker is the agent of the consumer. The proposed rule is also designed to widen the scope within which consumers receive information. The proposed test is intended to provide a clear indication of whether RESPA has been violated.

The difficulty with regulations, however, is that they tend to be inflexible, and thereby reduce the ability of the market to respond to the needs of individual

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[19] Davis, Otto A. Davis and Martin I. Kamien. Externalities, Information and Alternative Collective Action. In Haverman, Robert H. and Julius Margolis, eds. *Public Expenditure and Policy Analysis*. Chicago, Rand McNally College Publishing. 1976. p. 82.

[20] Public goods may be defined as goods, such as television signals, whose use by one consumer does not diminish their availability to others.

situations. While volume-based compensation clearly creates incentives for brokers to steer customers, it may be advantageous to costumers if part of the discount is passed to the customers. In that case, the implicit fee to the broker would not be a sign that the customer got less than the best deal.

Basically, there are two components to the price of mortgage loans. One component is the interest rate charged on the loan and the other component is the "points" paid. A point is 1% of the mortgage amount. The charging of points enables a lender to fine tune the yield on the loan, and obtain up front funds for the cost and risk of issuing the loan. Suppose the market rate of mortgage interest were 8%. If a borrower obtains a $100,000 loan at 8%, and pays 2 points to the lender, the actual yield to the lender would be higher than 8% (it would be about 8.21%). This is because, in effect, the borrower only received $98,000 but is making payments as if $100,000 were received. If the borrower wanted a 7.5% loan and were willing to pay 6 points, the yield to the lender would be about 8.14%. If the borrower were short of funds and were willing and able to pay a higher interest rate, the lender might be willing to pay $4,000 of the borrower's closing costs, make a loan with an interest rate of 8.5%, and obtain a yield of about 8.08%.[21]

The problem with yield spread premiums is that (to use the example above) the borrower may be getting an 8.5% loan when the market rate is 8%, and the $4,000 that could be going to the borrower may instead be used to compensate the mortgage broker. This is why the most critical part of the proposed rule is the test, and that is the very part that is not yet known. If the test is numerical range of permissible compensation, it may indeed act, as brokers claim, as something very much like a price ceiling. The implications of a test may be very different, however, if it identifies impermissible ways the broker may be compensated.

Legislative Options

HUD is examining the comments received regarding the proposed rule and is expected to issue a final rule on the subject.

Options for Congress include (1) maintaining oversight of the current regulatory process, (2) enacting legislation that amends RESPA and clarifies the issues, or (3) enacting a moratorium that, for a specified time period, prohibits the courts from certifying any more class action suits involving mortgage broker fees.

At a 1997 conference of the New York Association of Mortgage Brokers, Representative Lazio, Chairman of the Subcommittee on Housing and Community Opportunity of the House Banking Committee, told attendees not to expect much help from Congress on RESPA.[22] Attendees were urged to do more for borrowers, and to move the discussion away from the broker's own compensation.

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[21] The actual yield to the lender will be lower to the extent that a portion of the points paid by the consumer are used to compensate the loan originators.

[22] Congress Won't Rescue Brokers. Origination News, March 1997. Pp. 1, 28.

Some in the mortgage industry have been urging Congress to enact a moratorium that, for a specified time period, would prohibit the courts from certifying any more class action suits involving mortgage broker fees. In response, the Real Estate Settlement Procedures Act Class Action Relief Act of 1997, H.R. 1283, has been introduced in the House. The bill would amend RESPA to place a moratorium on any state or federal lawsuit that arises out of the allegation that RESPA has been violated through a payment by a lender to another lender or to a mortgage broker. From the date of enactment of the bill through December 31, 1998: (1) no party would be required to serve or respond to any discovery concerning any class certification issue, (2) no state or federal court would be permitted to enter an order certifying any class except an order that would terminate the class action by mutual agreement of the parties, and no state or federal court would be able to impose sanctions on any party for failure to comply with any discovery, and (3) state and federal courts would be required to stay further proceedings in any action in which the order certifying the class was entered into on or after January 1, 1996, except for proceedings that would terminate the class action by mutual agreement of the parties. To date, no action has been taken on the bill.

As mentioned above, many lenders, in their letters to HUD regarding the proposed rule, urged that HUD refrain from amending Regulation X at this time. They suggest that HUD wait for Congress to enact legislation that overhauls RESPA and the Truth in Lending Act.

RESPA was enacted to address abuses in the mortgage market as it existed in the 1970s. Today's mortgage lending industry has new and different kinds of business entities, and new business relationships between them. These entities and these relationships were not foreseen in 1974. Thus, HUD and the courts have the difficult task of trying to interpret RESPA for relationships and actions that did not exist and were not foreseen when the legislation was enacted. Supposedly, in Spring 1998, HUD will be submitting to Congress proposals for amending RESPA. In the meantime, more than 20 industry, agency, and consumer groups have formed the Mortgage Reform Working Group to develop proposals to overhaul RESPA.

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