Regulation in Housing Finance: Bringing Theory to Policy*

STANLEY D. LONGHOFER
Department of Finance, Real Estate, and Decision Sciences, Barton School of Business, Wichita State University, 1845 Fairmount, Wichita, KS 67260-0077
E-mail: stan.longhofer@wichita.edu

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1. Introduction

In recent years, a great deal of academic research has been devoted to policy questions surrounding the debate over discrimination in mortgage lending. In large part, this has been due to new data made available through the Home Mortgage Disclosure Act and to the controversial conclusions of the path-breaking and now well-known Boston Fed Study (Munnell et al., 1992, 1996).

While mortgage discrimination is clearly a visible and important issue, it is only one of many housing-finance policy issues with which policymakers and regulators must grapple on an ongoing basis. Unfortunately, the regulations that enforce legislation like the Real Estate Settlement Procedures Act (RESPA), the Truth in Lending Act (TILA), and the Community Reinvestment Act (CRA) have historically been developed with little input from rigorous economic analysis. In the same way, current policy debates over the recent growth in subprime lending, the emerging use of credit-scoring models, and the appropriate scope of government support for secondary market agencies would all benefit from more careful economic scrutiny.

In an effort to address these issues with academic rigor, the Federal Reserve Bank of Cleveland and the Journal of Real Estate Finance and Economics jointly sponsored a conference on regulation in housing finance in May 2000. The conference consisted of three sessions on regulatory issues in the housing-finance industry: RESPA reform, the impact of secondary market activities on primary mortgage market outcomes, and measuring the tangible effects of CRA and related regulations. The articles in this volume are the product of this conference.

This gathering had the explicit goal of bridging the divide between the theoretical and the pragmatic—of using rigorous economic analysis to identify specific insights that could help form effective regulatory policy. In light of this objective, the discussants for each session were selected in part because of their practical experience in dealing with the policy questions at hand. Accordingly, they contributed more than the traditional critique of individual articles by illuminating the larger policy issues involved and identifying the
contribution each article in the session makes in these debates. Perhaps most important, the discussants were asked to suggest how future research might help further guide policy decisions. Because their insights played a central role in achieving the conference’s main goal of bridging the gap between theory and policy, their comments have been included in this special issue of the *Journal*.

In this introduction, I briefly review the articles contained in this volume and the lessons they offer for policy formation. More broadly, I hope this article and this volume will help identify regulatory issues that deserve further academic study and inspire more researchers to devote their efforts to these topics.

Session 1: RESPA

The stated goal of RESPA is to “insure that consumers throughout the Nation are provided with greater and more timely information on the nature and costs of the settlement process and are protected from unnecessarily high settlement charges caused by certain abusive practices that have developed in some areas of the country.” To this end, the legislation employs two broad tools to regulate behavior by mortgage lenders and other service providers.

The first is disclosure. Among other things, RESPA requires lenders to provide potential borrowers with a good-faith estimate of settlement costs within three business days after the application is received. Furthermore, borrowers must be allowed to inspect the HUD-1 settlement statement that outlines the actual charges that will apply at least a day prior to closing. In addition, further disclosures regarding ongoing escrow accounts and mortgage servicing are required after the loan has been originated. Through these disclosures, it is hoped that consumers will be better able to make informed decisions regarding their choice of service providers.

The second broad element of RESPA is the regulation (prohibition) of certain abusive practices, including the payment of kickbacks to real estate agents for referring customers. While policymakers have traditionally presumed that referral fees (a less pejorative term than *kickbacks*) are inherently harmful for consumers, most economists would generally argue that such transfers are innocuous, as long as their presence is disclosed.

In the first article in this volume, Peter F. Colwell and Charles M. Kahn show that neither of these presumptions is necessarily true. In short, they argue that the services provided around a mortgage closing are quite likely to entail fixed costs that are high relative to the variable costs of serving any single customer. As a result, allowing service providers to pay middlemen referral fees encourages more of them to enter the market and ultimately benefits consumers. Even more striking—and perhaps contrary to prior intuition—they find that requiring middlemen to disclose the presence of these referral fees may actually make consumers worse off, once again because fewer providers will find it profitable to serve the market.

As John C. Weicher and David Fynn point out in their comments on this article, these conclusions effectively turn the basic rationale underlying RESPA on its head. Nevertheless, the logic of Colwell and Kahn’s argument is compelling, following directly