Comment: The Economic Functions of Referrals and Referral Fees

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Real estate transactions are the largest single purchase that most individuals will ever undertake. For this reason, the role of middlemen in such transactions is the subject of scrutiny. Individual borrowers want and need to be sure the transaction is fair. Brokers want to ensure their income by charging fees for services provided, and service providers want their fair share of transactions that are in the hands of the middlemen.

The joint concept of disclosure and informed consumers have formed the basis of the regulatory framework for the past 30 years. The theory is that consumers are able to make meaningful comparisons, and in fact they do make those comparisons in their shopping for financial products and services. For the most part, this regimen has served consumers well when it is used as intended. Recent discussions of the consumer disclosures mandated by Regulations Z and M illustrate this: the disclosure of an APL is intended to provide the consumer with the ability to make a meaningful comparison between a loan and a lease transaction. Whether consumers actually exhibit this rational behavior with any degree of consistency is a topic for another, less theoretical research paper. Recent discussions about reforming the Real Estate Settlement Procedures Act (RESPA) and the Truth in Lending Act (TILA) have attempted to provide purchasers in real estate transactions with a simpler and more meaningful set of disclosures. Current public policy is guided by the principle of an informed consumer who, with the appropriate tools, can make decisions that are the result of comparisons between terms offered by a variety of service providers.

In “The Economic Functions of Referrals and Referral Fees,” Peter F. Colwell and Charles M. Kahn raise a legitimate challenge to the conventional theory. Their theoretical article examines the role of middlemen in real estate transactions. Specifically, it examines the fees that might be charged in such transactions if they were not prohibited by RESPA. Among its other requirements, RESPA prohibits the payment of referral fees in real estate transactions, permitting only specific fees that are directly related to the provision of services. Fees must reflect the actual costs of providing services, and neither the middleman nor the lender is permitted to mark up the fees of the service provider unless specific additional services are provided.

Disclosure has been at the core of consumer policy for the past 30 years, since the passage of the Truth in Lending Act. Consumers’ right and ability to make informed decisions, using appropriate tools that have been prescribed by law to facilitate his understanding, is fundamental. Colwell and Kahn, however, propose that not only are there situations where RESPA’s fee prohibitions might be socially undesirable; there are situations where it may not be desirable to disclose them to the borrower.
Building on the middleman’s ability to create value by reducing the cost to the borrower, Colwell and Kahn create a well-reasoned theoretical model to support their hypothesis. One aspect of the analysis that is not considered is the borrower’s opportunity cost: Which transactions involve middlemen simply because of opportunity cost? In cases where the borrower is simply using the middleman due to time constraints or other more profitable opportunities, one of the article’s fundamental assumptions is challenged. In some transactions, this may in fact support the theory that informed borrowers may use middlemen simply to conduct the transaction and that if the transaction costs are less than the opportunity costs, referral fees (disclosed or not) are of little or no consequence.

The article assumes that the middleman’s advantage dissipates in the course of providing the service, but this is not necessarily so. Because the middleman’s role is to match clients with the right package of service providers, subsequent transactions may require a different combination of service providers. Consider a first-time homebuyer who would benefit from first-time homebuyer funds. In a later transaction, the same lender may not be the best service provider. In such circumstances, the use of a middleman may well be justified—if not necessary—because new circumstances warrant a new selection of service providers.

The article makes the valid point that RESPA’s prohibitions appear to disproportionately burden small service providers. The small service provider, limited by the costs of entry into the market, is less able to compete. Fewer service providers result in less competition and therefore in higher costs to borrowers. This is supported by a brief discussion of the controlled business arrangement rules, which do not permit fees per se but allow the profit in the transaction to be retained. Larger providers who are able to offer multiple services through related entities can capture and retain greater proportions of fees at lower costs, thus gaining a competitive advantage. Under the disclosure rules, RESPA simply requires the disclosure of the relationship. Legitimate fees for services actually provided are permitted, and the profit from the transaction is retained. Although there is no disclosure of the amount of profit retained, the disclosure of the amount of the fee, in theory, enables the borrower to shop for the most cost-effective bundle of services. Again, a more empirical article might shed significant light on actual consumer behavior.

The article’s weakness, in my opinion, lies in the results that lead from the assumptions stated at the outset of the presentation itself. The results of the assumptions do not necessarily follow, particularly if the middleman’s role is to identify the right service provider. The right provider may not be the lowest-cost provider. Further, the authors state, “Customers may prefer to purchase in a market in which middlemen as a matter of practice do not reveal information about any particular referral payment.” It is not clear that this result follows from the assumptions. The authors’ note 6, however, identifies the essential dilemma: “Of course, each customer individually would also prefer that the middleman quietly make an exception to this practice in his case.” If that point is valid, then the short-term interests of each customer will always outweigh the larger, socially desirable objective of containing costs and facilitating market entry for small and specialist providers. Customers will try to secure a slightly better deal, better understand the middleman’s costs, or at least ensure that their particular deal is fair. The article