RESPA and Online Mortgage Lending (with Glossary)

Grant E. Mitchell and Robert M. Jaworski

Online residential mortgage lending is subject to Federal legislation prohibiting referral fees in residential mortgage lending.

THE REAL ESTATE SETTLEMENT PROCEDURES ACT ("RESPA"), 12 U.S.C. §2601 et seq., is a far-reaching Federal law that was born in December, 1974, and which applies to almost all residential loan transactions, whether they are undertaken by pen, typewriter, computer, or—of course—the Internet. RESPA requires disclosures in covered transactions, it provides criminal and civil penalties for those who fail to follow the rules, and with substantial frequency, it also referees who wins and loses in the mortgage loan business. The appendix to this article sets forth some commonly used terms described in RESPA and online mortgage lending.

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RESPA REFERRAL FEE PROHIBITION • On the issue of referral fees**,** RESPA is deceptively simple. RESPA §8, 12 U.S.C. §2607 and Regulation X, 24 C.F.R. Part 3500, prohibit a person from paying or receiving a "thing of value" under any "agreement or understanding" that business incident to a "settlement service" involving a "Federally-related mortgage loan" shall be referred, and this includes loan origination, defined as taking of loan applications, loan processing and the underwriting and funding of such loans. 12 U.S.C. §2607(a); 24 C.F.R. §3500.14(b).

With limited exceptions, Regulation X provides that "any referral of a settlement service is not a compensable service." On the other hand, RESPA §8 never prohibits a payment by a lender to its duly appointed agent or contractor for services actually performed in the origination, processing, or funding of a loan, or a 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." 24 C.F.R. §3500.14(g)(1)(iii) and (iv).

The dilemma in the e-commerce world (and frequently the paper-commerce world) is that the prohibitions in RESPA §8 run contrary to the business generation instincts of the "marketing people." "If I can get enough eyes to my site who eventually translate into customers for a lender, why shouldn't I be well-rewarded for my success?" Similar questions have been raised since the dawn of RESPA. California case law involving commercial real estate transactions allows finder's fees to be paid. *See, e.g., Preach v. Rainbow*, 16 Cal. Rptr. 2d 320 (Cal. Ct. App. 1993). Many believed they should be permissible in residential real estate transactions as well. The Department of Housing and Urban Development ("HUD") said no, they were not permissable. Letter from Robert Hollister dated February 25, 1978, Paul Barron & Michael Berenson, *Barron's Federal Regulation of Real Estate and Mortgage Lending* Opinion 30 (4th ed. 2001). Later, HUD also disallowed payments by a lender to real estate brokers, even though a state regulatory board allowed them. Letter from Grant Mitchell dated February 8, 1994, collected in Barron's, *Federal Regulation of Real Estate and Mortgage Lending*, Fourth Edition, New Opinion 4. Economists occasionally suggest that a paid referral is cheaper than requiring a business to sift through a sea of uninterested persons to find the few that care for its product.

Nonetheless, this view has not prevailed in the residential real estate regulation context, and this may be because the precept that "a man's home is his castle" has been transmuted into the official policy of the Federal government, and perhaps, the state governments as well—witness the special tax treatment accorded home purchase costs, the ongoing subsidy in the Internal Revenue Code ("IRC") for interest paid during the life of the loan, the elimination of capital gains on residential property for all but the most expensive homes, and the nurturing of a well-established and well-funded secondary market to provide liquidity for home loans.

Seen in this light, it is not surprising that a potential homebuyer and homeowner, who, when RESPA was first passed, was an infrequent venturer into home finance, would be accorded special consumer protections by the Congress. And despite wishful thinking that cyberworld is so clear, so simple, and so representative of the working of a perfect market that fraud and calumny will disappear, this is not yet proven and the laws of the paper world, including RESPA, are likely to remain.

In addition to the RESPA rules, which were substantially revised in 1992, 57 Fed. Reg. 49600, November 2, 1992, there have been three important issuances from HUD that bear on online mortgage lending. They are:

• The February 14, 1995 Letter from Nicolas Retsinas, HUD Ass't. Secretary for Housing, collected in Barron's *Federal Regulation of Real Estate and Mortgage Lending*, Fourth Edition, ("IBAA Letter") that itemizes a number of common origination services and sets forth a minimum number of services that a person would have to perform to justify compensation in a mortgage lending transaction ("IBAA test");

• The Computer Loan Origination Policy Statement of 1996 ("CLO Statement"), 61 Fed Reg. 29255 (June 7, 1996), which sets forth broad policies showing how HUD views computer loan originations; and

• The HUD Policy Statement 1999-1 Regarding Mortgage Broker Fees (Broker Fee Statement), 64 Fed. Reg. 10,080 (March 1, 1999), which sets forth important principles regarding compensable goods and services and cross-references the IBAA Letter as providing useful information regarding compensable services. This statement was reaffirmed in HUD Policy Statement 2001-1, 66 Fed Reg. 53,052 (Oct. 18, 2001).

In this article, we will examine some common questions concerning the legality under RESPA §8 of certain practices connected with the marketing of mortgage loans in the e-commerce world. Using the HUD pronouncements mentioned above as a guide, the article will attempt to provide answers to these questions, or at least some thoughts on how HUD might be expected to deal with them.

Some Questions and Answers Regarding Internet Lending

Question 1. Suppose a lender enters into an agreement with a Web site operator whereby the Web site operator creates a "hyperlink" on its Web site by which visitors can "click through" to the lender's Web site and be offered a special program of rates and terms? May the lender pay the Web site operator a fee based on the number of people who visit the Web site operator's web site, or on the number of people who "click through" to the lender's Web site, or who both "click-through" to the lender's Web site and proceed further in the application process? How much of a fee can be paid by the lender to the Web site operator?

Answer: Payment based on the number of people that visit the Web site operator's Web site would appear analogous to payment for the placing of an advertisement in a newspaper or magazine, with the cost of the advertisement being based on the publication's circulation numbers. HUD has never questioned such payments, which, it seems, can rather convincingly be characterized as payment for a "good" (advertising space) or for "services" (the service of disseminating information to the public about the lender's products).

In addition, in 1994, HUD informally approved payments for a list of potential customers ("Prospects List Letter"). Letter dated March 24, 1994 from Grant E. Mitchell, Barron's *Federal Regulation of Real Estate and Mortgage Lending*, Fourth Edition. "Payment for a 'prospects' list does not violate RESPA. "It seems that a payment to the Internet Web site operator based on the number of "click thrus" can be perceived as payment for a stream of prospects, at least insofar as there is no obvious "endorsement" of the lender and/or its products by the Web site operator. The Prospects List Letter indicates that there is no violation "so long as the payment…is not further conditioned upon…an endorsement of the product being offered by the seller of the list." These payments would undoubtedly have to be minimal, say, a maximum of several dollars per item, and payments for comparable prospects list or advertising rates in the industry would likely be used for comparison.

Similarly, conditioning payment of the "click-thru" fee on the visitor providing his or her name, e-mail address, and telephone number would not appear to violate section 8 of RESPA. Under the "payment for a prospects list" analo-

gy, the Prospects List Letter itself recognized that the payment was not just for the prospect's name but for the information to enable the purchaser of the list to contact the prospect.

On the other hand, if the payment of a "click-thru" fee (presumably enhanced in amount) is conditioned on the visitor taking some further action, such as filling out a loan application or closing a loan, this would seem to go beyond the circumstances described in the Prospects List Letter, and could lead to a conclusion that the payment was not for a prospect but for a referral in violation of section 8(a) of RESPA. Therefore, to safely receive greater payments, it would appear that the Web site operator would have to be in a position to undertake or contract to perform, and actually perform, settlement type services.

Question 2. If only minimal fees can be paid for click-thrus, how can the Web site operator legally earn greater fees? Must the Web site operator perform a variety of loan services as specified in the IBAA letter to receive more substantial compensation, including (say) a flat fee or a percentage fee per loan? Would such an arrangement meet the safe harbor provisions of 24 C.F.R. §500.14(g)(1)(iii) and (iv)?

Under the IBAA test. It appears arguable that payments to the Web site operator of a flat fee for, or a percentage of the amount of, each loan originated through the Web site operator's Web site could only be characterized under the IBAA test as a permissible payment by the wholesale lender if the Web site operator is performing or arranging for performance of origination-type services. The test for compensability would be whether the services provided by the operator satisfied the threshold level of origination services set forth in the IBAA Letter (listed services).

Some relatively ministerial duties that the Web site operator can undertake would include taking the borrower's application, initiating/ordering verifications of employment and deposits, initiating/ordering requests for mortgage and other loan verifications, initiating/ordering appraisals, and ordering flood certifications. In addition, the Web site operator could also be seen as performing "counseling services" for the borrowers through the display on its Web site of detailed information concerning the loan rates and terms available from the wholesale lender, and through its display and maintenance of a toll-free telephone number through which a consumer can obtain additional information and/or answers to questions concerning, possibly, the home buying and financing process, how closing costs and monthly payments would vary under each product, what credit problems the consumer might have and how they may be cleared, and the like. Since these activities arguably include the taking of a loan application and at least five additional listed services, you could conclude that the services provided by the Web site operator to the wholesale lender would meet the first part of the IBAA test and would therefore be compensable.

Whether the fee paid to the Web site operator would satisfy the second part of the IBAA test, i.e., whether it can be seen as reasonably related to the services actually provided, would depend on whether comparable fees are paid under similar marketing arrangements. To support the reasonableness of the fee paid to the Web site operator, market data showing that the fee is in fact competitive in the marketplace for similar services in the geographical regions in which it is offered would be needed.

In the Broker Fee Statement, HUD cautioned that the IBAA Letter is not dispositive in analyzing more costly mortgage broker transactions where more comprehensive services are provided. The particular program reviewed by HUD in the IBAA Letter involved the performance of six listed services in return for a flat fee of about $200. 64 Fed Reg. 10085, fn. 6. To achieve a higher fee, the Web site operator should arguably

perform more than six and, to be safe, as many of the listed services as possible.

Under the CLO Test. The Web site operator's Web site could be viewed as constituting a CLO as defined in the CLO Statement, that is, a computer system used by a consumer to facilitate choice among alternative lenders and/or loan products offered in connection with a particular RESPA covered real estate transaction. The Web site provides to consumers who visit them almost all of the information and services identified by HUD in the CLO Statement as being representative of the information and services provided through a CLO.

Although the Web site may apparently be characterized as a CLO if listed services are being performed via the Web site, it may be more appropriate to analyze the services under the Broker Fee Statement and the IBAA test rather than under the CLO Statement. This is because:

- In the circumstance where the borrower and lender are brought together and an application is taken through the Web site, the Web site might be considered to meet the definition of a "mortgage broker" in Regulation X; and
- The CLO Statement states that if a CLO elects to operate as a mortgage broker, the mortgage broker compensation rules apply.

On the other hand, if the Web site were to be used only for general marketing purposes, rather than for brokerage or origination-type services similar to those set forth in the IBAA letter, resort to the CLO Statement to determine whether or not fees paid for such marketing services are compensable under RESPA would appear appropriate. The CLO Statement says simply that payments made to a CLO Operator do not violate RESPA §8 so long as services are provided to the customer by virtue of the CLO and the payment is reasonable in relation to those services. Under the CLO Statement, no specific form of payment is prescribed or prohibited and, in particular, payments based on closed loans are permitted so long as the payments are reasonable in the marketplace for the services provided. One cautionary note, however—in 1996 at least, HUD frowned on the concept of a single-lender CLO, indicating in the CLO Statement that "if a CLO lists only one settlement service provider and only presents basic information to the consumer on the provider's products, then there would appear to be no or nominal compensable services provided by the CLO to either the settlement service provider or the consumer, only a referral." 61 Fed. Reg. 29,255 (June 7, 1996).

Question 3. Does it matter if settlement services are automated?

Answer: There is no indication in RESPA, Regulation X, or any official HUD interpretation of RESPA or Regulation X that mortgage processing or underwriting services performed by a person are to be treated differently if performed in an automated manner. To the contrary, what little has been said by HUD on the subject appears to indicate that the performance of mortgage processing and underwriting services will be treated essentially the same under RESPA whether performed manually or in an automated manner.

For example, in the Broker Fee Statement, HUD acknowledges that the "advent of computer technology has, in some cases, changed how a broker's settlement services are performed," and indicates that "[f]or…services [other than the listed services] to be acknowledged as compensable under RESPA, they should be identifiable and meaningful services *akin to* those identified in the IBAA [L]etter including, for example, the operation of a…[CLO] or an automated underwriting system (AUS)]." 64 Fed. Reg. at 10,085 (emphasis added).

In addition, HUD specifically addressed in the CLO Policy Statement the provision of set-

tlement services through the use of a CLO (which by its very nature is automated), and indicated that it would essentially employ the traditional RESPA §8 analysis to determine whether or not payment for such services is permissible under RESPA §8.

Not examined in this article is the question whether or not a Web site operator could outsource some or all of its mortgage processing or underwriting services to an entity jointly owned by the Web site operator and a lender. However, there is no obvious reason why the same rules that apply to affiliated business arrangements generally would not also apply to online structured arrangements such as this.

Question 4. Is providing access to the Web site operator's Web site a facility or goods for which the Web site operator can be compensated in addition to the compensation for services that the Web site operator performs?

Answer: Arguably, payments for providing access to a Web site can be characterized as payments for "goods" (analogous perhaps to payments for print advertisements) or for a "facility" (the "rental" of space on the Web site which customers can "visit" and where they can "meet" with the functional equivalent of a loan officer and obtain information about the lender's products and submit a loan application). Under this argument, such payments would be permissible so long as reasonably related to the value of the Web site access furnished.

Furthermore, HUD has indicated in the Broker Fee Statement that mortgage brokers may furnish compensable goods and facilities in addition to performing compensable services, and has provided examples.

"[A]ppraisals, credit reports, and other documents required for a complete loan file may be regarded as goods, and a reasonable portion of the broker's retail or "store-front" operation may generally be regarded as facilities for which a lender may compensate a broker." 64 Fed. Reg. 10,085.

Again, accepting the argument that providing access to the Web site constitutes "goods" or a "facility," it would appear that the Web site operator may be reasonably compensated for providing such access in addition to receiving compensation for origination services.

Question 5. If marketing a lender's products through a Web site constitutes "goods" or a "service" for which the Web site operator can be compensated, are some methods of determining compensation more defensible than others?

Answer: If the compensation to be paid to the Web site operator is to be determined by the number of closed loans that came to the lender through the Web site operator's Web site, it seems possible to argue that the compensation constitutes an impermissible payment for a referral. The argument would be that if the wholesaler pays a fee to the Web site operator for marketing services based on closed loans, never pays a fee for marketing services for loans that do not close or for which no application is made, and there is no significant difference in the marketing services provided with respect to all visitors to the Web site operator's Web site, the fee would appear to more closely resemble a prohibited finder's fee than payment for marketing services.

However, this argument proves too much, and would call into question any payment for a settlement service which is contingent on the closing of the transaction, a result at odds with HUD's expressed thinking on the subject. HUD has never specifically disapproved payments to mortgage brokers based on closed loans, and, in fact, has indicated in an informal letter that percentage compensation based on closed loans does not necessarily violate RESPA §8. Letter from Grant Mitchell dated October 9, 1992 collected in *Pannabecker, The RESPA Manual: A*

Complete Guide to the Real Estate Settlement Procedures Act, A.S. Pratt and Sons, Arlington, Virginia, at A8-147. Rather, HUD stated that it would first look to see whether the payment is for services actually performed and in doing so would consider whether, in an arms' length transaction, a purchaser would buy the services at or near the amount charged. HUD also stated that, "[t]he fact that others pay comparable prices for similar services may be relevant to this inquiry." *Id.* Additionally, as indicated above, HUD has clearly indicated that CLOs may charge settlement service providers a fee for each closed transaction arising from the use of the CLO. 61 Fed. Reg. 29,257 (June 7, 1996).

Less problematic, clearly, are flat fees paid by a lender for the marketing services of a Web site operator (regardless whether or not a loan closes). The only apparent issue in such a scenario would be whether the flat fee was reasonable in relation to the marketing services provided. Somewhat more problematic than a flat fee and less problematic than a fee per closed loan would be a fee based on the number of "hits" on the lender's Web site that came through the hyperlink from the Web site operator's Web site, or a fee based on the total number of "hits" on the Web site operator's Web site. (While the former appears more susceptible than the latter to the argument that, because of the manner in which the fee is determined, it should not be considered to be *for* services, both seem justifiable.)

Question 6. Co-branding arrangements between one entity with access to potential customers and another entity with a product to sell are quite common on the Internet. Do co-branding arrangements involving residential mortgage lenders present special problems or limitations with respect to RESPA §8?

Co-branding presents the same type of RESPA problems as finder's fees. It would appear that the co-brander, which is typically not in the settlement service business, is being paid a fee in exchange for steering its associated customers to the preferred lender or other settlement service provider. Although a fee on the order of a reasonable fee paid for a selected prospects list as set forth in Question 1 above may be allowable, additional compensation without additional services such as the listed services would appear suspect under Section 8.

There have been several attempts to amend RESPA to allow co-branding arrangements, covertly during last minute discussions regarding the 1996 Budget Act as well as in two other bills.

Financial Regulatory Relief and Economic Efficiency Act of 1997 (S. 1407, 105th Congress, and FRREEA of 1999 (S. 576, 106th Congress) ("FRREEA "). However, no such proposal has ever been enacted. Treasury and HUD and other opponents of such an amendment have argued, so far successfully, that allowing payments to one group which performs no services, including groups yet unformed and for purposes unclear, would essentially eviscerate the anti-referral fee concept that is the essence of section 8(a) of RESPA.

Thus, co-branding in circumstances where the non-settlement services party performs no services, including Internet co-branding arrangements, will likely continue to be viewed by HUD as a violation of section 8.

CONCLUSION • Some say RESPA has outlived its usefulness—that the Internet will so commoditize mortgage loans as to squeeze out referral fees and kickbacks. Others are not so sure. Ordering a toy or a book that turns out wrong is one thing; entrusting your home to a cyber-system is another.

There is also a strongly held view that a referee, or perhaps a sheriff, is still needed to bring order to the cyber-frontier. The residential mortgage market has long been made national by Fannie Mae and Freddie Mac. In such an environment, clear rules governing compensation arrangements in Internet mortgage loan transactions appear desirable, particularly in view of

the fact that the technology that facilitates online mortgage lending also facilitates enforcement efforts against RESPA violators. Thus, any Web site is now available for a compliance audit at the click of a mouse on a PC on every desk of every Federal regulator.

We believe the time has come for HUD, in conjunction with ongoing Federal efforts to facilitate electronic transactions, via encryption, digital signatures, and the like, to establish Internet online mortgage transaction rules. These rules must obviously continue to protect consumers, but should do so in a way that does not stifle innovation or lead to greater inefficiencies in the delivery of mortgage loan products.

APPENDIX

E-Commerce and RESPA

Commonly Used Terms in Online Mortgage Lending

"Single lender site"—a site that displays only one lender's information and application materials for access to potential borrowers.

"Multi-lender sites"—a site that provides information regarding more than one lender and allows potential borrowers to select a lender for further processing.

"Content site"—a Web site that contains information, commercial advertising, and, possibly loan content information, which a potential borrower may select.

"Click-through"—an icon on a Web site that a potential borrower can click to be sent to another Web site.

"Framing"—a seamless process where the computer view goes from one site to a linked site without any obvious indication that the user has left the original site.

"Link"—to a connection with icon on a Web site which a Web site operator puts on its site, usually for some charge, so that a potential borrower can be sent to another Web site (see click-through).

"Hyperlink"—a link that, when clicked, automatically dials up the linked Web site.

"Impression"—a method of counting each time a Web site is visited.

"Section 8 of RESPA"—a criminal and civil Federal statute administered by the Department of Housing and Urban Development. Section 8(a) prohibits compensated referrals of settlement service business, and penalizes both the giver and the receiver; section 8(b) prohibits kickbacks, fee splitting, and unearned fees.

"Affiliated business arrangement"—an exception to section 8 of RESPA that allows one company in the settlement services business to have a profit-making interest in another company in the settlement services business, so long as the provisions of the safe harbor are followed—no required use of the related provider (with limited exceptions), disclosure of ownership must be made, and the compensation between the companies is limited to a return on partnership interest. However, an employer may pay its own employees for referrals to an affiliated business company. An affiliated business ("AfBA") disclosure form informs the borrower of some of the important details of such an arrangements.

"Settlement service"—any service provided in connection with a prospective or actual residential mortgage settlement covered by RESPA (almost every residential real estate transaction where the lender takes a lien on the property).

PRACTICE CHECKLIST FOR

RESPA and Online Mortgage Lending (with Glossary)

The Real Estate Settlement Procedures Act ("RESPA") and Regulation X forbid the payment or receipt of referral fees involving Federally-related residential mortgage loans. This includes loan origination, defined as the taking of loan applications, loan processing, and the underwriting and funding of such loans. However, the payment of compensation for services actually performed related to loan origination, processing, funding, or use of facilities and services is permitted.

• This creates a problem for web service providers that sell their services to lending institutions. Various compensation arrangements could be considered compensated referrals.

☐ Are fees paid according to the number of hits possibly referral fees? Apparently, no.

☐ Are fees paid for each hit that results in a successful loan a referral fee? Apparently, yes. If the fee is based mainly on the number of successful results, this is an impermissible referral fee. However, if some ministerial service is performed, such as screening applications or providing additional information, the fee may be permissible as compensation for services.

☐ Are fees that would otherwise be considered illegal referral fees considered permissible if the system is totally automated.?Apparently, no. Whether a system is automated has no bearing on the characterization of the fees.

☐ Is co-branding permissible, i.e., one party has access to potential customers and the other provides the Internet services? Apparently no, unless the party being paid is providing actual services.