



Issue Date: RESPA News Monthly  
March 2009, Posted On: 3/12/2009  
In-Depth Reports

# Dear HUD: Maybe the definition of required use is a bad idea

Column by Howard Lax

Our reader asks:

*I would appreciate your efforts to enlighten me further on an issue raised in the lawsuit brought by the National Association of Home Builders (NAHB) against HUD. In an [article published in Builder Magazine](#) on Jan. 5, 2009, **Pat Curry** wrote:*

*"As a practical consequence of the new rule, the [NAHB v. HUD] suit claims that builders will be able to offer incentives to use an unaffiliated lender, but not their own. 'Ironically, a home builder can actually require the use of the non-affiliated lender,' the plaintiffs argue."*

*I obtained a copy of the complaint, and the plaintiffs do indeed make that argument on page 32, in paragraph 83.a.; but there is no citation to authority, just their argument. So far, from reading the plain language of the statute and the regulations and the appendices, I do not find support for the argument made by the plaintiffs in their complaint. Please take a look at the complaint and explain their 'ironic' point.*

You are not the only one rethinking the wisdom of this "ironic" point. HUD [announced](#) that it is also rethinking its revised definition of required use. HUD reopened the comment period on this one issue for 30 days and delayed implementation of the provision for 90 days. The reasons for reconsideration begin with the methods that builders used to develop subdivisions.

## Once upon a time, in a galaxy far, far away...

Mass builders thrived by organizing and controlling the assembly line of residential construction from improved land to closing. The current model for construction to close is a one-stop-shop that allows the builder to set the pace of construction, sales and closings. Section 8 of RESPA ordinarily stands as a deterrent to self referral between related entities in new home construction. However, the definition of "required use" opened the door for builders to avoid this bottleneck. HUD rules did not prohibit referrals between affiliated entities if the entities offered discounts to borrowers and the borrowers were free to choose the discounted services or go elsewhere for settlement services.

The definition of required use only applies to two provisions of Regulation X: (i) Section 15 of Regulation X (nobody can require the use of an affiliated settlement service provider), and (ii) Section 16 of Regulation X (the seller cannot require the use of a title agency or title company when the buyer pays for the policy). These provisions are not key elements of RESPA for most lenders, real estate brokers or title agencies that operate stand alone businesses. Builders, unlike other parties in residential transactions, broadly use affiliated settlement service providers (real estate brokerages, mortgage brokerages and title agencies) to control and profit from building and selling homes at a steady pace in large subdivisions and condominium projects. Incentives given to buyers to stay within the builder's sphere of control allowed builders to control the pace of building and sales to maximize productivity and stabilize costs.

The old rule permitted builders to combine goods and services between its various enterprises into a "discount package" to entice buyers to utilize the builder's various enterprises to purchase, finance and

close, rather than going to outside settlement service providers. Under the old rule, the builder paid a portion of the closing costs for the buyer if the buyer used its affiliated mortgage company. Incentives were ratcheted up when sales slowed to include points and all closing costs. Some consumer advocates believed that incentives got out of hand when builders offered free decks and pools to induce buyers to use their affiliated settlement service providers. These consumer advocates argued that builder inducements to use an affiliate are tantamount to requiring the use of the affiliate, and are illegal under Section 15 of Regulation X. Some also argued that builders should lower their prices for homes rather than throw in free pools and decks.

### **The Empire strikes back**

HUD was swayed by arguments that builders impaired competition in the marketplace for settlement services. HUD decided that builder contributions to closing costs (seller incentives) do not eliminate the inference that the builder required the use of an affiliated settlement service provider. Hence, HUD changed its rule. The new definition of required use effectively restricts the bundling of goods and services across the builder's enterprise. Bundling of services is still permitted; however the builder cannot pay for the discounts. Each settlement service provider participating in the bundle must bear the cost of discounts offered to the buyer.

Furthermore, HUD also implied that only settlement services may be discounted as incentives to use affiliates – no more free decks and pools. Eliminating the incentives will break down the cohesive nature of the builder's business model and end builder incentives, or so HUD thought.

### **HUD's attempt to make resistance futile**

Since the rule prohibiting the required use of a mortgage company only applies when the person making the referral and the mortgage company are affiliated, the builder should be able to pay for settlement costs when the provider of settlement services and the builder are not affiliated. However, certain statements by HUD appear to prohibit this also.

HUD intended to cut incentives from builder's marketing plans, even if Regulation X could not be modified to eliminate all incentives. The NAHB lawsuit points out inconsistent HUD statements that lead us to believe that HUD wanted to ban all builder incentives. However, HUD could not find a legal leg to stand on to support its intentions. The final rule, therefore, stops short of a total ban on builder incentives.

You asked me to explain the point that NAHB was making in its lawsuit. The NAHB complaint tries to explain the differences between the new rule, and statements by HUD in 1) the preamble to the proposed rule and 2) the economic impact study. HUD's inconsistent statements leave builders wondering how HUD and state regulators will interpret the new rule. These inconsistencies also open the door for courts to make their own law where HUD could not.

Paragraph 79 of the NAHB complaint states:

*HUD stated in its Impact Analysis on the Final Rule that "[l]enders and settlement service providers will be allowed to package settlement services but not make a discount contingent on the purchase of anything that is not a settlement service from an affiliate." 3-84.*

In other words, a lender will not be able to offer an incentive for anything other than a settlement service — such as the purchase of a home from a home builder. In a Dec. 2, 2008, call sponsored by the Mortgage Bankers Association, HUD reversed course, indicating that a lender actually could offer a discount only to purchasers of its affiliate's homes, because the builder was not limiting the shopping ability of the purchaser.

Section 80 of the NAHB complaint goes on to explain that HUD stated that a builder could offer to let the buyer use any mortgage company from an approved list (including a mortgage company affiliated with the builder). HUD later reversed course and stated that this practice was prohibited.

## HUD ignored the laws of mortgage thermodynamics

It is my opinion that HUD failed to adequately evaluate the impact of the new definition of required use. My crystal ball reveals that the new definition of required use will spawn a loan origination process that is less transparent, and discourages shopping for settlement services.

The laws of thermodynamics dictate that energy always flows from where it is to where it is not. Water flows downhill, but the course of a river can be reversed. Builders will look for alternate pathways for their incentives so that they achieve the desired result of controlling the pace of home construction and sales. There is just too much at stake to give up on the builders' one-stop-shop model.

HUD is correct that the immediate impact of the new rule will be that builders will no longer offer a free swimming pool to a buyer when the buyer uses the builder's affiliated mortgage broker to finance the purchase of the home. However, HUD failed to consider that 1) builder incentives may be funneled through an affiliated mortgage broker as easily as an affiliated title agency, 2) affiliates can foot the bill for the new pool rather than the builder and 3) uncompensated referrals are permitted.

HUD and the settlement services industry are mesmerized by the lure of profits generated from referrals to affiliates. The affiliated business exception in Section 8(c) of RESPA is premised on the assumption that a builder is earning a return on an investment from an affiliated title company. Section 15 of RESPA was implemented to legitimize this return, even when the profits paid to the builder are generated by referrals made by the builder to the affiliated title company.

However, if there are no profits, and no distributions to the builder, then there is nothing to legitimize. Uncompensated referrals are not prohibited under RESPA. If the builder is not paid a penny for its referrals, there is no need to provide an affiliated business arrangement disclosure to the buyer, there is no need to disclose the affiliation and there is no need for the builder to disclose ownership interests or the fees charged by the affiliated settlement service provider.

## Return of the free pool

Jedi Master Yoda taught us to build or do not build — there is no try. Providing a free pool is simply a matter of believing that it can be done. Affiliated title companies cannot pay for a pool under state law — rebates of mortgage insurance premiums are prohibited. However, a mortgage broker can pay for a pool if the buyer purchases a home from an affiliated builder. The definition of required use applies to situations where the builder provides a pool if the buyer uses an affiliated settlement service provider, but the reverse is not a required use. The definition states:

*"Required use means a situation in which a person's access to some distinct service, property, discount, rebate, or other economic incentive, or the person's ability to avoid an economic disincentive or penalty, is contingent upon the person using or failing to use a referred provider of settlement services."*

The builder is not a settlement service provider. Hence, an affiliated settlement service provider can give incentives to buyers who purchase a home from an affiliated builder. If NAHB loses its lawsuit, and HUD implements its new definition of required use, then builders will simply set up mortgage brokerage companies that buy pools for customers of the builder, earn one dollar a year and pay no dividends to the builder. The builder does not care if it throws in a free pool itself, or the affiliated mortgage broker pays for the pool. The builder just wants control over the financing process to make sure it sells its homes at a steady pace. The builder's loan origination process will offer fewer disclosures, and discourage shopping for settlement services. As a special added attraction, the builder will have no concern for lawsuits for RESPA violations, and no need to retain Affiliated Business Arrangement Disclosures for five years.

## Banishing the 'dark side'

The allure of the dark side is strong. If HUD truly believes that more disclosure creates transparency and healthy competition, then HUD should scrap the new definition of required use. The confusion generated by HUD over builder incentives will drive builders to set up affiliated companies that control the financing of sales in the most opaque manner, and discourage buyers from shopping for settlement services.

[Affordable reprints of this article are available. Click here for more information.](#)

*Comment Box - October Research Corporation is not responsible for the comments posted on its web sites by readers. We will do our best to remove comments that include profanity, personal attacks or other inappropriate remarks.*