

## Attachment I

### Guidelines for Analyzing Section 4 Applications for Compliance with the Real Estate Settlement Procedures Act

#### Background and Definitions

The purpose of the Real Estate Settlement Procedures Act of 1974 (RESPA) [12 USC Sections 2601 et seq.] is to provide borrowers with pertinent and timely disclosures regarding the nature and costs of the real estate settlement process. The Act also protects borrowers from unnecessarily high settlement costs resulting from certain abusive practices, such as referral<sup>1</sup> fees and kickbacks. The Department of Housing and Urban Development (HUD) promulgated Regulation X [24 CFR Part 3500] to implement RESPA. Section 8 of RESPA, which prohibits referral fees and kickbacks, addresses whether a person gave or received any "thing of value"<sup>2</sup> in connection with the referral of a settlement service. In the context of an application filed under Section 4 of the Bank Holding Company Act to engage in a Joint Venture involving federally related mortgage activities, it is important to ensure that the Joint Venture partners are not receiving kickbacks.

#### Section 8 of RESPA

Section 8 of RESPA allows a party to refer business to an affiliate with which it has an affiliated business arrangement<sup>3</sup>, provided the only thing of value the party receives is a return on its "ownership interest." In contrast, Section 8(a) of RESPA [12 USC 2607] prohibits the payment or acceptance of kickbacks for the referral of settlement service business in connection with a federally related mortgage loan<sup>4</sup>. Section 8(b) prohibits the splitting of fees other than for services actually performed. RESPA does not prohibit compensation for services performed<sup>5</sup>. Section 8(c) enumerates certain instances in which payments may be made. These include:

- payments of fees to attorneys for services actually rendered or to a title company for services actually performed in the issuance of a policy of title insurance;
- payments of fees by a lender to its duly appointed agent for services actually performed in the making of a loan;
- payments to any person of a bona fide salary or compensation or other payment for goods or facilities actually furnished or for services actually performed;
- payments pursuant to cooperative brokerage and referral arrangements or agreements between real estate agents and brokers; and
- affiliated business arrangements, provided that certain provisions are met.

Section 8(c) permits the providers of settlement service to enter into affiliated arrangements and refer customers to each other if three conditions are met:

1. The consumer receives a written disclosure of the nature of the relationship between the referring party and the settlement service provider and an estimate of the provider's charges;
2. The consumer is not required to use the affiliate; and

3. The only thing of value received from the arrangement, other than payments for services rendered, is a return on ownership interest.

The third condition may be difficult to determine. When assessing whether a payment is a return on ownership interest or a payment for referrals of settlement service business, HUD considers the following questions:

- Has each owner or participant in the new entity made an investment of its own capital, as compared to a "loan" from an entity that receives the benefits of referrals?
- Have the owners or participants of the new entity received an ownership or participant's interest based on a fair value contribution, or is it based on the expected referrals to be provided by the referring owner or participant to the entity?
- Are the dividends, partnership distributions, or other payments made in proportion to the party's investment in the entity, or does the payment vary to reflect the amount of business referred to the new entity or a unit of the new entity?
- Are the ownership interests in the new entity free from tie-ins to referrals of business, or have there been any adjustments to the ownership interests based on the amount of business referred?

HUD's Regulation X (24 CFR Section 3500), which implements RESPA, more directly specifies what is not a return on ownership interest:

1. any payment which has as a basis of calculation no apparent business motive other than distinguishing among recipients of payments on the basis of the amount of their actual, estimated or anticipated referrals;
2. any payment that varies according to the relative amount of referrals by the different recipients of similar payments; or
3. a payment based on an ownership, partnership or Joint Venture share, which has been adjusted on the basis of previous relative referrals by recipients of similar payments.

Since these payments are not a return on ownership interest, receipt of such payments from an affiliate could violate Section 8. Similarly, if the other conditions of the affiliated business exception are not satisfied, then payments between affiliates may be referral fees in violation of Section 8.

As previously noted, the affiliated business arrangement exception is available only in situations where referrals are made to a "provider of settlement services." HUD has stated that the exception does not allow for compensation (including a return on ownership interest) to sham arrangements that are not bona fide providers of settlement services. While the statute does not directly address sham arrangements, Section 3500.14 of Regulation X does address a shell company that contracts out all of its functions to another entity. Where the affiliated entity provides no substantive services for the fee, or portion thereof, that it receives, HUD deems the arrangement as violating Section 8 of RESPA because the shell affiliated entity is merely passing unearned fees back to its owner for the referral of business. To provide further guidance on whether an entity is a bona fide provider of settlement services, HUD issued a Statement of Policy on sham business arrangements in 1996. Staff should review the Joint Venture contracts

to determine that payments received by the Joint Venture are made only for services performed by the Joint Venture and are in compliance with the Policy Statement.

#### HUD's Statement of Policy 1996-2

The Policy Statement describes ten factors HUD considers when determining if the affiliate is a bona fide provider of settlement services. The answer to any one factor will not determine whether an affiliated business arrangement is a sham. HUD examines all ten factors together to determine whether the entity receiving referrals of business is a bona fide provider of settlement services. In a Section 4 application, staff should review the Joint Venture contracts between the bank holding company and the Joint Venture to confirm that the Joint Venture is a bona fide provider of settlement services. To determine if the application to form a Joint Venture needs additional review for RESPA compliance, the Reserve Bank should evaluate the Joint Venture's proposed activities under the following ten factors:

**1. Does the new entity have sufficient initial capital and net worth, typical in the industry, to conduct the settlement service business for which it was created, or is it undercapitalized to do the work it purports to provide?**

While there is no prescribed amount for initial capitalization of Joint Ventures, HUD's FHA program requires approved lenders to have \$150,000 in initial capital, an amount determined to be sufficient to conduct a mortgage lending business. If the application is for a mortgage broker or banker, \$150,000 is generally considered sufficient.

The application package should contain a pro forma balance sheet for the Joint Venture identifying the initial capital investment by each partner, along with any corresponding loans. Ideally, each partner should make an investment of cash or other assets to the Joint Venture, rather than "borrowing" the money from the partner that will receive the benefit of loan referrals or sales from the Joint Venture. The applicant should provide information supporting the market value of contributed assets, if any. The value of each partner's respective contributions should be proportional to their respective interests in the entity. Staff should also confirm that any proposed dividends and other partnership distributions are paid in proportion to the stockholders'/partners' ownership interests in the Joint Venture.

If the Joint Venture is not adequately capitalized or if the third-party partner does not contribute cash or adequate assets to initially capitalize the Joint Venture, the Joint Venture may be a shell entity, rather than an independent operating entity. Additional evidence of improprieties would be the payment of dividends or other partnership distributions in proportion to the referrals or an adjustment of ownership interest according to the referrals.

**2. Is the Joint Venture staffed with its own employees to perform the services it provides, or does the new entity have "loaned" employees of one of the parent providers?**

The Joint Venture should be staffed with its own permanent employees and it should be the sole provider of compensation to those employees. Staff should analyze the Joint Venture's pro forma

financial statements to ensure that compensation levels are reasonable compared to the number of anticipated employees.

**3. Does the new entity manage its own business affairs, or is an entity that helped create the new entity running the new entity for the parent provider making the referrals?**

Management is an important indicator of responsibility and liability for a company's performance. If the Joint Venture has no full-time, permanent management or is managed by a parent company, it may be a sham entity. Under the Policy Statement, it is permissible for a Joint Venture to rely on a parent for *some* management functions. However, the Joint Venture should be operating independently, making the majority of its business decisions without being required to consult the parent provider.

**4. Does the new entity have an office for business separate from one of the parent providers? If the new entity is located at the same business address as one of the parent providers, does the new entity pay a general market value rent for the facilities actually furnished?**

If the Joint Venture leases space from a parent provider, the Joint Venture should be paying a general market rent. The applicant should be able to provide market data supporting the rental rate agreed to in the lease agreement.

In conversations between Board Staff and HUD, HUD explained that it has encountered "bogus" rental arrangements that are really agreements for the payment of referral fees. For example, one case involved a title insurance company that paid a "rental fee" to a real estate broker for the "per use rental" of a conference room for closings. The title insurance company paid a \$100 fee for each transaction. This "rental fee" was greater than the general market value for the use of the space. The facts of the case revealed that the room was rarely used for closings. HUD concluded that this was a sham rental arrangement and the "rent" was really a disguised referral fee in violation of Section 8(a). Similarly, if the Joint Venture "rents" office space from a parent at below-market rates, it could be receiving a thing of value from that parent in exchange for referrals to the parent.

**5. Is the new entity providing substantial services, i.e., the essential functions of the real estate settlement service, for which the entity receives a fee? Does it incur the risks and receive the rewards of any comparable enterprise operating in the marketplace?**

Reserve Bank Staff should review any agreements between the parent and the Joint Venture. If the agreement transfers all risk to the parent, there is no real risk for the Joint Venture. For example, a mortgage banking Joint Venture between a builder and a bank holding company subsidiary may involve a loan purchase agreement between the Joint Venture (loan originator/seller) and the buyer (parent/holding company subsidiary) of the loans. If this agreement contains a repurchase provision whereby the seller of the loans must repurchase any loans that are delivered to the buyer but found to be unsatisfactory, then the Joint Venture is likely bearing the risks typical for a mortgage banker.

**6. Does the entity perform all of the substantial services itself, or does it contract out part of the work? If so, how much of the work is contracted out?**

See discussion following Question #8.

**7. If the new entity contracts out some of its essential functions, does it contract services from an independent third party, or are the services contracted from a parent, affiliated provider or an entity that helped create the controlled entity? If the new entity contracts out work to a parent affiliated provider, or an entity that helped create it, does the new entity provide any functions that are of value to the settlement process?**

See discussion following Question #8.

**8. If the new entity contracts out work to another party, is the party performing the contracted services receiving a payment for services or facilities provided that bears a reasonable relationship to the value of the services or goods received, or is the contractor providing services or goods at a charge such that the new entity is receiving a "thing of value" for referring settlement service business to the party performing the service?**

The sixth, seventh, and eighth factors are closely related. The sixth factor looks to whether the Joint Venture performs all of the substantial settlement services it offers. If some of these services are contracted out, the question becomes "How many of these services are outsourced?" For services that are contracted out<sup>7</sup>, the seventh factor focuses on whether the services are provided by a parent, and if so, does the Joint Venture provide any services that are of value.

The Joint Venture may receive other "things of value" that are not directly tied to contracted services. For example, in some cases, the parent company and the Joint Venture may be splitting overages. In addition, the Joint Venture may get a line of credit from a parent at a lower than market interest rate. Any payment or service provided among the affiliates should be examined to ensure no "thing of value" is being provided in exchange for referrals.

**9. Is the new entity actively competing in the market place for business? Does the new entity receive or attempt to obtain business from the settlement service providers other than one of the settlement service providers that created the new entity?**

See discussion following Question #10.

**10. Is the new entity sending business exclusively to one of the settlement service providers that created it (such as the title application for a title policy to a title insurance underwriter or a loan package to a lender), or does the new entity send business to a number of entities, which may include one of the providers that created it?**

A business typically solicits and tries to obtain work from various sources to increase its profits. Relying solely on referrals from a related company suggests that the venture is not competitive and may not provide a service commensurate with its fees<sup>8</sup>. Exclusive dealing is strong evidence that the venture has no legitimate stand-alone business purpose. In most cases, the parent

provider may receive a substantial amount of the business of the Joint Venture but it should not be the exclusive recipient<sup>9</sup>.

In addition, it must be determined that the only thing of value received from the arrangement, other than payments for services rendered, is a return on ownership interest. When assessing whether a payment is a return on ownership interest or a payment for referrals of settlement service business, HUD considers, among other issues, whether each party is bringing its own capital to the investment and how profits are divided.

### Mortgage Brokerage Services - The Retsinas Letter

If the Joint Venture acts only as a mortgage broker, HUD has provided additional guidance in a letter from Assistant Secretary for Housing, Federal Housing Commissioner Nicolas P. Retsinas, ("the Retsinas letter") that identifies loan origination services performed by mortgage brokers or fees and also outlines HUD's position on fees for such settlement services<sup>10</sup>. The services performed by the Joint Venture should be analyzed to determine if the compensation the broker receives is reasonable for the services it performs, or if a party may be receiving a kickback or other unearned fee.

The Retsinas letter sets forth the framework that HUD now uses in enforcement to determine those services for which mortgage brokers (including banks that perform mortgage broker services) can be compensated under RESPA. Under this framework, HUD looks not merely at whether an agreement calls for certain work to be performed in exchange for a fee, but also at whether such work was actually performed, whether those services were necessary for the transaction, and whether they were duplicative of services also performed by others.

The Retsinas Letter outlines the services normally performed in the origination of a loan:

- a. Taking information from the borrower and filling out the application;
- b. Analyzing the prospective borrower's income and debt and pre-qualifying the prospective borrower to determine the maximum mortgage that the prospective borrower can afford;
- c. Educating the prospective borrower in the home buying and financing process, advising the borrower about the different types of loan products available, and demonstrating how closing costs and monthly payments would vary under each product;
- d. Collecting financial information (tax returns, bank statements) and other related documents that are part of the application process;
- e. Initiating/ordering verifications of employment and verification of deposits;
- f. Initiating/ordering requests for mortgage and other loan verifications;
- g. Initiating/ordering appraisals;
- h. Initiating/ordering inspections or engineering reports;
- i. Providing disclosures (truth in lending, good faith estimate, others) to the borrower;
- j. Assisting the borrower in understanding and clearing credit problems;
- k. Maintaining regular contact with the borrower, realtors, and lender, between application and closing to apprise them of the status of the application and to gather any additional information as needed;
- l. Ordering legal documents;

- m. Determining whether the property was located in a flood zone or ordering such service; and
- n. Participating in the loan closing.

In determining whether or not to bring an enforcement action under RESPA, HUD generally would be satisfied that no RESPA violation had occurred, if:

- The mortgage broker took the application;
- The mortgage broker performed at least five (5) additional items on the list above; and
- The fee was reasonably related to the market value of the services that were performed.

In addition, HUD has particular concern that a fee for steering a customer to a particular lender, which is prohibited under Section 8 of RESPA, could be disguised as compensation for "counseling-type" activities. Therefore, if a mortgage broker is relying on taking the application and performing only "counseling-type" services (items (b), (c), (d), (j), and (k) on the list above) to justify its fee, HUD also will look to see that meaningful counseling, and not steering, is provided.

#### Enforcement Authority under RESPA

HUD, not the Federal Reserve, has enforcement authority under RESPA. However, Reserve Bank staff is encouraged to perform an initial review of Joint Venture applications to determine if sham business arrangements or other RESPA compliance problems are evident. Reserve Bank staff should then inform the applicant of any compliance issues and encourage the applicant to work with HUD to address the issues. When it is unclear whether the proposed structure violates RESPA, Reserve Bank staff should contact either Beverly Smith, Manager of Applications (202-452-3946) or Tracy Anderson (202-736-1921) in Compliance Oversight. Board staff will consult with HUD, when necessary.

Board Staff has developed the following language that has been used by Reserve Bank staff in recent Section 4 approvals to remind the applicant of its obligation to comply with RESPA:

"Approval of this notice is subject to the Board's authority to require reports by, and make examinations of, bank holding companies and their subsidiaries, and to require such modification or termination of activities of a bank holding company or any of its subsidiaries as the Board finds necessary to assure compliance with the BHC Act and the Board's regulations and orders issued thereunder. In this light, the Federal Reserve System expects that [applicant's name] will continue to work with the Department of Housing and Urban Development to resolve any Real Estate Settlement Procedures Act (RESPA) issues related to [applicant's name] operations and will operate [Joint Venture] in compliance with all applicable laws, including RESPA."

If you have any questions or comments about this language, please contact Beverly Smith or Tracy Anderson at the Board.

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## Footnotes:

<sup>1</sup>A "referral" is defined as any oral or written action directed to a person that affirmatively influences the selection by that person of a settlement service provider when such person will pay for the service. A "settlement service" is any service provided in connection with a real estate settlement, including but not limited to: title searches, insurance and examinations, providing title certificates, attorney services, document preparation, property surveys, credit reports or appraisals, pest and fungus inspections, real estate agent or broker services, originating a federally-related mortgage (including, but not limited to, taking loan applications, loan processing, and underwriting and funding loans), and handling the processing, and closing or settlement.

<sup>2</sup>A "thing of value" is any payment, advance, funds, loan, service, or other consideration. It includes money, discounts, machinery (such as fax machines), and gifts (such as tickets to sporting events or holiday baskets). However, uncompensated referrals are permitted and a person can always be compensated for work actually performed.

<sup>3</sup>An "affiliated business arrangement" is an arrangement in which a person who is in a position to refer business incident to (or a part of) a real estate settlement service for a federally related mortgage loan, or an associate of such person, has either an affiliate relationship with or a direct or beneficial ownership interest of more than 1 percent in a provider of settlement services, and either person directly or indirectly refers such business to that provider or affirmatively influences the selection of that provider.

<sup>4</sup>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. [12 USC 2607(a)]

<sup>5</sup>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 [12 USC 2607(b)] (emphasis added).

<sup>6</sup>Statement 1996-2 (May 31, 1996). A copy of this letter may be found at <http://www.hud.gov/offices/hsg/sfh/res/res0607c.cfm>

<sup>7</sup>In cases where work is contracted out to another entity (be it an independent third party or a participant in a Joint Venture), HUD has looked at whether the contracting party receives payments from the new entity at less than the reasonable value of the services rendered. If so, then the difference between the payments made to the contracting party and the reasonable value of the services may be a disguised referral fee in violation of Section 8. For example, if a mortgage banking Joint Venture is only taking loan applications while passing all applications to a third party service provider for underwriting and closing, it may be questionable whether the Joint Venture is providing sufficient services to earn its fee.

<sup>8</sup>For example, a new mortgage banking entity only receives customer referrals from an affiliate or a parent and not from an outside source, selling the loans to another affiliate or another parent upon origination.

<sup>9</sup>For example, HUD determined that one mortgage banker's plan to sell a minimum of 10 percent of its loans to unrelated third parties and up to 90 percent of its loans to a parent was an acceptable plan, given other factors in the case. However, the scenario could change for another mortgage banker, depending on the evaluation of that mortgage banker under the previously discussed ten factors.

<sup>10</sup>Letter from Nicholas Retsinas to J. Michael Hinchman, President, dBAA Mortgage Corporation (February 14, 1995)