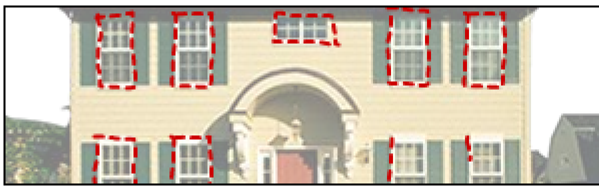
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# Closing cost scams

**You always thought those mysterious fees at closing were a total scam. Congrats! You were right. Here's what you can do to avoid paying through the nose.**

**By Stephen Gandel, MONEY Magazine staff writer**
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NEW YORK (MONEY Magazine) -- Technology has magically lowered the price of buying everything from stocks to airline tickets. But home buyers now pay eight times the closing costs they paid 40 years ago. Here's how residents of one Minnesota street were overcharged again and again on their home purchases, many by thousands of dollars. And why your street probably isn't all that different.

When Lewis Leung was buying his two-bedroom ranch in St. Louis Park, Minn. in 2004, he read up on mortgages. He got rate quotes from lenders on the Web. He even compared their good-faith estimates of the numerous extra fees he'd have to pay to close the deal.

But did he sign with the lender who quoted him the best combination of rate and fees? Nope. Instead, under pressure to get a loan quickly, he went with the mortgage broker recommended by his real estate agent. Ditto when tapping a title insurer.

"The agent and I looked at a lot of houses together over the months," Leung explains. "You build up a bit of trust."

Maybe that trust was misplaced. Going with his agent's advice cost Leung hundreds of extra dollars in fees and up to $9,320 in higher interest payments over 30 years.

A bum steer? Not to Century 21 Luger, Leung's agent. The realtor's referrals netted the agency and its affiliates an extra $3,635 on the transaction, though Leung didn't know it. This is on top of the $6,150 the realtor collected from its portion of the seller's commission, plus $189 that Century 21 Luger said it had to charge Leung to cover its costs.

"I knew I should do it myself," Leung says of his decision to go with his agent's referrals. "But after months of looking for a house, I was tired, and I just didn't think it would affect my bottom line all that much."

**Mystery charges and buyer exhaustion**

Ever bought a house? Then you know what it's like to be confronted, while making the biggest financial transaction of your life, with a bundle of fees you don't quite understand. They're enumerated on what's called your HUD-1 document, the mortgage settlement statement you get the day you close, as required by the Department of Housing and Urban Development.

The charges listed include mysterious things like title insurance, settlement fees, appraisal fees, processing fees, document-preparation fees and others, as well as charges paid by the seller, like your broker's commission. You probably didn't spend a lot of time on your HUD-1, at least not until it was too late, because all those fees can seem like warts on the side of an elephant, a few hundred or maybe a few thousand dollars out of a transaction that runs into the hundreds of thousands.

Together, though, these fees add up. Americans spend $110 billion a year buying and selling houses, not including the cost of the homes themselves. And while technology has magically lowered the cost of buying everything from airline tickets to stocks to wedding gifts, real estate purchases remain stubbornly expensive. Home buyers now pay eight times as much in closing costs as they did 40 years ago.

Regulators have begun to ask why. The Department of Justice sued the National Association of Realtors last fall, claiming that its rigid rules for home listings artificially inflate commissions. And state insurance commissioners in California, Colorado, Florida, Maryland and Ohio have recently uncovered what they say are networks of sham title insurance companies set up to hide illegal rebates to banks, builders and realtors in exchange for steering business their way.

Colorado insurance regulator Erin Toll tells MONEY there are probably more than 100 "shams" -- her word -- in her state alone.

"The current system doesn't work at all," says mortgage expert Jack Guttentag, a professor emeritus at the Wharton School and head of Mtgprofessor.com. "Real estate fees are much higher than they'd be if the market worked properly. The whole thing is something of a tragedy."

**One street's story**

Many problems with "sham" title insurance companies -- companies set up to hide illegal rebates to banks, builders and realtors in exchange for steering business their way -- might have been fixed by now, except for this: No one knows the scope of the fees that home buyers pay -- or who profits most from them.

A tiny agency called the Federal Housing Finance Board is the only entity that tracks closing costs. But it doesn't collect data to break down numbers between realtors, lenders and title companies.

And lenders aren't required to file HUD-1 forms at all -- not even with HUD itself. The only place HUD-1s get filed away, if at all, is in basements, attics and home offices across the country.

So that's where MONEY went -- specifically, to the basements, attics and home offices on a single street, Aquila Lane, in a popular suburb just west of Minneapolis called St. Louis Park.

Why there? Because residents of the entire Minneapolis/St. Paul region pay more when buying a house than residents of any other metro area in the country, a MONEY analysis of Federal Housing Finance Board data shows. Brokerage commissions there are as high as 7 percent, while typical pretax closing fees, at about 1.1 percent of loan amounts, are more than double the national average. And folks in St. Louis Park are hammered harder than those in just about any other zip code in the Twin Cities region.

As part of a four-month investigation, MONEY went door to door on Aquila Lane, asking people about their home-buying experiences. Forty-two houses there have changed hands since 2000; 20 of the new owners talked to MONEY, and of those, 12 shared their financial documents. Most residents never knew that their closing costs were exorbitant or negotiable or even avoidable.

Based on our reviews of their HUD-1s with industry experts, the 12 Aquila homeowners would have saved an average of 23 percent on their closing costs if they'd shopped around, which in many cases would have amounted to thousands of dollars.

**What brokers don't do**

Freight trains ran alongside Aquila lane, shuttling goods into downtown Minneapolis, until 1984, when the rail line was abandoned. Now bike paths wend where tracks once lay. The adjacent park boasts softball fields, tennis courts and a popular sledding hill. Even in this up-and-coming bedroom burb, Aquila Lane stands out as highly desirable.

So when a two bedroom house on the south end of the street went on sale for $165,000 in 2003, Nikole and Josh Didier stretched for it. On the advice of their real estate agent, Edina Realty's Chuck Skolnick, they sought a loan through Edina's affiliated mortgage brokerage.

"Chuck was phenomenal in working with us," says Nikole. "We used Edina for everything."

That proved to be expensive. The couple's pretax closing costs came to $4,565, including at least $2,125 in up-front fees that went directly to their mortgage broker. At 2.7 percent of the loan, that pretax total is nearly seven times the national average.

Worse, the Didiers ended up with a two-year ARM at a high 8 percent. The Didiers figured at the time that it was the best their broker could get them, given some credit problems they'd had.

Turns out they almost certainly could have done better. Mortgage brokers have no obligation to get their customers the best deal.

On the contrary, they have an incentive to push them toward a mortgage with an unnecessarily high rate. That's because the bank's payment to the mortgage broker, called a yield spread premium, compensates the broker for the spread between the lowest rate at which the lender will make the loan and the rate the borrower ends up with.

In other words, the higher the rate, the more money the broker makes.

Based on the large referral payment of $3,398 by lender First Franklin to the Didiers' mortgage broker with Edina, they probably signed up for an interest rate between one and two percentage points higher than the best rate the bank was offering at the time, calculates Wharton's Guttentag.

A shocked Josh Didier says today that he didn't even know the bank was rewarding his broker. "We thought we had paid our mortgage broker up front."

An Edina spokesman calls its payment from the lender on the Didier loan "customary compensation," adding, "We'd be losing money on this mortgage" without it. "This loan was compliant within our company guidelines on responsible lending. It was competitive in the marketplace."

**The bunk behind junk fees**

These days nearly everyone knows someone -- a brother-in-law, a college pal, a former hairdresser -- who's become a mortgage broker.

There aren't many barriers to entry. Only about half of all state governments have any licensing requirements, which, when they do exist, usually amount to a day or less of training. In the other states, all you have to do is register and you're in.

The National Association of Mortgage Brokers (NAMB) does have a code of ethics, but it doesn't do any testing or screening or even require professional ethics classes.

Beth and Robert Grommesh bought their place at 3049 Aquila in 2005 with a $522,500 loan. The various pretax fees came to $8,856, or 1.7 percent of their loan. Among those costs, according to their HUD-1, were $1,265 in charges for "processing" and "administration."

NAMB board member Jim Pair calls these "junk fees" because, he says, they're generally not related to any actual service performed by a broker and, if so, are violations of NAMB's code of ethics.

"As a mortgage broker, I don't perform those services, so I can't charge for them," Pair says.

Yet such fees can be routine: We found them in 10 of the 12 Aquila purchases. The long list of names that fees go by (in addition to processing and administration charges, Aquila residents were hit with application, commitment, courier, document prep, origination and underwriting fees) suggests that specific things were done to earn them.

Actually, says University of Minnesota law professor Prentiss Cox, a former head of the Minnesota attorney general's consumer division, most all of these fees end up in lender or broker coffers regardless of what a HUD-1 says: "They should just call them 'Pluto research fees.' They're just making this stuff up."

**Toothless regulations**

The federal Real Estate Settlement Procedures Act, or RESPA, was passed back in 1974 to prevent just such a state of affairs. Among other provisions, it requires lenders to send, within three days of a loan application, a good-faith estimate to the borrower detailing the interest rate and fees.

In theory, all this information allows consumers to compare offers and select the best deal. In reality, the law is so toothless that it enables lenders to ignore their estimates in your HUD-1 come closing day.

"I call them bad-faith guesstimates," says Brian Montgomery, an assistant secretary at HUD.

When Kevin Slama and Brooke Perry applied for a $213,000 loan to buy their home on Aquila Lane in 2004, for example, their good-faith estimate for fees was $4,524. The actual fees turned out to be $7,320 -- or 61 percent higher.

Yet fees aren't the costliest result of the loopholes. RESPA was also meant to stop realtors from taking kickbacks for steering customers to favored lenders, title companies, appraisers or home inspectors. But it doesn't prohibit agents from making referrals within their own firm, as long as the agent isn't directly compensated.

And the law says nothing about indirect compensation -- or about how much the agent's employer can benefit from referrals. So the two-decade-long housing boom has seen firms morph into huge organizations that offer their own mortgage and title services. Even small shops can have a lending officer these days.

The result: Almost no one in this arrangement has an incentive to offer consumers the most competitive price.

**Title inflation**

On its face, title insurance seems like a fair deal. For around $1,000, a policy protects you for the life of your mortgage against the possibility that the person who sold you your home was not the full and rightful owner.

So if, for example, a letter comes in the mail saying the previous owner never paid off the mortgage and the bank plans to foreclose, no problem: The title insurer will make the bank whole.

In fact, virtually nobody ever gets one of those letters. Most potential claims are cleared up with a title search before the policy goes into effect. Since 1995, title insurers have on average spent less than 5 percent of their revenue on claims, according to a recent industry report. By contrast, property and casualty insurers typically pay out 80 percent of their premiums to cover policyholders' losses.

Given those juicy numbers, why hasn't competition lowered title insurance premiums? Because home buyers almost never shop prices for title insurance. They rely instead on recommendations from advisers like real estate agents, whose firms frequently get a cut of the premiums.

Again, this is made possible by the Real Estate Settlement Procedures Act, or RESPA, loophole that allows referral payments to in-house or affiliated service providers. It's fully within the law for realty outfits to set up their own in-house title agency -- essentially the sales office for a title insurer -- in return for a substantial chunk of the insurance premium.

Such agents have long argued that they're being paid for substantive title work, not for a referral. But regulators are increasingly accusing in-house and third-party agents of being shell companies created solely to skirt RESPA's prohibition against outside referral payments.

Colorado shut down 11 such entities in November and is investigating some 450 other title agents. And among HUD's 14 major case settlements last year, 13 involved alleged kickbacks in the title insurance business.

**Keeping the consumer in the dark**

"This is an industry that is not based on price competition," says California Insurance Commissioner John Garamendi, whose office is also investigating the title business. "It's based on keeping the consumer in the dark."

Not surprisingly, most home buyers we spoke to on Aquila paid substantial sums to in-house or affiliated title agents. When Lewis Leung bought his house, for example, his Century 21 Luger agent suggested he buy a policy from Old Republic National Title, one of the country's largest title insurers.

"She said I could find my own title insurer or use the one that she trusted," says Leung.

About $895 went to something called Reliance Title. Reliance -- you guessed it -- is owned by realtor Jim Luger, who founded Century 21 Luger 30 years ago.

Assuming industry norms, experts estimate Luger's title agency pocketed 80 percent of the total, passing on just 20 percent to Old Republic, which carries the risk on Leung's policy.

Jim Luger wouldn't confirm the breakdown, saying it was a private matter between his firm and Old Republic.

"It's legal and standard industry practice," says Luger of using affiliated title agents. "The people who come to us get good service and good rates."

Rande Yeager, CEO of Old Republic (and president of his industry's trade group), echoes Luger's claim that agency relationships serve home buyers well. As for the industry, "Customers get a good service at a fair price," Yeager says.

It's doubtful Leung would see it the same way. He would have paid $250 less, for instance, had he bought a policy from independent Minneapolis-based insurer Title-1.

**The stubborn 6 percent commission**

Galling as junk fees and inflated title costs may be, they are small potatoes compared with the big money commanded by real estate brokers in the form of sales commissions -- $65 billion last year. And it's over the size of sales commissions that the struggle to unleash competitive forces in the real estate business has been most fiercely waged

The crux of the battle is this: Scores of discount brokerages have opened around the country offering to help sell your home for much less than the 6 percent commission that traditional agents typically charge. Traditional brokers who bring would-be buyers into homes represented by discounters stand to earn a much smaller commission.

Most brokers say they do so anyway: Boycotting certain homes to protect commission structures would violate their profession's obligation to show customers every appropriate home on the market.

**No-shows with a discounter**

Jeff Miller, for one, doesn't believe them. In June he listed his house with St. Louis Park discounter Home Avenue. Waiting for buyers at yet another empty open house last September, Miller got the sense that he was very much alone. His wife Jo had wanted him to go with a traditional brokerage, but he resisted, figuring, who needs an agent in this crazy market?

But not one bid came in during the time the Millers had their house on the market with a discounter. Though buyers stopped in to see the place, the people who really move a house -- agents, who bring in the most potential buyers -- were largely absent.

Few ever brought buyers, yet each one brought a version of the same story: Dump your discount broker or your house won't get sold.

"One of the brokers told me that my house was the last one on their list to show a prospective buyer," says Miller.

Under pressure from his wife, Miller caved two weeks before Thanksgiving and hired a traditional agent charging a full commission. On a snowy day in November, 28 agents showed up. No sale as of early February, Miller reports, but seven potential buyers have been brought in for a look.

**Pressure to use full-price brokers**

Stewart and Amy Krummen planned to use a discount broker to sell their three-bedroom Cape Cod on Florida Avenue, but, they say, the owners of the five-bedroom split-level they wanted on Aquila insisted that the Krummens use their full commission broker.

Why? The Krummens say they were told the owners were nervous they'd fail to sell quickly -- and delay the Aquila closing.

In the end, the Krummens acquiesced and paid $17,710 in full commission on their sale. The Aquila house seller declined to comment; the broker says the Krummens' purchase was not contingent on their hiring her.

The Krummens remember it differently. Either way, their house sold within 24 hours. Says Stewart, "We paid a lot of money for something we could have done with a day's work."

**Simple solutions to fee bloat**

The real problem in real estate transaction costs is greater than what's happening on Aquila Lane. Home buyers are at a huge disadvantage when they deal with the realtors, mortgage brokers and title companies they hire. Most folks buy or sell a house only a few times in their life, so they build up little knowledge of how the process is supposed to work or how much it should cost.

Meanwhile, real estate pros have relatively little incentive to treat customers fairly. Sellers often move, and buyers may not seek another house for a decade, which is longer than the career life of the average real estate agent. So unlike, say, a grocer or a hairdresser, agents get little repeat business.

As the real estate boom enters what looks like a new phase of less frenzied growth, there's more need than ever for laws that better align the interests of real estate professionals and their firms with the interests of their customers.

**Bundle services**

According to John Weicher, director of the Center for Housing and Financial Markets at the nonprofit Hudson Institute and a former HUD official in charge of RESPA regulation, one simple solution would be to allow real estate services to be bundled.

Realtors or mortgage brokers could charge a single fee for everything a client needs to buy a house -- loan, title, the works. Consumers could easily compare fees and rates, pushing lenders to compete on price. Lenders would also pressure title insurers, appraisers and other service providers in the same way that Wal-Mart pressures its suppliers.

"If lenders had to buy their own title insurance, premiums would drop like a rock," says Wharton's Guttentag.

**Put teeth in RESPA**

Another way to correct the system would be to make lenders stick to their good-faith estimates. HUD officials, who are working on changing the rules of the closing game, argue that this could bring down costs because lenders would have an incentive to offer lower prices, not just lower estimates.

Reform proposals have been floated before, only to be shot down by industry lobbyists. Maybe it's different this time. The Justice Department has brought antitrust allegations against realtors. And perhaps HUD's nascent efforts at reform will make a difference.

A skeptical Allen Fishbein, director of housing and credit policy at the Consumer Federation of America, chooses to reserve judgment.

"We have a long way to go," he says. "Right now the only competition in the real estate business is to see who can get the consumer to pay the most." ■

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