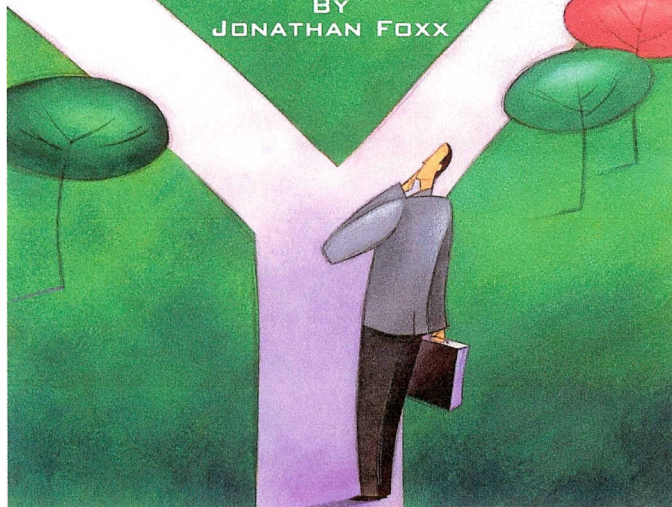


SAVING THE YIELD SPREAD PREMIUM

BY
JONATHAN FOXX



The ancient Roman god, Janus, was two-faced—his back-to-back visages looking at the past and into the future—a symbolic representation of ineluctable transitions through the passage of time, a reminder of essential change from one condition to another, whether for better or worse. Like it or not, the yield spread premium (YSP) will be going through its own transition soon, and, depending on the politics—and not necessarily the facts—the essential change will be enduring and irreversible.

If the YSP is believed to be a legitimate financing tool and proves to be a useful means in the service of borrowers, it may yet survive; if not, its demise is on the way. At this time, it is in danger of becoming extinct! The House recently passed the Mortgage Reform and Anti-Predatory Lending Act,¹ which will amend the Truth-in-Lending Act (TILA), and it has gone to the Senate.² Its provisions directly affect the fate of the YSP. If it passes on to the White House in its current form and President Obama signs it, this legislation will become law.

A key provision is the virtual removal of yield spread premiums!³

Prior to the enactment of the Real Estate Settlement Procedures Act (RESPA) in 1974, the U.S. Department of Housing and Urban Development (HUD) and the Veterans Administration (VA) issued a report asserting, amongst

other things, that “settlement charges often are based on factors unrelated to the cost of providing the services,” and advocated regulating settlement costs. This position was an underlying feature of the debate, beginning in 1972, which led up to the formation of RESPA.⁴ Congress decided that RESPA



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should not implement price controls, such as setting maximum allowable costs, believing instead that proper disclosure and prohibiting certain practices were sufficient to avoid abuse. HUD has maintained that RESPA is not intended to be a rate-making statute. And it has indicated in various policy issuances that the YSP is not per se legal or illegal. Yet in the near future the YSP—a component of total compensation, and a means whereby a borrower, if properly empowered, could actually determine its use—will be heading to the dustbin of history.

This controversy can be considered by briefly exploring certain evaluative criteria.

Broadly, the following areas constitute the core of the debate:

- ❖ Can the YSP cause price discrimination?
- ❖ Can borrowers be charged more because of the YSP?
- ❖ Can the YSP provide a dollar for dollar financing offset?
- ❖ Does the YSP cover the cost of goods and services?

Let us briefly consider each of these questions. Afterward, a suggestion will be offered that, if implemented, would strongly empower the borrower, fortify the lender and broker relationship, preserve continuity and potency of market forces, and save the YSP.

Price discrimination: Can the YSP cause price discrimination?

There is some evidence that less sophisticated borrowers and borrowers with certain racial profiles have paid higher loan costs. According to HUD’s Office of Policy Development and Research, “price discrimination has been known to occur,” whereby “loan fees are highly correlated to race and education characteristics, with African-American and Latino borrowers paying an average of \$415 and \$365 more, respectively, than other borrowers.”⁵

HUD’s recent, final version of Regulation X revisions,⁶ designed to create a more level playing field, were in part a response to a regulatory impact analysis—required by the Regulatory Flexibility Act—that stated “there is strong evidence of information asymmetry between mortgage originators and settlement service providers and consumers, allowing loan originators to capture much of the consumer surplus in this market through price discrimination.”⁷ Total loan costs are elevated in loans containing YSPs, discount points and seller contributions to closing costs. The YSP may not necessarily offer the borrower a savings, though it can be used to increase the cost. “Research shows that borrowers saved only \$20 in upfront cash for each \$100 paid in YSP. Mortgage-brokered loans benefited the least, saving only \$7 per \$100 in YSP.”⁸ Higher fees, lower savings, meaning increased costs to borrowers, can lead directly to price discrimination.

Higher costs: Can borrowers be charged more because of the YSP?

Mortgage brokers can obviously increase their compensation by selecting the lender that offers a higher YSP for a loan, though another lender may offer a loan with similar features, but at a lower YSP. It doesn’t matter that the compensation is paid indirectly (i.e., YSP paid by lender), the consumer is ultimately paying for it. If such increased compensation is not used as a financing offset, the mortgage broker could be incentivized to choose the higher YSP, without having to provide any additional financing, products, or services to the borrower. This is a prima facie violation of RESPA,⁹ because a borrower’s upfront cash requirements are not lowered, yet the mortgage broker’s compensation is increased in excess of what is reasonably related to the total value of the origination services provided by the broker.¹⁰

Offset financing: Can the YSP provide a dollar for dollar financing offset?

HUD has consistently taken the position that the YSP can play a significant role in offsetting financing costs.¹¹ In its Statement of Policy 2001-1, HUD stated that “a yield spread premium can be a useful means to pay some or all of a borrower’s settlement costs. In these cases, lender payments reduce the up-front cash requirements to borrowers. In some cases, borrowers are able to obtain loans without paying any upfront cash for the services required in connection with the origination of the loan. Instead, the fees for these services are financed through a higher interest rate on the loan. The yield spread premium thus can be a legitimate tool to assist the borrower”¹² (emphasis added). Indeed, HUD believes this use of the YSP “fosters homeownership.”¹³ Analogous to the case of the YSP having the potential to cause a higher cost loan, if the YSP is only used to increase the borrower’s interest rate as well as the broker’s overall compensation, but does nothing to lower up-front cash requirements for the borrower, this use of the YSP would not be a bona fide source of financing and certainly violates RESPA.¹⁴

Goods and services: Does the YSP cover the cost of goods and services?

This is an area that has been litigated extensively and, even to this day, the outcome is uncertain.

The legal landscape has stretched far and wide, in various jurisdictions, from initially maintaining that the YSP is a referral prohibited by RESPA’s Section 8,¹⁵ to the YSP being a form of compensation and not a violation of RESPA;¹⁶ from the YSP being a permissible payment for goods (i.e., loans with YSPs),¹⁷ to a reversal of that position, holding that the YSP was potentially a prohibited referral fee under Sections 8(a) and 8(c) of RESPA.¹⁸ In that latter ruling, a case decided by the Court of Appeals for the Eleventh Circuit, in *Culpepper v. Inland Mortgage Corporation* (Culpepper), the Court offered a two-pronged test to determine if the YSP was compliant with RESPA:

1. Are goods or services provided in exchange for the yield spread premium?; and
2. Was the YSP a payment in exchange for those goods or services.

First, the court decided that the YSP was not a payment for the good itself (i.e., the “good” being the loans with YSPs, table-funded), because the lender, not the broker, actually owned the loan already. Second, the court decided that the YSP was not a payment for the good itself, asserting that direct payments to the broker is the allowable compensation, and, in any event, given that the YSP is calculated on the basis of the loan’s interest rate, where there is no ostensible difference between a loan with a YSP and a loan without a YSP, the YSP had to be a prohibited referral fee.

HUD then weighed in, offering its Statement of Policy 1999-1, and in so doing offered its own Two-Part Test. Essentially, HUD's position was (and still is) that a mortgage broker's total compensation is RESPA-compliant (1) if "goods or facilities were actually performed for the compensation paid," and (2) if the "payments are reasonably related to the value of the goods or facilities that were actually furnished or services that were actually performed."¹⁹ HUD provided a list of compensable services which, although it is not (and was not meant to be) exhaustive, clearly identifies numerous services that mortgage brokers render in return for direct and/or indirect compensation from the borrower. Importantly, HUD identified certain goods provided by a mortgage broker, but it made clear that the loan (i.e., a loan with YSP, table-funded) was not itself a "good." Explicitly, HUD stated that, "while a broker may be compensated for goods or facilities actually furnished or services actually performed, the loan itself, which is arranged by the mortgage broker, cannot be regarded as a 'good' that the broker may sell to the lender and that the lender may pay for based upon the loan's yield's relation to market value, reasonable or otherwise."²⁰ Even though HUD had answered key questions, many courts still vacillate in their interpretations.

Indeed, litigation continued, bringing about an additional response from

HUD. Its 2001-1 Statement of Policy²¹ was issued, in part, to clarify HUD's position on YSPs, due to a decision of the Court of Appeals for the Eleventh Circuit, in *Culpepper v. Irwin Mortgage Corporation*, which upheld certification of a class in a case alleging that YSPs violated Section 8 of RESPA.²² The Court had found that the lender, pursuant to a prior understanding with mortgage brokers, had paid YSPs to the brokers based solely on the brokers' delivery of above par interest rate loans. Furthermore, the court described HUD's 1999-1 Statement of Policy as "ambiguous." At the time, other courts were rendering conflicting decisions. HUD's response asserted the legality of YSPs, when services are actually rendered for compensation reasonably related to the value of the services and it makes clear the operational effectiveness and purpose of YSPs in increasing homeownership, as well as identifying those areas where the YSP may be abused.

But how to determine that the compensation payments are reasonably related to the value of the services actually furnished and performed?

Suggestion

Implicit in each of the criteria given above is the view that the YSP can be abused, though it may serve a legitimate purpose. Many commercial transactions are subject to abuse, if left unregulated. To eliminate the YSP, when it is a useful means and legitimate tool to originating residential

mortgage loans, would not only deprive the borrower of its application, but also cause a pervasively destructive impact on the mortgage brokerage industry. This is clearly a case that cries out for better regulation.

HUD had recommended regulatory measures in 1997, when it published a proposed rule to give a qualified "safe harbor" for payments to mortgage brokers under RESPA's Section 8.²³ HUD proposed that there would be no violation of RESPA—and a presumption would be made that broker fees, both direct and indirect, were legal—if a mortgage broker should enter "into a contract with consumers explaining the broker's functions (whether or not it represented the consumer) and the total compensation the broker would receive in the transaction, before the consumer applied for a loan."²⁴

Recent RESPA reform has been an attempt to remediate through increased disclosure. The new Good Faith Estimate (GFE), consisting of three pages, provides a rather thorough outline of the settlement charges. The GFE requires that the YSP to be disclosed more comprehensively, requiring a "credit" field to be used to disclose a yield spread premium and a "charge" field to be used for discount points.²⁵

However, does this go far enough in determining the extent to which the YSP is applied to the loan and, importantly, establish the "reasonableness" of this particular compensation for

goods or services actually rendered? After all, HUD's remedy would simply be to require an enhanced disclosure of the YSP to the borrower. Indeed, the Mortgage Reform and Anti-Predatory Lending Act, mentioned above, will surely add a whole new set of mandatory disclosures to the already huge number of disclosures required by existing law. But the resolution will not be found in more and more disclosures or by allowing the government to interpose itself between the consumer and private enterprise through more disclosure forms and promulgating arbitrary standards.

An important piece is still missing, one that gives the consumer (and, therefore, market forces) the ability to set a fair market standard for compensation payments that are "reasonably related to the value of the services actually furnished and performed."²⁶ In the long run, if appropriately implemented, it would also remedy many of the issues involving price discrimination, higher costs, and offset financing, because it would give the borrower control over the use of the YSP.

The missing piece is simply to credit the YSP directly to the borrower. The borrower would then have the choice to use the YSP in accordance with the borrower's own interests. Once the borrower specifically authorizes how the YSP is to be used, a standard of "reasonableness" would be established.

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HUD offers \$58 million for housing counseling



The U.S. Department of Housing and Urban Development (HUD) has announced that more than \$58 million is available for a broad range of housing counseling programs to help families find and preserve housing. The funding is an increase of \$11 million, or 23 percent, over last year. These grants will be awarded competitively to hundreds of HUD-approved counseling agencies and state Housing Finance Agencies that offer a variety of services, including how to purchase or rent a home, how to avoid foreclosure, how to improve credit scores, and how to qualify for a reverse mortgage.

"Now, more than ever, it is crucial that American families make informed decisions about their housing choices," said HUD Secretary Shaun Donovan. "These counseling agencies are also vital to the success of the President's Making Home Affordable Plan which is helping families avoid foreclosure and remain in their homes."

HUD-approved counseling agencies provide homeownership counseling, as well as financial literacy education to renters and homeless individuals and

families. This year, HUD's Housing Counseling Grant program will provide approximately \$47 million for comprehensive counseling; \$8 million for Reverse Mortgage Counseling, \$2 million for supplemental funding for Loan Document Review Counseling, and \$1 million in supplemental funding for Fair Lending and Mortgage Fraud Analysis and Counseling.

National and regional agencies distribute much of HUD's housing counseling grant funding to community-based grassroots organizations that provide advice and guidance to low- and moderate-income families seeking to improve their housing conditions. In addition, these larger organizations help improve the quality of housing counseling services and enhance coordination among their counseling providers.

HUD will award grants to approximately 400 applicants. Applications may be downloaded from HUD's Web site, including instructions on submitting proposals via FedEx, United Parcel Service, and the U.S. Postal Service. Applications must be postmarked on or before Friday, July 17 and received by the designated reviewing office within five days.

For more information, visit www.hud.gov.

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Market forces will respond accordingly, as borrowers agree to the utilization of the YSP. Placing the control of the YSP into the hands of the borrower and letting its use be determined by the borrower will protect the borrower and provide a true "safe harbor."

Like the Roman god, Janus, we now occupy the middle ground between the past and the future, between how the YSP has been used in the past and how (or even if) it will be used in the future. As events unfold, however, saving the YSP by empowering the borrower to authorize its use may not go far enough! For the Service Release Premium (SRP), the undisclosed income paid to a lender when it sells an above par loan into the secondary market, is in some ways an analogue to the YSP. RESPA does not require a lender to disclose the SRP to the borrower, though it does require a mortgage broker to disclose the YSP. Should the YSP be revised or eliminated without concomitantly changing the application of the SRP? Legislation aimed at changing the YSP, but not the SRP, seems to favor the lender over the mortgage broker. Both the lender and broker serve the consumer! Borrowers will benefit from the proper use of the YSP and the SRP. In future articles, we will explore the role played by the SRP in originating residential mortgage loans, and, importantly, how revising the application of the SRP will benefit consumers, maintain a stable market, and preserve the vitality of all loan originators.

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Footnotes

- 1- HR 1728.
- 2- Passed by the House on May 7, 2009 and received by the Senate on May 12, 2009.
- 3- Amending TILA Sec 129B, inter alia, by inserting a new subsection after subsection (b): Sec 103(4)(A) "No provision of this subsection shall be construed as permitting yield spread premiums or other similar incentive compensation."
- 4- Hearing before the Subcommittee on Housing of the House Committee on Banking and Currency (1972),

Real Estate Settlement Costs: FHA Mortgage Foreclosures, Housing Abandonment, and Site Selection Policies.

- 5- *Research Works*, Volume 5, Number 8, September 2008, pp 1-2.
- 6- Released: Nov. 12, 2008.
- 7- FR-5180, Filed: 05/08/09.
- 8- *Research Works*, Op. cit., p.1.
- 9- 24 CFR 3500, Real Estate Settlement Procedures Act.
- 10- HUD offered a "Two-Part Test," in its Statement of Policy 1999-1, to determine if a loan origination is RESPA compliant: (1) whether services were actually furnished and actually performed for the compensation paid, and (2) whether the compensation payments are reasonably related to the value of the services actually furnished and performed. See: 24 CFR Part 3500 (RESPA), Statement of Policy 1999-1, US Department of HUD, 02/22/99.
- 11- 54 FR 38646 (September 20, 1989), final rule in Deregulation of Mortgagor Income Requirements; HUD's recognition in 1992 that the YSP must be disclosed, codified in "Fact Situations" 5 and 13 in Appendix B to 24 CFR Part 3500; see also, Op. cit. Statement of Policy 1999-1.
- 12- 24 CFR Part 3500 (RESPA) Statement of Policy 2001-1, Section I.A.
- 13- Ibid.
- 14- 24 CFR 3500.14 (g)(1)(iv), permits "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."
- 15- Mentecki v. Saxon Mortgage, Inc., 1997 WL 45088 (E.D. Va. 1997).
- 16- Barbosa v. Target Mortgage Corporation, 968 F.Supp. 1548 (S.D. Fla. 1997).
- 17- Culpepper v. Inland Mortgage Corporation, 953 F.Supp. 367 (N.D. Ala. 1997).
- 18- Culpepper v. Inland Mortgage Corporation, 132 F.3d 692 (11th Cir. 1998).
- 19- HUD Policy Statement, 64 FR 10080, 10084, Op. cit., Note 10.
- 20- Op. cit., Note 10, Statement of Policy 1999-1, Section II.C.
- 21- Op. cit., Note 12, Statement of Policy 2001-1.
- 22- Culpepper v. Irwin Mortgage Corporation, 253 F.3d 1324 (11th Cir. 2001).
- 23- Codified at 62 FR 53912.
- 24- Op. cit., Note 10, Statement of Policy 1999-1, Section F. This qualified "safe harbor" would only be available to those payments that did not exceed a test to preclude "unreasonable fees." The test was to be established in the rule-making.
- 25- 24 CFR Parts 203 and 3500, FR: Vol. 73, No. 222, pp. 68204-68288 (11/17/08).
- 26- Op. cit., Note 10, Statement of Policy 1999-1, "Two-Part Test."



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