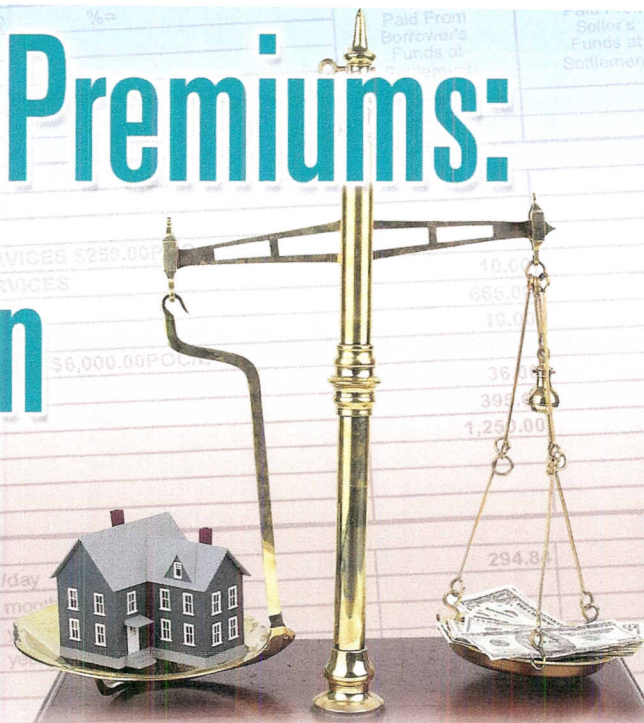


Yield Spread Premiums: Compensation or Kickback?

By Jonathan Foxx



Legitimate compensation or an illegal referral fee (kickback) ... really two existentially different and diametrically opposed concepts! Each claims reference to the yield spread premium (YSP). An entire class of financial institutions serving the consumer is being held up to public opprobrium over the legal practice of receiving YSPs from a lender for assisting in the negotiation and origination of residential mortgage loans.

The class of financial entities we refer to, of course, is mortgage brokers.

A political storm is raining down on YSPs and mortgage brokers, as typified by the rhetoric of Barney Frank (D-MA), Chairman of the House Financial Services Committee, whose HR 1728,¹ passed by a vote of 300 to 114 on May 7, bans "yield spread premiums and other abusive compensation structures that create conflicts of interest or reward originators that "steer" borrowers." Titled the "Mortgage Reform and Anti-Predatory Lending Act," HR 1728 now moves to the Senate, where there is no equivalent legislation. If it passes on to the White House and President Obama signs it, this legislation will become the law of the land. There are several features to HR1728 that offer significant protection to the public. However, the provision to remove YSPs as "abusive compensation" is pivotal.

Rep. Frank has taken to demonizing non-bank financial institutions, not just mortgage brokers. He has opined that "if, in fact, mortgage loans, residential mortgage loans, were made only by banks or thrifts or credit unions, then we would not have a sub-

prime crisis and I think we wouldn't have the economic problem we now have."² With this scenario declaimed by this leading politician, one can only marvel at such successful bank lobbying efforts!

The level of scorn and malign commentary has gradually reached a fevered pitch, where certain consumer advocacy groups, politicians, heralded economics professors and some professor-politicians alike now willfully call the YSP a kickback. For a very long time, however, they viewed the YSP as a vital, functional component within the broader context of mortgage loan originations.

These aforesaid protagonists, however, have now become muted observers or antagonists, such as the professor-politician Austan Goolsbee, a member of the President's Council of Economic Advisers, who stated in March 2007 (prior to joining the Obama Administration) that "the mortgage market has become more perfect, not more irresponsible,"³ because of innovation, responsiveness to market forces and borrowers' needs. These days, Mr. Goolsbee seems to be more circumspect when it comes to such observations.

"More perfect" then, but not now?

It is indisputable that borrowers' financing needs caused lenders to originate new loan products and, mutatis mutandis, permitted mortgage brokers to offer them. And it is also indisputable that the legitimately applied YSP was a feature to the growth of this innovation.

Linking the nomenclature of "yield spread premiums" with "kickbacks" is an attempt by various parties, including the mainstream media, to sway public sentiment toward viewing YSPs as inherently, adversely affecting the borrower, and by extension, implying that the mortgage broker's receipt of a YSP from a lender is somehow a kind of sneaky, underhanded act. A *New York Times* editorial recently inveighed that the "first step must be to outlaw the kickbacks" and "the most clearly unethical form of payment is the so-called yield spread premium."⁴

These assertions amount to inferring that the YSP is a prime causative agent of the mortgage meltdown crisis, and specifically, the sub-prime defaults, because brokers had allegedly "steered" borrowers to inappropriate loans that paid higher YSPs. This allegation is really part of the ongoing "blame game" that has saturated the economic environment for the last two years. In this circular firing squad, the last one standing (rightly or wrongly) takes all.

HUD and YSPs

Nevertheless, in October 2001 the U.S. Department of Housing and Urban Development (HUD) issued a Policy Statement that was introduced by a press release from HUD's Secretary, Mel Martinez, stating, in part, that "yield spread premiums are legal if the broker actually performs services for the homebuyer, and if the total compensation the broker receives is reasonably related to the total value of the services the broker performs."⁵

HUD's view, enunciated by Mr. Martinez in the aforementioned announcement, is that "it has always been HUD's position that yield spread premiums serve an important purpose in the housing market," and that "YSPs are a legitimate tool to help families become homeowners;"⁶ but, they can certainly be abused. For example, when "a broker may persuade the homebuyer to accept a higher interest rate without enjoying lower upfront costs" and consequently the lender or broker "pockets the yield spread premium, and the homebuyer is worse off."

There is a considerable difference between a fee that "serves an important purpose," but may be abused, and a fee that should be entirely "outlawed" because it is "clearly unethical!"

We will not debate here the fundamental merits of the YSP, its role in residential mortgage loan originations, or even how to keep it as a viable, "legitimate tool" which will not adversely affect the consumer. Those endeavors should be high priorities for public debate.

Our interest here is in providing clarity to the more narrow issue of whether a YSP should even be considered under current law to be an illegal referral fee or characterized as a kickback.

Terminology matters!

Let us turn to the very definition of an illegal referral fee, a "kickback," given in Regulation X, the implementing regulation of the Real Estate Settlement Procedures Act (RESPA).⁷ RESPA devotes an actual section to

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kickbacks and unearned fees, centered on the concept of a "thing of value" being exchanged between two or more entities that provide settlement services, known as "settlement service providers." A "thing of value" is a broad term and does not mean just a transfer of money; that is, it includes any payment, advance, funds, loan, service or other consideration. Let's see how the term "thing of value" is used by a relevant statute and how a settlement service provider is legally compensated for an actual service rendered.

First, there is the prohibition against kickbacks:¹¹

No person shall give and no person shall accept any fee, kickback or other thing of value pursuant to any agreement or understanding, oral or otherwise, that business incident to or part of a settlement service involving a federally related mortgage loan shall be referred to any person. Any referral of a settlement service is not a compensable service, except as set forth in Sec. 3500.14(g)(1). A business entity (whether or not in an affiliate relationship) may not pay any other business entity or the employees of any other business entity for the referral of settlement service business.

Clearly, a "compensable service" is not a kickback if it complies with Section 3500.14(g)(1), et sequi.

That section outlines compensable services¹² as:

(i) A payment to an attorney at law for services actually rendered; (ii) A payment by a title company to its duly appointed agent for services actually performed in the issuance of a policy of title insurance; (iii) 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; (iv) 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; (v) A payment pursuant to cooperative brokerage and referral arrangements or agreements between real estate agents and real estate brokers. (vi) Normal promotional and educational activities that are not conditioned on the referral of business and that do not involve the defraying of expenses that otherwise would be incurred by persons in a position to refer settlement services or business incident thereto; and (vii) An employer's payment to its own employees for any referral activities.

HUD has noted the legislative history demonstrates that "[t]o the extent the payment is in excess of the reasonable value of the goods provided or services performed, the excess may be considered a kickback or referral fee proscribed by Section [8]."¹³ So, the payment must be reasonably related to the value of the services actually furnished and performed.

Additionally, there is the following prohibition against splitting fees:¹⁴

No split of charges except for actual services performed. 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 settlement service in connection with a transaction involving a federally related mortgage loan other than for services actually performed. A charge by a person for which no or nominal services are performed or for which duplicative fees are charged is an unearned fee and violates this section. The source of the payment does not determine whether or not a service is compensable. Nor may the prohibitions of this part be avoided by creating an arrangement wherein the purchaser of services splits the fee.

A concise reading of these sections of Regulation X reveals that no kickback occurs when:

1. A lender (a settlement service provider) pays a mortgage broker (that is, another settlement service provider) for rendering "compensable services," pursuant to §3500.14(g)(1), such payments being reasonably related to the value of the services that are actually rendered, and
2. No fees may be charged by, or split between, settlement service providers, for services not rendered, or considered to be nominal or duplicative.

If these criteria are met, the fees received are considered legitimate compensation.

Compensable services

But what are compensable services?

Fortunately, HUD has opined regarding the fundamental requirements for a compensable service. Back in 1999, when mortgage brokers originated an estimated half of all residential mortgage loans in the United States, (and the number of loans so originated grew significantly since then), HUD issued a Policy Statement¹⁵ which recognized that mortgage brokers were providing many services in their intermediary capacity between applicant and lender. HUD's Statement of Policy (1999-1) crisply stated:

Mortgage brokers provide various services in processing mortgage loans, such as filling out the application, ordering required reports and documents, counseling the borrower, and participating in the loan closing. They may also offer goods and facilities, such as reports, equipment and office space to carry out their functions.



"The YSP certainly can be abused. But does that mean it should be eliminated, thereby economically diminishing an entire class of financial institutions—mortgage brokers—the same institutions that have been at the forefront of originating residential mortgage loans for millions of people across the economic spectrum?"

Clearly, there has been a recognition—by the way, dating all the way back to 1992 when HUD first defined the term "mortgage broker"—that certain, actual services rendered by a mortgage broker constitute a legitimate business practice and are compensable. Whether compensation consists of direct (i.e., broker fee paid by borrower), indirect (i.e., YSP paid by lender), or some combination thereof, the consumer is paying the mortgage broker's compensation.

HUD's Two-Part Test

In the same Statement of Policy, HUD offered a Two-Part Test to determine the legality of payments made by a lender to a mortgage broker (or other settlement service provider):

Two-Part Test:

(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.

Examples of compensable services

Using HUD's own 1995 letter to the

Independent Bankers Association of America as a basis for describing a generic, though not necessarily complete, set of compensable services for which a broker may charge a fee to the consumer, providing that such services were actually rendered, HUD's 1999-1 Statement of Policy indicated numerous types of services for which the mortgage broker may be compensated, either directly or indirectly, and therefore "compensable services."

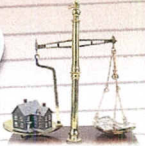
Compensable services list

- 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 could 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 VOsEs (verifications of employment) and VODs (verifications of deposit);
- 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, lender, between application and closing to appraise them of the status of the application and 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.

Although the list is not, and was not meant to be, exhaustive, it is clear that numerous services are rendered by mortgage brokers in return for direct and/or indirect compensation from the borrower. All the goods, services and facilities, when actually

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802. Loan Discount	% to	ABC MORTGAGE SERVICES \$250.00POC	10.00
803. Appraisal Fee	to	ABC MORTGAGE SERVICES	665.00
804. Credit Report	review to W. Is. Orgo Bank		19.00
805. Title Insurance	to	ABC MORTGAGE SERVICES	1,250.00
806. Escrow Fee	to	ABC MORTGAGE SERVICES	
807. Courier Fee	to	ABC MORTGAGE SERVICES	
808. Processing Fee	to	ABC MORTGAGE SERVICES	



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furnished and performed, are entirely legal, and receiving compensation for providing such goods, services and facilities, directly and/or indirectly, is not a violation of RESPA's prohibition against kickbacks. HUD's position has consistently been that YSPs are not per se legal or illegal: The legality of YSPs is based on the application of HUD's test, as stated in its 1999-1 Statement of Policy (and described, in part, above).

Removing ambiguity

HUD elaborated further its position with respect to YSPs. Indeed, as stated in HUD's subsequent 2001-1 Statement of Policy:¹⁶

The Conference Report on the Department's 1999 Appropriations Act directed HUD to address the issue of lender payments to mortgage brokers under RESPA. The Conference Report stated that "Congress never intended payments by lenders to mortgage brokers for goods or facilities actually furnished or for services actually performed to be violations of [Sections 8](a) or (b) (12 U.S.C. Sec. 2607) in its enactment of RESPA." H. Rep. 105-769, at 260.¹⁷

The 2001-1 Statement of Policy further supports the legality of YSPs when services are actually rendered for compensation reasonably related to the value of the services. The 2001-1 Statement of Policy 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 Corp.*,¹⁸ which upheld certification of a class in a case alleging that YSPs violated Section 8 of RESPA. In *Culpepper*, the Court found that the defendant 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. Thus, the Court asserted that YSPs are kickbacks where the lender's payments were based exclusively on interest rate differentials reflected on rate sheets, and the lender had no knowledge of what services, if any, the broker performed. Furthermore, the court described HUD's 1999-1 Statement of Policy as "ambiguous."¹⁹ Other courts were rendering conflicting decisions.

Consequently, to remove any "ambiguity" regarding Section 8 of RESPA, HUD issued its 2001-1 Statement of Policy, as a means to clarify its interpretation for lenders, brokers, and consumers. This issuance is a very detailed

and somewhat complex document, addressing several areas of importance, such as the splitting of fees. However, it also seeks to make clear the operational effectiveness and purpose of YSPs in increasing homeownership, as well as those areas where the YSP may be abused.

In addition to reiterating HUD's Two-Part Test to determine the legality of the YSP (supra), the 2001-1 Statement of Policy emphasizes the importance of full disclosure of any broker fees, including the YSP, as early in the loan application process as possible. Meaningful disclosure of all charges and fees is essential under RESPA, HUD maintains, and "such disclosures help protect consumers from paying unearned or duplicate fees."

HUD's view

HUD devotes an entire section in the 2001-1 Statement of Policy to the prohibition against unearned fees, colloquially, kickbacks. According to HUD, YSPs are not per se unearned fees or illegal. They can serve a "useful means" and, if such means is appropriately provided and not abused, the YSP is not a kickback.

As HUD describes that "useful means":

A yield spread premium is calculated based upon the difference between the interest rate at which the broker originates the loan and the par, or market, rate offered by a lender. The Department believes, and industry and consumers agree, 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. The availability of this option fosters homeownership. [HUD 2001-1 Statement of Policy, Part A.]

Indeed, HUD further seeks to demonstrate the importance of YSPs to the loan origination process and the means by which borrowers may benefit from it:

Yield spread premiums permit homebuyers to pay some or all of the upfront settlement costs over the life of the mortgage through a higher

interest rate. Because the mortgage carries a higher interest rate, the lender is able to sell it to an investor at a higher price. In turn, the lender pays the broker an amount reflective of this price difference. The payment allows the broker to recoup the up front costs incurred on the borrower's behalf in originating the loan. Payments from lenders to brokers based on the rates of borrowers' loans are characterized as "indirect" fees and are referred to as yield spread premiums. [HUD 2001-1 Statement of Policy, Part A.]

Compensation?

It would seem, then, that because the YSP can be abused, it does not infer that it serves no useful means or is inherently a kickback. Of course, some mortgage brokers have used YSPs as a way to enhance the profitability of mortgage transactions without offering the borrower lower upfront fees.

YSPs can be used to increase the borrower's interest rate and the broker's overall compensation, without lowering upfront cash requirements for the borrower. That would mean a total compensation in excess of what is reasonably related to the total value of the origination services provided by the broker, and it would fail to comply with the second part of HUD's Two-Part Test. This use of the YSP is not a bona fide source of financing. Obviously, using the YSP in this way is clearly abusive, leads to price discrimination, inter alia, and violates Section 8 of RESPA.

The YSP certainly can be abused. But does that mean it should be eliminated, thereby economically diminishing an entire class of financial institutions—mortgage brokers—the same institutions that have been at the forefront of originating residential mortgage loans for millions of people across the economic spectrum? And does its removal disadvantage prospective homeownership and refinancing, given HUD's view of the role played by the YSP in the loan origination process?

Kickback?

The scope of this article focused on whether the YSP is a kickback, not an evaluation of its merits, lack thereof, or effectiveness in increasing homeownership and the ability to refinance.

Certain factors may be dispositive in deciding if the YSP has an inherently adverse impact on borrowers, such as determining whether its legitimate use causes price discrimination, costs the borrower more, provides a dollar for dollar financing offset, or covers the cost of goods and services. These areas of review must be carefully elucidated, if we are to determine whether the YSP should be banned or better regulated.

However, so long as the mortgage broker fully discloses, meets HUD's Two-Part Test, and there is no illegitimate fee splitting in the loan transaction, the YSP is not a kickback.

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Footnotes

- 1- HR 1728, the "Mortgage Reform and Anti-Predatory Lending Act."
- 2- Press Release, the House Committee on Financial Services, April 29, 2009.
- 3- Rep. Barney Frank, guest speaker, address to business leaders at the Boston Harbor Hotel, NECN broadcast, "Barney Frank Defends His Foreclosure Plan," May 16, 2008.
- 4- Goolsbee, Austan. "Irresponsible Mortgages Have Opened the Doors to Many of the Excluded," *The New York Times*, New York Edition, page C3, March 29, 2007.
- 5- Editorial Opinion, *The New York Times*, New York Edition, page A22, April 10, 2009.
- 6- Christie, Les. "Sub-Prime Blame Game," *CNN.com*, July 4, 2007.
- 7- Press Release, U.S. Department of Housing and Urban Development, Oct. 15, 2001.
- 8- Idem.
- 9- 24 CFR 3500 Real Estate Settlement Procedures Act (RESPA).
- 10- 24 CFR 3500.14(d); codified to 12 USC 2602.
- 11- 24 CFR 3500.14; 12 USC 2607.
- 12- 24 CFR 3500.14(g)(1)(i-vii).
- 13- 24 CFR 3500 Real Estate Settlement Procedures Act (RESPA) Statement of Policy 1999-1 §D U.S. Department of Housing & Urban Development, Feb. 22, 2009.
- 14- 24 CFR 3500.14(c).
- 15- Op. Cit.
- 16- 24 CFR 3500.14 Real Estate Settlement Procedures Act (RESPA) Statement of Policy 2001-1 Section I-A.
- 17- Section 8 is the provision of RESPA that addresses kickbacks, fee-splitting and unearned fees.