

YIELD SPREAD PREMIUM

By Alan M. Tarter and Christopher J. Gulotta



Alan M. Tarter

The mortgage brokerage industry has grown in recent years to the point where as many as half of all home mortgages are facilitated by a mortgage broker.¹ The broker acts as intermediary between the borrower (whether a home-buyer or a homeowner refinancing an existing mortgage) and the institutional lender (lender).

For facilitating the transaction,² the broker receives compensation from either the borrower or the lender or both. Borrowers may pay brokers a “direct,” or origination fee based on “points,” or a fractional percentage of the loan amount. In certain instances, however, the broker receives an “indirect” fee from the lender. Fees paid by the lender to the broker are known as yield spread premiums (YSPs).

A YSP³ is a payment to the broker from the lender for originating and processing a loan with either: (i) a rate identical to that which a borrower could otherwise obtain from a lender (i.e., the lender’s “retail rate”) or (ii) a fractionally higher interest rate — an “above-par” loan — than the lender is prepared to offer borrowers. A higher YSP is paid most commonly when the broker arranges terms somewhere in between the retail rate available to direct borrowers and the wholesale rate that lenders offer brokers.

In recent years, following on the growth of the mortgage broker industry, consumers and their lawyers have come to question the practice of banks paying brokers YSPs, and a few courts have suggested that such payments are unlawful under Sec.8 of the Real Estate Settlement Procedure Act (RESPA). The Department of Housing and Urban Development (HUD), while contemplating the regulations discussed below, has never officially stated a view as to the legality of YSPs.⁴

This article will examine (i) the practice of paying mortgage brokers in the form of YSPs, (ii) the issue of whether such fees may be unlawful, (iii) the pending purported class actions filed by borrowers against mortgage brokers, (iv) the prospect of new regulation of YSPs and (v) the manner in which mortgage brokers can act to insulate themselves against the threat of litigation.

Yield Spread Premiums

While, in some cases, the mortgage broker will be compensated

solely by “direct fees” paid by the borrower, it often happens that the borrower either lacks sufficient cash to pay points on the loan at closing or, for other reasons, prefers not to pay such points. In this event, the broker may still be able to offer a “no-fee/no-point” loan by looking to the lender for compensation in the form of a YSP.

In exchange for arranging for the borrower to accept an at-par or above-par interest rate (which will directly effect the YSP paid to the broker), the lender (rather than the borrower) pays the broker this “indirect” fee. Ultimately, in the instances where the borrower has accepted an above-par interest rate, the indirect fee⁵ is paid by the borrower in the form of fractionally higher interest payments.

While YSPs have become common in the industry, home buyers and consumer advocates have complained that the fee serves as an inducement to the broker to misrepresent the lowest available mortgage rates.⁶ A bank may, for example, be willing to offer a mortgage on a particular property at 7.5 percent (i.e., its retail rate). If the broker arranges for its client to pay the retail rate, the broker receives a YSP from the bank. If, however, the broker arranges for the borrower to accept a rate above the bank’s retail rate (i.e., above-par) at, for example, 7.75 percent, then the bank will pay the broker a higher YSP.

In the instances where a broker has arranged for an above-par loan, consumers have alleged that they were not aware that they might have obtained a lower rate (i.e., the at-par, retail rate). Additionally, while the higher YSP in such instances appears to be between the bank and the broker, it is financed indirectly by the additional interest paid by the borrower.⁷

RESPA Violation?

During the past two or three years, a number of borrowers have initiated lawsuits, often filed as putative class actions, challenging the legitimacy of YSPs under Sec.8 of RESPA, 12 USC Sec.2607. *Culpepper v. Inland Mortgage Corp.*⁸ is typical in its facts of the many YSP cases filed around the country.

In that case, the plaintiff-borrower retained Premiere Mortgage Company (Premiere), a mortgage broker, which arranged for a 30-year loan from Inland Mortgage Corp. (Inland) at an interest rate of 7.5 percent. The borrower paid Premiere a one point “origination fee,” or \$760. In addition, Inland paid the broker a YSP of 1.675 points, or \$1,263.

(continued on next page)

YIELD SPREAD PREMIUM

(continued from previous page)

The borrowers alleged that Inland's rate sheet provided for a 30-year loan at 7.25 percent, but that if Premiere had offered those terms, its YSP from Inland would have been just .125 points, or \$97. The court noted that the loan in this case was "table funded," meaning that Inland advanced the funds and Premiere contemporaneously assigned the loan to Inland.

The borrower alleged that this YSP was in essence a kickback from the bank to the broker in violation of RESPA Sec.8,9 which provides:

(a) Business referrals:

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 part of a real estate settlement service involving a federally related mortgage loan shall be referred to any person.

(b) Splitting charges:

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.

(c) Nothing in this section shall be construed as prohibiting . . . (2) the payment to any person of a bona fide salary or compensation or other payment for goods or facilities or for services actually performed.

In this case, the district court dismissed the plaintiff's claim, but the Eleventh Circuit reversed, holding that summary judgment was improper because payment of the YSP might violate RESPA.

The district court had concluded that Premiere had sold the loan to Inland and that the YSP fell within the "payment for goods" (i.e., the loan) exception to RESPA Sec.8(c). The appellate court, seizing on the fact that the loan was table funded, held that there was no actual sale and that the YSP was in fact a referral fee in violation of Sec.8(a). The panel concluded, "A referral actually occurred when Premiere chose to register the Culpeppers' loan with Inland and not with the other Lenders with whom Premiere did business."¹⁰ While nothing in the law bars sales of mortgages in the secondary market, the lender conceded that this was not a secondary market transaction.

Similarly, the Culpepper court held that the YSP was to compensate Premiere for providing services to Inland, as it was undisputed that the payment of the YSP was not tied to the quantity or quality of the services that Premiere provided. "Rather, the sole determinant of whether a yield spread premium would be paid was the interest rate on the loan." Thus, the YSP payment was held to be simply in exchange for a referral, which does violate the statute.¹¹

To date, the Culpepper court is the only federal appellate court to hold that a YSP may constitute a violation of RESPA. The district courts, for their part, are divided on the issue.

In *Mentecki v. Saxon Mortgage*, for example, an action in the Eastern District of Virginia, the defendant-lender moved to dismiss, contending that YSPs are authorized implicitly by HUD regulations which refer to them in passing. The court rejected this argument and squarely held that such payments are illegal kickbacks under RESPA:

The court concludes that the payment of a yield spread premium is a referral prohibited by 12 U.S.C. Sec. 2607(a). By their very nature, yield spread premiums are not compensation given for services actually performed by the broker. The reality of the transaction is that the broker benefits by payment of the premium, the Lender benefits by obtaining a higher than par loan, and the borrower pays. Quite simply, the premium regards the broker for referring the above-par loan.¹²

The court went on to reject the argument that a YSP is a legitimate fee "for services actually performed" within the safe harbor of Sec.2607(c):

The court is unable to see what service is provided to the consumer, as it must under section 2607(c)(1)(C) or (c)(2), unless it is the provision of a bad deal. Nor can the premium be defended as compensating the broker where the broker has already charged the borrower directly for all services provided.¹³

While the court denied the motion to dismiss, it did allow for the possibility that the defendants would be able to prove that YSPs are authorized as fees for services under the safe harbor of Sec.2607(c).

A few district courts, generally prior to Culpepper, have held that payment of a YSP does not violate RESPA, and have granted lenders' motions for summary judgment to dismiss the action. In *Barbosa v Target Mortgage Corp.*,¹⁴ for example, a court in the Southern District of Florida engaged in an extensive

(continued on next page)

YIELD SPREAD PREMIUM

(continued from previous page)

analysis of the law and economics of the situation and held that YSPs are not unlawful payments under the statute: “From a straightforward reading of the statute, the Court concludes that [the Lender] cannot have violated subsection (a), because the undisputed record evidence establishes that its payment to [the broker] was not for the referral of business.”

This court considered the YSP to be a different form of payment to the broker for its services, not a “kickback” or a “referral fee” paid by the lender. The court went on to conclude that “under the facts of this case the yield spread differential payment resulted from a market transaction legitimately structured by [the Lender]. Under RESPA, this suffices to establish reasonableness.”¹⁵ It should be noted, however, that the Barbosa court now seems to be in the minority on this issue, and it relied in part on the district court opinion in Culpepper, subsequently reversed on appeal.

Class Action Issues

Perhaps more important than whether YSP payments are unlawful is the question of whether YSP actions can be litigated as class actions. While no circuit court has yet ruled on the question, lender and broker defendants have fared better on this issue as the district courts have ruled generally, if not universally, that classes of plaintiffs comprised of mortgage borrowers challenging YSP payments should not be certified pursuant to Rule 23(b)(3) of the Federal Rules of Civil Procedure.

In *Moniz v. Crossland Mortgage Corp.*,¹⁶ the plaintiff moved to certify a class of all borrowers who obtained a loan from the defendant bank where a broker was paid a YSP. The court denied the motion, however, holding that class certification was not appropriate because the question of whether a particular YSP violated RESPA depended on whether it was “reasonable” under the circumstances.

Because the reasonableness of each YSP in each mortgage transaction would have to be evaluated individually, common questions of law and fact were held not to predominate:

So long as the ultimate combination of compensation is reasonable, the broker and borrower are entitled to negotiate the loan that best fits the needs of the transaction at issue. Thus, in order to resolve this dispute, this Court would have to evaluate each of the 18,000 transactions at issue to determine if the broker received the right amount of compensation, whether through points from the borrower, a yield spread premium

from the Lender, or both. This analysis necessarily would result in questions regarding individual members of the class predominating over questions common to the class.¹⁷

Similarly, in *Marinaccio v. Barnett Banks*,¹⁸ the court denied the plaintiff-borrower’s motion to certify a class, in large part because it concluded, on the merits, that payments of YSPs to brokers by lenders are not per se violations of RESPA. Moreover, in order to determine whether a particular payment had run afoul of the statute, the trier of fact would need to examine what services were actually performed in exchange for each of the premiums paid in each of the approximately 6,700 separate loan transactions to be encompassed by the proposed class.

Because HUD regulations implementing RESPA call for a review of whether the payment in each of these transactions bears a “reasonable relationship to the market value of the . . . services provided,” each claim would require the analysis of such factors as geographic market variations, the size and type of the loan and the amount of services required for the particular transaction. Thus the court found that questions of law or fact common to the members of the proposed class did not predominate over the questions affecting only individual members as required by Rule 23(b)(3).¹⁹

More recently, however, two class actions lawsuits were certified. In *Mulligan v. Choice Mortgage Corporation*²⁰ a New Hampshire federal court granted the borrower-plaintiff’s motion to certify a class, rejecting the same argument that prevailed in *Marinaccio*. The defendant had argued that the trier of fact would “not be able to determine whether any of the loans at issue are subject to the exemption without first making a case-by-case determination as to whether the amount of the YSP Choice received in any particular case bore a ‘reasonable relationship’ to the market value of any services Choice provided to the Lender or borrower in that case.”²¹

Allowing the class action to go forward, the court permitted the plaintiffs the opportunity to prove that the defendant-lenders provided no service in return for a YSP on a class-wide basis:

The fatal flaw in Choice’s argument is that it fails to address plaintiffs’ claim that Choice violated RESPA because it failed to provide any legitimate goods or services in exchange for the YSPs it received. If this assertion can be proved at trial through evidence common to the entire class, it will not be necessary to conduct a case-by-case inquiry of the reasonableness of any particular YSP as the trier of fact will already have determined

(continued on next page)

YIELD SPREAD PREMIUM

(continued from previous page)

that Choice failed to render any compensable goods or services in exchange for the YSPs it received. 22

The court refused, however, the plaintiff's motion to certify a class as to its claim that the lenders violated the Racketeer Influenced and Corrupt Organizations Act (RICO) as well as RESPA. 23

Mulligan remains decidedly the minority view. Indeed, even after the Eleventh Circuit, in *Culpepper*, gave some support to the merits of RESPA claims, district courts have continued to deny motions for class certification. In *Taylor v. Flagstar Bank, FSB*, 24 the court analyzed exhaustively the cases both before and after *Culpepper* as well as Rule 23, and concluded that trying a RESPA case as a class action would be inappropriate:

The court cannot decide that an illegal kickback or fee-split occurred, without looking to see exactly what services were performed, and whether those services were reasonably charged. *Moniz*, 175 F.R.D. at 4 (“in order to resolve this dispute, this Court would have to evaluate each of the 18,000 transactions at issue”); *Martinez*, slip op. at 5 (“Although the Court’s inquiry into the nature of the transaction structure by the Lender might involve common issues, the equally or more important issue of the services provided by the broker to the borrower (and possibly the Lender) would differ in each case.”). Class certification is improper, simply put, largely because of the nature of the law at issue. 25

The *Taylor* court considered *Culpepper* and concluded that it did not speak to the class certification issue at all.

New HUD Regulations

Despite the recent spate of litigation, HUD has not yet issued a statement as to the lawfulness of YSPs. The agency has, however, proposed a rule amending Regulation X (24 CFR 3500.14(g)(2)) which would establish a presumption, referred to as a “qualified safe harbor,” that YSPs are legal and permissible if the mortgage broker provides disclosure of its role and its fees, and uses a form contract (between broker and borrower) drafted by HUD. This contract would disclose the mortgage broker’s compensation from both sources (the borrower and the institutional lender), and would “clarify for the borrower the differing functions of mortgage brokers and the role of the mortgage broker in the particular transaction.”

The proposed HUD mortgage broker contract would inform

the borrower whether: (i) the broker is the agent of the borrower and “will shop for the most favorable mortgage loan that will meet the borrower’s stated objectives,” (ii) the broker represents the lender and merely arranges loans, or (iii) the broker is operating as an independent contractor representing neither the lender nor the borrower.

The contract would also disclose whether the broker is to receive an indirect fee from the lender and/or a direct fee from the borrower. The contract would specify the maximum points and other compensation that the broker would earn for a loan up to a particular amount. If the mortgage broker uses the HUD form and performs consistently with it, any YSP the broker earns would be presumed legal.

However, even where a mortgage broker uses the HUD form contract, the presumption of legality would be rebuttable in cases where the compensation received by the mortgage broker exceeded a yet-to-be-determined formula. As this formula was conspicuously absent from the proposed rule, mortgage brokers are still justified in their concern that HUD will introduce regulations limiting their fees (for example, to a one- or two-point maximum).

Even if a particular transaction does not fall within the proposed safe harbor, however, a broker could rebut any suggestion that a YSP is unlawful by establishing, as under the current law, that their compensation, in the form of a YSP or otherwise, is reasonably related to the value of the goods and services provided under the unique circumstances associated with each loan transaction.

In addition to HUD’s new proposal, a bill was introduced in the last Congress that would have suspended YSP-related class actions. The Mortgage Litigation Reform Act of 1998, introduced in the Senate by Senators Rod Grams, R-Minn., Lauch Faircloth, R-N.C. and John Breaux, D-La. and in the House by Representative Robert L. Ehrlich, R-Md., would have imposed a moratorium on the certification of class actions through the 1998 calendar year.

This legislation was not passed before the 105th Congress went out of session. Prior to adjourning, however, Congress sent a joint House/Senate Conference Report to the White House which indicated that “Congress never intended payments by Lenders to mortgage brokers for goods or facilities actually performed to be violations of RESPA.” The report further directed HUD to clarify its position regarding YSPs within 90 days from the

(continued on next page)

YIELD SPREAD PREMIUM

(continued from previous page)

enactment of the HUD/VA FY 1999 appropriations bill, which occurred in late October. Thus, a new rule must be announced by the end of January 1999.

Limiting Exposure

Whether or not HUD ultimately enacts its proposed amendment to Regulation X, mortgage brokers would be well advised to adopt its program of full disclosure, indicating to borrowers the possibility that the broker will accept a YSP from the lender as part of the broker's compensation. HUD and the courts that have been sympathetic to borrowers' RESPA claims tend to be motivated by the same principles: that consumers should be granted meaningful and timely disclosure of fees, direct and indirect, to be paid to their brokers.

While HUD appears to approve of the availability of "no fee/no point" loans, the agency does seem concerned in the instances where such loans are made possible by "indirect" fees that are disclosed late, if at all. There is, after all, no reason to expect that a consumer unable or unwilling to pay points on a loan up front, or a consumer whose unique circumstances require an industry expert to properly place the loan with an appropriate lender, will object to his broker being compensated by the lender in the form of a YSP.

Nor will the borrower necessarily object to paying for the broker's service indirectly. The proposed rule seems motivated by the notion that the "no fee" loans involving an above-par rate (and thus a higher YSP) may not truly be free, and that consumers should not be told otherwise. Acting in accordance with HUD's proposed disclosure rules would go a long way toward establishing a broker's good faith, both within this industry and with the general public.

-
1. See Department of Housing and Urban Development estimate discussed at 24 CFR Part 3500.
 2. The mortgage broker acts as a middleman between lender and borrower. The broker processes the mortgage application, reviews the borrower's income, asset and credit history, and often provides property analysis. See *Barbosa v. Target Mortgage Corp.*, 968 F.Supp. 1548, 1552 (S.D. Fla. 1997).
 3. Yield spread premiums are also referred to as "Servicing Release Premiums," "Additional Compensation Paid By Lender," "Par Plus Premiums," "Premium Pricing" and/or "Volume Based

Compensation."

4. See *Barbosa v. Target Mortgage Corp.*, supra, noting HUD's impasse on the issue.
5. The terms "direct fees" (those paid to the mortgage broker by the borrower) and "indirect fees" (fees paid by the lender and funded by a fractionally higher interest rate) are taken from the HUD report on its amendment to Regulation X, discussed infra.
6. See, e.g., *The New York Times*, Jan. 25, 1998, sec. 3, p.10, col 1; Aug. 31, 1998, sec. 9, p. 3, col 1.
7. *The New York Times*, Aug. 31, 1998, sec. 9, p.3, col 1.
8. 132 F3d 692 (11th Cir. 1998).
9. 12 USC Sec.2607.
10. 132 F3d at 696.
11. *Id.* at 697. See also *Brancheau v. Residential Mortgage and Mercantile Bank of St. Louis*, 1998 U.S. Dist. LEXIS 14439 (D. Minn. Sept 4, 1998) which rejected the defendant-lender's motion for summary judgment, which was based on the argument that YSPs are per se legal.
12. 1997 U.S. Dist. LEXIS 1197 (E.D.Va. Jan. 10, 1997)
13. *Id.*
14. *Supra*; see also *Martinez v. Weyerhaeuser Mortgage Co.*, U.S. Dist. LEXIS 22172 (S.D. Fla. June 25, 1997). Both cases were decided by Judge Kenneth L. Ryskamp.
15. *Id.* at 48-49.
16. 175 FRD 1 (D. Mass. 1997).
17. *Id.* at 10.
18. 176 FRD 104 (SDNY 1997)
19. To certify a proposed class under Rule 23 of the Federal Rules of Civil Procedure, a plaintiff must show that "(1) the class is so numerous that joinder of all members is impractical, (2) there are questions of law or fact common to the class, (3) the claims or defenses of the representative parties are typical of the claims or defenses of the class, and (4) the representative parties will fairly and adequately protect the interests of the class."
20. 1998 U.S. Dist. LEXIS 13248 (D.N.H. Aug. 11, 1998).
21. *Id.* at 16-17.

(continued on next page)

YIELD SPREAD PREMIUM

(continued from previous page)

22. *Id.* at 16.

23. *Id.* For another case in which a class was certified following Mulligan and distinguishing *Marinaccio and Moniz*, see *Brancheau v. Residential Mortgage and Mercantile Bank of St. Louis*, 1998 U.S. Dist. LEXIS 14439 (D. Minn. 1998). It should be noted that both Mulligan and Brancheau rely on Culpepper's analysis of RESPA even though the court in Culpepper explicitly refused to decide whether a class should be certified.

24. 181 FRD 509 (M.D. Ala. 1998).

25. *Id.* at 37. Other cases in which motions for class certification were denied include *Conomos v. Chase Manhattan Corp.*, 1998 U.S. Dist. LEXIS 3135 (SDNY, March 17, 1998); *Hinton v. First Amer. Mortgage*, 1998 U.S. Dist. LEXIS 2712 (N.D. Ill., March 3, 1998); *Barboza v. Ford Consumer Fin. Co.*, 1998 WL 148832 (D. Mass., Jan. 30, 1998); and *DuBose v. First Security Savings Bank*, 1997 U.S. Dist. LEXIS 22280, (M.D. Ala., Oct. 23, 1997).
