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The Yield Spread Premium Controversy

Roger Bernhardt

In 1974, in response to public outcries over high real estate closing costs, and the disclosure that lawyers, lenders, and title companies were all paying kickbacks in order to get the business, Congress enacted the Real Estate Settlement Procedures Act (RESPA) (12 USC §§2601–2617). As is typical of much legislation, there was brave bold language at the start (12 USC §2607, §8(a)): “No person shall give [or] accept any fee, kickback, or thing of value pursuant to any agreement . . . that business . . . shall be referred. . . .” That was then followed by language taking most of it back (§2607, §8(c)): “Nothing in this section shall be construed as prohibiting . . . (2) the payment to any person of . . . compensation . . . for goods or facilities actually furnished or for services actually performed. . . .” So kickbacks were out, but fees for goods or services or facilities were in. Those provisions in RESPA are still the same, but the world has changed.

The New World of Mortgage Lending

In the 1970s, people got mortgage loans by borrowing from the bank or S&L where they saved and did business. After the loan was made, the lender kept the mortgage in its portfolio, using the interest earned to satisfy the interest demands of their savings depositors.

But the S&Ls failed in the 1980s, and that style of lending vanished. Instead, real estate funds from Wall Street started purchasing large pools of mortgages guaranteed by the government or rated by an agency. A mortgage lender was no longer an institution making its own loans from its own deposits, but rather was an “originator” who borrowed funds from *A* just long enough to lend them to *C* on a mortgage and then sell the mortgage to *D*. The secondary market had arrived.

If it made economic sense to disconnect lenders from funding sources, it also made sense to disconnect them from borrowers. No sense in paying a lot of money to keep up a fancy building downtown and paying a large staff to always be on call to serve any potential borrower who might walk in, when others were performing the lending function more cheaply. So with the rise of the new lenders arose also the new mortgage loan brokers, who maintained little storefront offices in shopping malls and were willing to provide personalized service, like making night visits to their customers to help them get mortgage loans. The lender became an anonymous institution that had a virtual office at best. (Whoever heard of Standard Federal Bank, the defendant in *Glover v Standard Fed. Bank* (8th Cir 2002) 283 F3d 953, although it lends billions per year?)

In this new world, homeowners or home buyers have their “retail” mortgage loan broker shop around among “wholesale” mortgage lenders, who send the brokers daily rate sheets showing what the market rate is for each kind of loan available. According to many economists, this new market has been good for everybody, especially borrowers, who have seen mortgage interest rates fall significantly. (The interest rate spread between mortgages and U.S. Treasury bills—that most secure of loan instruments—is only half of what it used to be). As a result, there are over 30,000 mortgage loan brokers around doing business with over 150 large mortgage wholesale lenders, amounting to half of the mortgage market.

Compensation in the New System

In the old days, when one institution did it all, compensation was not a complicated issue: The lender's interest rate covered all of the services and nothing had to be broken out. In the new piecemeal lending world, however, far more sophisticated accounting techniques are required.

Since the wholesale lender does not intend to keep the loan (*i.e.*, it will sell the loan), a sale price must be set for it—and the marketplace does that easily. If the loan is for \$100,000 at 7-percent interest, and the current rate for new loans is also 7 percent, then the market price of this loan is \$100,000. But if new loans are being made at only 6.9 percent, then this 7-percent loan is worth more, and will sell for a *premium*—more than \$100,000—just like a bond. And, conversely, if today's rate is higher than 7 percent, this old loan will sell for a commensurate discount.

More complicated is the question of how much the lender should pay to get the loan in the first place. Initially, the loan application comes to it from the mortgage loan broker, who expects payment for the service of “placing” the loan. Even if the mortgage loan broker's services benefit the lender as well as the borrower, the borrower is the one who will pay for them, since lenders pass through the cost for all of their services. The problem arises when borrowers don't have the cash to pay the mortgage loan broker—indeed, lack of cash is probably why they are borrowing money in the first place.

Thus, the mortgage loan broker's compensation generally will be paid out of the funds being loaned from the lender to the borrowers, by way of the spread between what will be given by the lender and what will be received by the borrower. This could be accomplished by a differential in the principal—*e.g.*, \$101,000 is lent but only \$100,000 is received—but loan limits and loan-to-value ratios may get in the way, so the spread is achieved through an interest rate differential instead.

The daily rate sheets sent by each wholesale lender to mortgage loan brokers show the current rate the lender is charging on loans that day, say, 7 percent (the *par* rate). The lender has no aversion to making a loan at 7.1 percent instead (or at 6.9 percent), and will be happy to do so for appropriate compensation. It will make a loan at 6.9 percent if it is paid, say \$1000, to make the loan (or if it remits only \$99,000 for the \$100,000 note it receives); and if it is asked to make the loan at 7.1 percent, it will send an extra \$1000 along with the \$100,000, that premium being calculated on the same basis as determines how much a purchaser of an existing 7.1-percent loan pays for it if the current rate is only 7 percent. If this “*yield spread premium*” is used to compensate the mortgage loan broker, then the cost to the borrower for these services is capitalized and spread out over the life of the loan rather than coming out of the borrower's pocket as an up-front cost. Again, everybody should be better off, since borrowers who don't want the higher rate can elect to pay the cost themselves and get a loan at par instead.

The RESPA Risk

All this seems perfectly sensible . . . but now comes RESPA. When a mortgage loan broker lends his own funds and then sells the loan to a real lender for a profit based on yield spread, there is no legal problem, because RESPA specifically does not apply to secondary market sales of loans; furthermore, the payment premium for an above-par loan is obviously not a kickback or illegal referral fee.

But there is a potential problem when the loan funds come from the wholesale lender rather than the mortgage loan broker at the start: The arrangement no longer constitutes an exempt secondary market transaction because it does not involve the sale of an existing loan by the mortgage loan broker to the wholesale lender (in contrast to what occurs the next day when the wholesaler sells the loan to an investor). The economics are still the same—a wholesale

lender will pay the same premium for the opportunity to make a 7.1-percent loan as it would pay to purchase an existing 7.1-percent loan (assuming the par rate is 7 percent). Now, however, because the transaction does not involve the sale of an existing loan, it is no longer exempt from RESPA.

With respect to RESPA, the yield spread paid for the opportunity to make an above-par loan has this quirk: The check for the yield spread came to the mortgage loan broker from the lender and the lender was chosen by the mortgage loan broker, so it looks somewhat like a fee paid for the referral of business. (The similarity is deceptive, since each mortgage broker receives the daily rate sheets of numerous lenders and chooses loans for his customers based upon their competitive par rates, not based upon the comparative spreads above and below those par rates, which are merely mathematical derivatives; but, as a matter of form, the broker did choose the lender and the lender did pay the broker).

Even if a yield spread premium paid to the mortgage loan broker does look like it might fit under RESPA §8(a), is it not saved by §8(c)'s legalization of compensation "for goods or facilities actually furnished or services actually performed"? Although there is no doubt that the mortgage loan broker has performed services that old full-service lenders used to (but no longer need to) provide through their own employees and in their own facilities, the Eleventh Circuit Court of Appeals last year held that the yield spread premium could not be said to have been given "for" those services and facilities, since it was never calculated according to their worth, but rather was measured by the spread between the actual loan rate and the par rate. *Culpepper v Irwin Mortgage Corp.* (11th Cir 2001) 253 F3d 1324. (An obvious response to this contention—that the compensation is based on the fact that the loan is above par—cannot be made because that would be treating the loan as a "good," which HUD says it is not, since the loan has not yet been made. The rest of us might think that there is no real difference between the value of an opportunity to make a loan and the value of a loan already made, when both are at the same rate, but government bureaucrats can nevertheless find distinctions there.)

Now, in *Glover*, the Eighth Circuit has weighed in, rejecting the Eleventh Circuit's formal analysis and instead endorsing HUD's more substantive standard of looking at the *total compensation* paid to the mortgage loan broker, without a showing of exactly how much of the yield spread premium covered which services and facilities the broker performed or furnished. Only compensation that is unreasonable will be treated as an illegal referral fee.

The Class Effect

The *Glover* test has both a substantive and procedural impact, the latter probably the more important. Substantively, many more yield spread premiums are likely to be upheld than would be the case under the *Culpepper* requirement of showing which dollar was *for* which service. *Culpepper* set a standard that could probably never be met, whereas *Glover* makes the basic arrangement legal, outlawing it only in cases of actual abuse.

Procedurally, the *Glover* standard eliminates yield spread premiums as class action candidates: Each individual yield spread premium will have to be scrutinized in the context of that loan and those services to see whether it constituted reasonable compensation for goods, services, and facilities actually rendered. That sort of analysis makes class treatment all but impossible. As potential class actions, yield spread premium claims were attractive to the plaintiff bar; well over 100 such cases had been filed around the country. If the other circuits side with the Eighth Circuit rather than the Eleventh Circuit, the logistics may well change. Many mortgage loan brokers may well be charging unreasonable fees for their services, but it is doubtful that even statutory attorney fees and treble damages will make these cases as attractive to attorneys as the prospect of successful class certification.