Loyola Consumer Law Review

Volume 18 | Issue 2 Article 2

2005

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FEATURE ARTICLES

Hidden Costs to Homeowners: The Prevalent Non-Disclosure of Yield Spread Premiums in Mortgage Loan Transactions

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I. Introduction

Many borrowers receive mortgage loans with the assistance of a mortgage broker.[1] A mortgage broker is a person who acts as an intermediary between a lender and a borrower in a mortgage loan.[2] With the infinite variations in rates and terms of mortgage loan programs, mortgage brokers often provide a valuable service by helping borrowers select a loan that best meets their needs. Furthermore, brokers typically assist borrowers throughout the loan process by providing services such as completing required loan applications, ordering appraisals, retrieving the borrowers' credit report, and gathering all information required to complete the loan. Oftentimes, borrowers may receive a better rate and term on their loan program by going through a mortgage broker rather than if they went directly to a lender. This is because lenders provide brokers with wholesale rates and terms that are not available to the general

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[1] At least half of all residential mortgages are originated by brokers. Taiesha L. Cantwell, *Yield Spread Premiums: Who's Working for the Borrower? HUD's Erroneous Regulation and its Bar on Plaintiffs,* 21 L. & INEQ. 367, 369-70 (Summer 2003) (citing Bjustrom v. Trust One Mortgage, 178 F. Supp. 2d 1183, 1193 (W.D. Wash. 2001) (noting that "mortgage brokers occupy approximately fifty percent of the market").

[2] *Id.* at 370.

public. However, while mortgage brokers provide valuable services, the cost of those services are often undisclosed to the borrower.[3]

Brokers often receive compensation by charging the borrowers direct fees. For instance, a mortgage broker may charge a borrower one percent of the loan amount as a loan origination fee. Brokers may also charge other fees such as processing , document preparation , and application fees. These additional fees are generally referred to as "garbage fees" and are paid to a broker.[4] Importantly, garbage fees are not paid to a third party, such as an escrow agent, insurance carrier, or appraiser in exchange for additional services that are necessary to complete the loan transaction. Brokers typically use garbage fees to generate income.[5]

A lesser known manner by which brokers get compensated, and the subject of this article, are yield spread premiums paid to brokers by lenders.[6] While there are several factors that determine the yield spread premium amount, they are generally linked to the interest rate of a loan. Lenders provide mortgage brokers with rate sheets that have various interest rates for a particular loan program. Below is a hypothetical interest rate sheet for a thirty-year fixed loan:

Rate	Cost
5.250%	2.000
5.375%	1.500
5.500%	1.000
5.625%	0.500
5.750%	**0.000 (Par)**
5.875%	(.500)
6.000%	(1.000)
6.125%	(1.500)

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[3] *Yield Spread Premiums: A Powerful Incentive for Equity Theft*, Ctr. for Responsible Lending (CRL), CRL Issue Brief No. 11, at 2 (June 18, 2004).

[4] *See* Dian Hymer, What Are Garbage Fees? at http://doityourself.com/houseclosing/garbagefees.htm.

[5] *See id.*

[6] Payment to mortgage brokers in the form of yield spread premiums, in addition to the mortgage refinance boom of recent years have made mortgage brokers one of the highest paid professionals in the United States. John Hechinger, *Mortgage Brokers Benefit From Refinancing Boom*, WALL ST. J. ONLINE (2005), http://www.collegejournal.com/salarydata/realestate/20030404-hechinger.html?refresh=on (last visited Oct. 23, 2005) (stating that in 2004, the average mortgage broker made $120,000, while owners of brokerage firms made an average of $400,000).

6.250% (1.875)
6.375% (2.125)
6.500% (2.375)

In general, a loan at "par" is the interest rate that the lending institution will fund at 100 cents on the dollar.[7] In our example, the par rate is 5.750%. A loan above par is a loan that carries a higher interest rate for which lending institutions are willing to fund more than 100 cents on the dollar. Under today's standard practices, the excess over par is paid to mortgage brokers in the form of yield spread premiums.[8] The higher the rate is above par, the higher the yield spread payment to the mortgage broker. According to the 2002 report of Professor Howell E. Jackson and Jeremy Berry, the average yield spread premium is $1,848 per transaction, making it the most important single source of revenue for mortgage brokers.[9]

Yield spread premiums can be a great benefit for many borrowers. Borrowers who do not have enough funds to pay for closing costs out of pocket can use yield spread premiums to cover those costs. Yield spread premiums provide borrowers with the ability to obtain a higher interest loan and pay lower or no closing costs up front. However, the majority of borrowers, regardless of whether they can cover settlement costs out of pocket or not, receive loans with yield spread premiums.[10] Most yield spread premiums charged by brokers are either inadequately disclosed or not disclosed at all to borrowers, even to those who can pay for settlement costs up front.[11] Therefore, yield spread premiums often result in borrowers receiving loans at higher interest rates, which increases the overall cost of a loan. The Center for Responsible Lending estimates that excessive interest rates cost borrowers a total of $2.9 billion per

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[7] *See* Culpepper v. Inland Mortgage Co., 132 F.3d 692 (11th Cir 1998).

[8] *See id*; The Illinois District Court found that a yield spread premium is a payment from the lender to the broker for delivering a loan with an interest rate above a pre-set par rate. *See* Watson v. CBSK Financial Group, Inc., 197 F. Supp. 2d 1118, 1120 (N.D. Ill. 2002)(stating that the amount of the premium is determined by a rate sheet).

[9] Howell E. Jackson & Jeremy Berry, *Kickbacks or Compensation: The Case of Yield Spread Premiums*, 80 *available at* http://www.law.harvard.edu/faculty/hjackson/pdfs/january_draft.pdf (draft Jan. 8, 2002) (last visited Oct. 23, 2005).

[10] *Id.*

[11] *Id.*

year.[12] This paper contends that this commonly used practice of receiving compensation for raising interest rates is a breach of a broker's fiduciary duty.

This article will begin with a discussion regarding a mortgage broker's fiduciary relationship with his or her borrower. In particular, a mortgage broker breaches his or her fiduciary duty to disclose all material information by failing to adequately disclose the receipt of yield spread premiums. Next discussed will be the federal legislation designed to protect and inform borrowers in mortgage loan transactions. Lastly, the authors will scrutinize current legislation and contend that they fail to adequately protect borrowers against paying undisclosed yield-spread premiums.

II. The Origins of The Fiduciary Duty

The fiduciary duty is an equitable doctrine that emerged from the Courts of Chancery.[13] The primary goal of the fiduciary duty is to prevent those holding positions of power from abusing their authority.[14] "Because of the dependency and vulnerability that was involved in trust situations, equity imposed special duties on the trustee known as fiduciary duties".[15]

Fiduciary relationships are recognized at law in a number of situations. A fiduciary relationship has been held to exist in relationships between a bank and its clients, a lawyer and his or her clients, a doctor and a patient, a trustee and beneficiary, a director and his or her company, and a mortgage broker and his or her borrower.

III. Fiduciary Duty of Mortgage Brokers

The legal duty of the professional mortgage broker may be

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[12] *Yield Spread Premiums: A Powerful Incentive for Equity Theft, supra* note 3, at 1.

[13] Tim Hammond, *The Stolen Generation: Finding a Fiduciary Duty*, 5 MURDOCH U. ELECTRONIC J. OF L., 2 (June 1998), *available at* http://www.murdoch.edu.au/elaw/issues/v5n2/hammond52nf.html (last visited Oct. 23, 2005).

[14] *Id.* (citing Hon. Justice Owen, *The State as a Fiduciary*, Seminar on the Recent Developments in the Law of Fiduciary Obligations, Law Society of Western Australia Inc., Perth, 1 (1996)).

[15] *Id.* (citing JRM Gautreau, *Demystifying the Fiduciary Mystique*, 68 CANADIAN BAR REVIEW, 1 (1989)).

created by statute or common law.[16] Courts have held that an agency relationship exists between a mortgage broker and the broker's client when the broker has a duty to act primarily for the benefit of his or her client in matters connected with mortgage loans.[17] As an agent, a mortgage broker holds a position of trust and confidence with respect to his or her principal. Therefore, the broker is required to exercise honesty and good faith toward the principal in all matters within the scope of the broker's employment.[18]

According to the Restatement of Contracts, "a fiduciary may be liable for a mistaken assumption, known to be held or believed by the unknowing party that remains uncorrected by the broker thereafter."[19] Furthermore, the broker cannot hold the borrower or lender to the form or content of a written document if the broker knows that it is incorrect, or if the broker knows that the other party is mistaken as to the document's content or legal effect.[20] The broker is expected to correct such mistakes for the principal's benefit and failure to do so may be grounds for liability.[21]

Currently, there are many types of mortgages available to borrowers. For example, borrowers can obtain a traditional thirty year fixed loan, an adjustable rate loan, or a negative amortization loan. One of the major advantages of using a mortgage broker is that they are knowledgeable of the various types of loans and can recommend certain loans depending on a borrower's individual needs. However,

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[16] The California Department of Real Estate defines mortgage brokers as "an agent for the purpose of arranging the home loan transaction. This relationship imposes a legal duty on the broker to disclose to [the borrower] the material. . .facts [borrowers] need to know about the loan. The broker has a duty of fairness and honesty.. . ." Cal. Dept. of Real Estate, *Using the Services of a Real Estate Broker*, *available at* http://www.dre.ca.gov/mlbrkr.htm (last visited Oct. 23, 2005).

[17] *See e.g.* UMET Trust v. Santa Monica Med. Invest. Co., 140 Cal. App. 3d 864, 873 (Cal. Ct. App.1983); DeLeon v. Beneficial Construction Co., 55 F.Supp.2d 819, 827 (N.D.Ill.1999)(stating when one party undertakes to find financing on behalf of another, a principal and agent relationship is created); *See* Abbitt v. Gregory, 160 S.E. 896, 906 (1931); Johnson v. Phoenix Mutual Life Ins. Co., 266 S.E.2d 610, 620 (N.C. 1980)(stating that a broker is manifestly engaged in the business of selling his services in procuring a loan which is most favorable to the needs and of the potential borrower who, in turn has sought to obtain a broker who can best represent his interests in securing proper financing).

[18] 2 New York Real Property Service, Brokers and Agents § 15:7 (1987).

[19] Restatement (Second) of Contracts §161 (1981).

[20] *See id.*

[21] *See id.*

the interest rates and corresponding yield spread premiums vary between loan programs. This creates an inherent conflict as mortgage brokers may receive a more favorable yield spread premium from one loan program as compared to another. For example, a borrower may be searching for the security of a fixed loan. However, a mortgage broker may attempt to "sell" the borrower an adjustable rate loan because he or she will receive a higher yield spread premium under the adjustable rate program.

a. Duty to Fully Disclose

Mortgage brokers have an obligation to make a full and accurate disclosure of the terms of a loan to their borrowers.[22] Brokers must disclose all material facts that may affect a principal's decision, rights, and liabilities.[23]

In *Armstrong v. Republic Realty Mortgage Corp.*, a mortgage broker arranged a three-tier conditional loan between the plaintiff and a lender.[24] When the lender refused to fund the third tier of the loan under the loan agreement, the plaintiff asked the broker to contact the lender to request that the lender either fully fund the loan or permit prepayment of the loan without the contractual prepayment penalty.[25] Instead, the broker urged the lender to increase the prepayment penalty, reached an agreement from the lender to split the increased penalty amount, and subsequently urged the plaintiff to pay a penalty amount that exceeded the amount that the lender would initially accept.[26] The broker had a conflicting interest as prepayment of the loan decreased the broker's ongoing loan service fees from the lender.[27] As a result, the court found that the broker violated its fiduciary duty by not disclosing this adverse interest.[28]

Similarly, the court in *Realty Projects, Inc. v. Smith,* found that mortgage brokers hold themselves out to prospective borrowers as loan experts who attempt to obtain a loan that meets their clients'

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[22] 18 AM. JUR. 3D PROOF OF FACTS 559, § 11 (2005).

[23] *Id.*

[24] Armstrong v. Republic Realty Mortgage Corp, 631 F.2d 1344, 1346 (8th Cir. 1980).

[25] *Id.*.

[26] *Id.*

[27] *Id.* at 1349.

[28] *Id.* at 1350.

needs at the lowest practicable cost.[29] When a borrower indicates that he or she needs a loan that falls within an amount on which limitations are imposed on the broker's commissions, and the broker suggests, without any economic justification, a higher loan amount that exceeds the said limitations, the broker is required to inform the borrower that he or she will be subject to substantially greater brokerage fees.[30] Failure to do so amounts to a violation of the broker's fiduciary duty of full disclosure to his or her principal.[31]

The court in *UMET Trust v. Santa Monica Investment Co.*, found that a mortgage broker breached his fiduciary duty by failing to advise the principal that his interest in property as a lessee in a sale-leaseback transaction could be terminated upon abbreviated notice, that the statutory right of redemption existed in the loan agreements and that anti-deficiency statutes[32] do not apply to sale-leasebacks.[33] The court also held that it is a violation of the broker's duty to disclose if the broker affirmatively represents that sale-leaseback financing provides the same flexibility as a conventional loan and will accomplish the same result.[34] The duty to disclose such facts is not terminated by the principal's retention of separate counsel.[35]

Accordingly, mortgage brokers have a duty to disclose to a borrower that he or she is paying a higher interest rate than the broker could have obtained for him on a particular loan without a yield spread premium. Yield spread premiums frequently are not disclosed on Good Faith Estimates.[36] The Real Estate Settlement Procedures

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[29] Realty Projects, Inc. v. Smith, 32 Cal. App. 3d 204, 210 (2d Dist. 1973).

[30] *Id.* at 211.

[31] *Id.*

[32] Anti-deficiency statutes protect buyers from personal liability if a lender forecloses on property that has dropped in value. If a borrower doesn't make payments and the loan is secured against the property by a recorded deed of trust, the lender has the right to foreclose and take the property away from the buyer. *See e.g.* Ariz. Rev. Stat. Ann., §§33-801 – 33-821. (See T.1), Title 33, Chapter 6.1.

[33] UMET Trust v. Santa Monica Medical Investment Co., 140 Cal. App. 3d 864, 873 (2d Dist. 1983).

[34] *Id.*

[35] *Id.*

[36] A survey by the Justice & Integrity Project found that yield spread premiums were disclosed on Good Faith Estimates less than one percent of the time. Press Release, The Justice & Integrity Project, *Mortgage Industry May Owe Homeowners Billions for Overcharges* (Apr. 4, 2005), *available at* http://www.emediawire.com/releases/2005/4/prweb223707.htm (last visited Oct.

Act requires the provision of a "good faith estimate of the amount or range of charges for specific settlement services the borrower is likely to incur in connection with the settlement as prescribed by the Secretary"[37] However, even when disclosed, brokers are only required to provide an estimated yield spread premium.[38] Currently, mortgage brokers may disclose a range of anticipated yield spread premiums.[39] The Oregon Department of Consumer and Business Services found a range of 0-3% acceptable.[40] However, the problem with offering such a range is that it can be quite large. For example, for a $300,000 loan, the estimated yield spread premium may be between $0 and $10,000. Such a range does not provide the borrower with a close estimate of the actual yield spread premium paid to the broker.

b. The Intended Use of Yield Spread Premiums

The Housing and Urban Development (HUD) supports the general premise of using yield spread premiums to assist borrowers in paying closing costs associated with mortgage loans.[41] In its policy statement, HUD explained that yield spread premiums are a valuable "option" that "permit homebuyers to pay some or all of the up front settlement costs over the life of the mortgage through a higher interest rate."[42] HUD found that this method of financing was particularly suited for borrowers whose loan-to-value ratio already reached the maximum permitted by a lender.[43]

However, brokers rarely describe yield spread premiums as an optional method for financing their settlement costs for a mortgage

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23, 2005).

[37] 12 U.S.C. 2604(c); Or. Dep't of Consumer & Bus. Servs., Division of Fin. & Corp. Secs., *Mortgage Lenders Frequently Asked Questions: Disclosure of Yield Spread Premiums (YSP),* http://www.cbs.state.or.us/external/dfcs/faqs/mortgage/ysp.htm (last visited Oct. 23, 2005); 24 CFR 3500.7(a)(allowing for a good faith estimate of the amount of or range of charges).

[38] *Id.*

[39] *See* supra note 37.

[40] Or. Dep't of Consumer & Bus. Servs., *supra* note 37.

[41] *See* HUD Policy Statement II, 66 Fed. Reg. 53,052, 53,054 (Oct. 18, 2001).

[42] *Id.* at 53,054.

[43] *See id.*

loan.[44] Most often, borrowers are told that they qualify for a certain interest rate and are never made to understand that the interest rate is higher than the par rate or that the higher interest rate is used to finance a payment to the mortgage broker.[45]

Furthermore, despite HUD's support of using yield spread premiums as an "option" for financing settlement costs for a select number of borrowers with special circumstances, the overwhelming majority of transactions involve yield spread premiums.[46] In fact, Professor Howell Jackson and Jeremy Berry reported that yield spread premiums are paid in eighty-five to ninety percent of all mortgage loan transactions.[47] The study further concluded that most of the borrowers who were charged yield spread premiums had loans that were less than the lending institutions' maximum loan-to-value ratios.[48] Therefore, the settlement costs in these transactions could have been covered by increasing the loan amount.

IV. Real Estate Settlement Procedures Act

The Real Estate Settlement Procedures Act (RESPA) is a consumer protection statute, first passed in 1974.[49] The purpose of RESPA is to protect consumers from abusive practices that result in unnecessarily high settlement charges, and to provide them with more timely and accurate information about the nature and costs of the settlement process.[50] Specifically, Congress passed RESPA to eliminate kickbacks and referral fees that tend to increase the costs of those services.[51]

RESPA mandates lenders to provide borrowers with

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[44] *Predatory Mortgage Lending Practices: Abusive Uses of Yield Spread Premiums: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 107th Cong. (Jan. 8, 2002)[hereinafter Hearings] (statement of Prof. Howell E. Jackson).

[45] *Hearings, supra* note 44.

[46] Jackson & Berry, *supra* note 10, at 73.

[47] *Id.*

[48] *Id.*

[49] *See* Real Estate Settlement Procedures Act of 1974, 12 U.S.C. §§ 2601-2617 (West 2005).

[50] 12 U.S.C. § 2601(a).

[51] 12 U.S.C. § 2601(b)(2).

disclosures at various stages of a loan transaction.[52] More specifically, RESPA requires a lender to disclose the costs associated with the settlement, outline the lender servicing and escrow account practices, and describe business relationships between settlement service providers.[53] RESPA also prohibits certain practices that increase the cost of settlement.[54] For example, Section 8 of RESPA prohibits a person from giving or accepting anything of value for referrals of settlement service business relating to a federally related mortgage loan.[55] It also prohibits a person from giving or accepting any part of a charge for services that are not performed.[56] Section 9 of RESPA prohibits home sellers from requiring buyers to purchase title insurance from a particular company.[57]

a. RESPA Required Disclosures

When a borrower applies for a mortgage loan, mortgage brokers and/or lenders must give the borrower a Special Information Booklet which contains consumer information regarding various real estate settlement services,[58] a Good Faith Estimate (GFE) of settlement costs that lists the charges the buyer is likely to pay at settlement, and a Mortgage Servicing Disclosure Statement which discloses to the borrower whether the lender intends to service the loan itself or transfer it to different lender.[59] The Mortgage Servicing Disclosure Statement also provides information about complaint resolution.[60]

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[52] 12 U.S.C. § 2601(b)(1).

[53] 12 U.S.C. § 2601(b)(1).

[54] *See* 12 U.S.C. §§ 2607- 2608.

[55] 12 U.S.C § 2607(a).

[56] 12 U.S.C. §2607(a).

[57] 12 U.S.C. § 2608(a).

[58] 12 U.S.C § 2604. The Special Information Booklet is required for purchase transactions only.

[59] 12 U.S.C. § 2604(c).

[60] 12 U.S.C. § 2604(c). RESPA does not provide an explicit penalty for the failure to provide the Special Information Booklet, Good Faith Estimate or Mortgage Servicing Statement. However, bank regulators may choose to impose penalties on lenders who fail to comply with federal law.

b. Disclosures at Settlement

At settlement, lenders are required to provide the borrower with a HUD-1 Settlement Statement (HUD-1).[61] The HUD-1 is a standard form that shows all charges imposed on borrowers[62] in connection with the settlement. RESPA allows the borrower to request to see the HUD-1 Settlement Statement one day before the actual statement is issued at closing.[63] The settlement agent must then provide the borrowers with a completed HUD-1 based on information known to the agent at that time.[64] The final HUD-1 shows the actual settlement costs of the completed loan transaction.[65]

Prior to the issuance of the final HUD-1, lenders are required to create an Initial Escrow Statement.[66] The Initial Escrow Statement itemizes the estimated taxes, insurance premiums, and other charges anticipated to be paid from the Escrow Account during the first twelve months of the loan.[67] It also lists the escrow payment amount and any required cushion.[68] Although the statement is usually given at settlement, the lender has forty-five days from settlement to deliver it to the borrower.[69]

c. Section 8: Kickbacks, Fee-Splitting, Unearned Fees

Section 8 of RESPA prohibits any person or entity from giving or accepting a fee, kickback, or anything of value in exchange for referrals of settlement service business involving a federally related mortgage loan.[70] In addition, RESPA prohibits fee splitting

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[61] 12 U.S.C. § 2603(a) Also referred to as the "Closing HUD."

[62] 12 U.S.C. § 2603(a) The Closing HUD also shows charges to the seller if it is a purchase transaction. Separate forms may be prepared for the borrower and the seller. Where it is not the practice that the borrower and the seller both attend the settlement, the HUD-1 should be mailed or delivered as soon as practicable after settlement.

[63] 12 U.S.C. § 2603(b).

[64] 12 U.S.C. § 2603(b).

[65] 12 U.S.C. § 2603(b).

[66] *See* 24 C.F.R. § 3500.17 (2005).

[67] 24 C.F.R. § 3500.17(g).

[68] 24 C.F.R. §3500.17(g).

[69] 24 C.F.R. §3500.17(g).

[70] 12 U.S.C. § 2607(a).

and receiving unearned fees for services not actually performed.[71]

In 2001, in response to a series of cases involving the certifiability of RESPA yield-spread premium classes, HUD reemphasized that a fact-finder cannot presume a payment to constitute a kickback or referral fee, even if the payer of the fee is not aware of the specific services performed by the recipient.[72] HUD has consistently maintained that indirect fees, such as yield spread premiums, benefit consumers who are unable to pay direct fees up front to obtain home loans.[73] However, HUD's policy is problematic as it assumes that services are actually being performed in exchange for the yield spread premium. In most cases, mortgage brokers are paid directly by the borrowers and indirectly through undisclosed yield spread premiums.[74]

Based on HUD's policy statement, courts should apply a two-part analysis in determining whether yield-spread premiums are reasonably related to work actually performed.[75] First, courts should look to whether goods or facilities were provided, or services performed by the broker in the transaction.[76] Second, courts should look to see if the total compensation is reasonably related to the total set of goods or facilities actually furnished, or services performed.[77] In 2001, HUD issued a policy statement expressly rejecting a court's examination of whether services were actually provided specifically for the yield-spread premium.[78] Instead, HUD proposed that courts should focus on whether a particular charge for a mortgage deviates from market rates in the area for similar services.[79]

A broker might justify the payment of a yield spread premium (YSP) including (1) taking information from the borrower and filling

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[71] 12 U.S.C. § 2607(a).

[72] 66 Fed. Reg. at53,055 .

[73] 66 Fed. Reg.at 53,504.

[74] Cantwell, *supra* note 1, at 372.

[75] *See* Bjustrom v. Trust One Mortgage, 178 F.Supp.2d 1183, 1194 (W.D. Wash. 2001).

[76] *See id.*

[77] *See id.* at 1194-95.

[78] *See id.* In its policy statement, HUD had adopted a two-part test for ascertaining violations of RESPA Section 8: (1) whether services were actually performed by the recipient of the challenged payment; and (2) whether the payment was reasonably related to the value of the services.

[79] *Id.*

out the mortgage application; (2) analyzing the prospective borrower's income and debt to determine the maximum mortgage the borrower can afford; (3) educating the borrower in the home buying and financing process; (4) collecting the necessary information and other related documents necessary for the application process; (5) verifying the borrower's employment; (6) orchestrating appraisals and inspections; (7) providing disclosures to the borrower (*i.e.* truth in lending, good-faith estimate); (8) helping the borrower clear up credit problems; (9) keeping the parties in contact and up to date on the status of the mortgage application; (10) ordering legal documents; (11) assessing whether the property was located in a flood zone; and (12) participating at the closing.[80]

While a payment to a broker who provides "no, nominal, or duplicative work" would violate RESPA, it is not necessary, when justifying the payment of a yield spread premium, that the lender or the broker "tie the YSP payment to specific services provided."[81] If it is determined that the broker did indeed provide goods or services of the kind typically associated with a mortgage transaction, then the total compensation paid to the broker must be reasonably related to the total value of the goods or services actually provided.[82]

HUD's 2001 policy statement lists several factors that are relevant when assessing the reasonableness of a mortgage broker's compensation: (1) " fees paid in relation to price structures and practices in similar transactions and in similar markets," and whether the compensation paid to the broker is "commensurate with the amount normally charged for similar services, goods or facilities"; (2) "the level of difficulty involved in qualifying [and processing] the applicant for particular loan programs," depending upon the applicant's credit rating, employment status, levels of debt, experience, etc.; (3) whether the mortgage broker is required "to perform various levels of services under different servicing or processing arrangements with wholesale lenders"; and (4) whether the mortgage broker's total compensation is commensurate for "loans of similar size and similar characteristics within similar geographic markets."[83] "[C]omparison to prices in similar markets is generally a

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[80] 64 Fed. Reg. 10,080, 10,085(C)(a) to (n) (Mar. 1,1999) (to be codified at 24 C.F.R. pt. 2500).

[81] Heimmermann v.First Mortgage Corp, 305 F.3d 1257, 1263-64 (11th Cir. 2002).

[82] *Id.* at 1263-64.

[83] 66 Fed. Reg. at 53,055.

key factor in determining whether a mortgage broker's total compensation is reasonable."[84]

A critical error in HUD's Policy Statement is its assumption that mortgage brokers use yield spread premiums to "recoup the upfront costs incurred on the borrower's behalf."[85] In their report, Jackson and Berry estimated that borrowers, on average, enjoy only twenty-five cents of benefit for each dollar paid in yield spread premiums.[86] This means that seventy-five cents for every dollar of yield spread premiums paid to a broker serves to increase the broker's compensation. On average, mortgage brokers earn $1,046.00 more on loans that involve yield spread premiums.[87] As a result, yield spread premiums charged in the majority of transactions fail both parts of the two-part test outlined by HUD.

A yield-spread premium, no matter what amount, is excessive if not received in exchange for goods or services rendered. Furthermore, a broker breaches his or her fiduciary duty to act in the best interest of the principal when he receives and fails to disclose payment for goods or services not rendered. Consequently, a more appropriate inquiry would be whether the mortgage broker adequately disclosed the yield spread premium, whether goods or services were rendered, and whether the borrower agreed to the payment structure.

d. The Individualized Approach to Fact-Finding by Courts

Consistent with the recommendations of HUD, courts have been unwilling to set universal guidelines on what constitutes reasonable fees.[88] Rather, case law indicates that courts will treat each loan transaction individually.[89] In *O'Sullivan v. Countrywide Home Loans, Inc.*, the plaintiffs challenged certain fees charged by attorneys that provided settlement services to Countrywide mortgage customers. According to the plaintiffs, fees listed on the brokers' HUD-1 disclosure statements as "document preparation fees" and

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[84] 66 Fed. Reg. at 53,055.

[85] 66 Fed. Reg. at 53,054.

[86] Jackson & Berry, *supra* note 10, at 102-16.

[87] *Id.*

[88] *See* O'Sullivan v. Countrywide Home Loans, 319 F.3d 732, 736 (5th Cir. 2003); Barnes v. Republic Mortgage Ins. Co., No. CV 199-240, 2003 WL 17384544 at *6 (S.D. Ga. 2003).

[89] *See O'Sullivan*, 319 F.3d at 736.

"attorney's fees" were actually part of a fee-splitting scheme in which Countrywide received payments from law firms in exchange for business referrals.[90] The plaintiffs in two consolidated cases sought, and the district court granted, certification of classes, including approximately 80,000 Countrywide borrowers to litigate the question of whether this practice constituted an unlawful kickback or referral fee arrangement under RESPA.[91]

On appeal, the Fifth Circuit noted that while RESPA prohibits kickbacks and referral fees, it expressly permits compensation "for goods or facilities actually furnished or for services actually performed."[92] The appellate court noted that, in the yield-spread premium context, HUD policy statements had cautioned courts against simply presuming that all transfers of value between mortgage lenders and settlement service providers amount to unlawful kickbacks or referral fees.[93]

Applying HUD's 2001 statement, the Fifth Circuit reversed the district court decision granting class certification on the ground that, in at least some transactions, borrowers will have received real value from real services performed.[94] "[I]ndividualized fact-finding will be required for each transaction on the issues of what goods and services [the law firms] provided to Countrywide, and whether the flat fee charged was reasonably related to their value."[95]

The U.S. District Court for the Southern District of Georgia reached a similar result in *Barnes v. Republic Mortgage Insurance Co.*[96] That case grew out of a series of class actions where the plaintiffs alleged that a number of the defendant's mortgage insurance structures amounted to kickback and referral fee arrangements under RESPA.[97] In particular, the plaintiffs challenged structures in which lenders would take back risk from insurers in

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[90] *Id.* at 736.

[91] *Id.* at 737.

[92] *Id.* at 738 (citing 12 U.S.C. § 2607(c)(2)).

[93] *Id.* at 740 (citing 66 Fed. Reg. at 53055).

[94] *O'Sullivan*, 319 F.3d at 744-45.

[95] *Id.* at 741.

[96] Barnes v. Republic Mortgage Ins. Co., No. CV199-240, 2003 WL 17384544, at *6 (S.D. Ga. 2003).

[97] *Id.* at *3.

exchange for payments.[98]. In these arrangements, which included captive reinsurance, contract underwriting, and pool insurance, the plaintiffs alleged that the mortgage insurers were in fact provided services at a loss—thus conveying uncompensated value to lenders—in exchange for referrals of lucrative mortgage insurance business.[99] The district court denied the plaintiffs' motion for class certification.[100] Noting that "the central question is how we are to measure value," the court concluded that the value of the restructured insurance coverage could not be assessed on a class-wide basis.[101] In the court's words, "they are not susceptible to evaluation based on generalizations about the abstract value of the structural transactions."[102]

As discussed, neither the legislators nor the courts have been willing to set global parameters as to what constitutes reasonable broker fees for services performed. Due to the lack of guidance on what constitutes reasonable fees, the best protection afforded to both borrowers and brokers is adequate disclosure, active negotiation, and agreement of both parties.

V. The Truth In Lending Act

The Truth in Lending Act (TILA) requires "meaningful disclosure of credit terms" and is designed to protect consumers against inaccurate and unfair credit billing and credit card practices.[103] TILA applies to individuals or businesses that offer or extend credit when four conditions are met: (1) the credit is offered or extended to consumers; (2) the offering or extension of credit is done "regularly"[extends credit more than twenty-five times (or more than five times for transactions secured by dwelling) per year]; (3) the credit is subject to a finance charge or is payable by written agreement in more than four installments, and; (4) the credit is primarily for personal, family, or household purposes.[104]

TILA requires brokers and lenders to disclose, in writing, the

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[98] *Id.*

[99] *Id.*

[100] *Id* at *16.

[101] *Id.* at *8.

[102] *Id.* at *9.

[103] Truth in Lending Act, 15 U.S.C. § 1601(a) (2005).

[104] 15 U.S.C. § 1602.

terms and conditions of a mortgage, including the annual percentage rate (APR) and other fees and charges.[105] The disclosure statements should disclose the following: (1) identity of creditor; (2) amount financed; (3) itemization of amount financed; (4) annual percentage rate, including applicable variable rate disclosure; (5) total payments; (6) payment schedule; (7) prepayment penalties; (8) and finance charges.[106]

Yield spread premiums are problematic because the purpose of a yield spread premium and its relationship with the interest rate are often not disclosed to the borrower. [107] Although lender payments to mortgage brokers must be revealed on government mandated disclosure statements, the form of the disclosure is cryptic and does not reveal the relationship between the interest rate charged on the borrower's mortgage and the magnitude of the yield spread premium. For example, the disclosure of a $4,000.00 yield spread premium on a good faith estimate is typically listed among numerous other charges and identified as "YSP of $4,000.00 POC".

This obscure form of disclosure is not sufficient to enable borrower to make an informed credit decision. Some brokers and lenders actually fail to provide any disclosure of the yield-spread premium until the point at which the borrower signs the closing documents which is a violation of TILA.

Under the TILA, all lenders are required to disclose the APR of a loan.[108] The APR is a way to calculate the annual cost of loans, taking into consideration loan origination fees, points, buy-down points, mortgage insurance premiums, application fee, underwriting, and the other costs associated with securing a loan.[109] The APR is generally higher than the note rate and is intended to help borrowers determine the "true cost" of the loan.[110]

However, yield spread premiums are not included when calculating the APR.[111] Yield spread premiums, which are paid by the

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[105] U.S.C. § 1638(a).

[106] 15 U.S.C; § 1638(a)(1-15).

[107] Cantwell, *supra* note 1, at 372.

[108] 15 U.S.C. § 1638(a)(4).

[109] What is APR for Mortgage Loans? Business Week Online, at http://allbusiness.businessweek.com/article.asp?ID=3382&CenterID=3891&CatID =3895

[110] 76 AM. JUR. 3D PROOF OF FACTS 193, § 17 (2005).

[111] Cantwell, *supra* note 1, at 381.

lender, are considered indirect fees for borrowers because the payment of premiums typically results in a higher interest rate to the borrower.[112] This ultimately means that the compensation that the broker receives from the lender is not included in the APR.

VI. Proposals for Instituting the Use of Retainer Agreements as Standard Practice

Although federal laws attempt to provide procedural safeguards to ensure that costs associated with mortgage transactions are made aware to the borrower, they have proven inadequate. For instance, RESPA requires mortgage brokers to provide borrowers with a Good Faith Estimate of all costs associated with a mortgage loan.[113] However, Good Faith Estimates do not adequately disclose fees for two main reasons. As its name indicates, brokers are not bound by any of the figures produced on the good faith estimate. While binding brokers to a quoted interest rate is not practical since interest rates can change on a daily basis, brokers are not even bound by the quoted "garbage fees" which are directly controlled by the broker.[114] All too often, brokers adjust "garbage fees" in conjunction with the yield spread premium amount received. Secondly, the standard for what constitutes good faith as it applies to yield spread premiums has not been established. As previously discussed, yield spread premiums may be estimated as 0-3% of the loan amount.[115] For a modest $300,000 loan, that is a range of $10,000.

A persistent problem with current laws is that they do not emphasize the key area of law that governs all transactions between mortgage brokers and borrowers: agency law. As stated repeatedly in this article, brokers have a fiduciary duty to their borrowers. Lawmakers should enact regulations that enforce that duty. This can be accomplished twofold. First, mortgage brokers should negotiate and disclose their compensation upfront through a retainer agreement. Second, the services provided, and the cost for those services, should be explicitly defined by a written agreement.

A retainer agreement confirms a mortgage broker's

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[112] *Id.* at 370.

[113] 12 U.S.C § 2604(c) (2005).

[114] *See* 12 U.S.C. 2604(c). As stated previously in this article, RESPA only requires brokers to estimate the closing costs associated with a loan. Therefore, brokers are only required to provide a good faith estimate of garbage fees.

[115] Or. Dep't of Consumer & Business Servs., *supra* note 37.

commitment to accepting and handling the borrower's mortgage needs, and simultaneously confirms the borrower's commitment to compensate the broker for his or her services. Simply put, it confirms the formation of an agency relationship. One of the main benefits of a retainer agreement is that it allows all parties to negotiate the terms of the agency relationship before any services are provided. A key advantage for mortgage brokers is that they can incorporate a retainer fee into the terms of the agreement. A retainer fee would significantly reduce the amount of borrowers that begin the mortgage process with more than one mortgage broker. Currently, mortgage brokers are generally compensated only when a loan closes. Therefore, many mortgage brokers are wary of providing hours of unpaid service to a borrower who eventually closes a loan with another broker. This creates distrust and makes the formation of an agency relationship extremely difficult. However, once a broker receives a retainer fee, the mortgage broker can feel confident that he or she will be adequately compensated for the services provided. This will allow brokers to focus on their fiduciary duty of obtaining the best mortgage loan for the borrower.

A retainer agreement, in and of itself, does not adequately protect borrowers. The compensation that the broker earns must be negotiated and explicitly defined in the retainer agreement. In negotiating a fee, borrowers should be wary of brokers who connect their fees directly to the interest rate of a particular loan. The parties should negotiate a fee depending upon factors such as the complexity of the financial circumstances of the borrower, the difficulty of obtaining a particular loan, and the broker's experience and expertise. Borrowers can pay the mortgage broker in any agreed upon manner such as a fixed dollar amount, an hourly charge, or even a percent of the loan amount. By agreeing to a specific percent of the loan amount, regardless of interest rates, borrowers can feel confident that their broker will provide them with the best loan package available.

Yield spread premiums need not be completely eliminated. As discussed in this article, yield spread premiums can be a valuable option for many borrowers. However, brokers should be prohibited from received yield spread premiums directly from lenders as compensation. Rather, yield spread premiums should be credited to the borrower. The borrower can then use the amount received in yield spread premiums to pay the mortgage broker the previously agreed amount.

Under the retainer agreement model, borrowers pay mortgage brokers for services actually provided. Under the current yield spread premium compensation system, mortgage brokers don't necessarily receive compensation for services they provide, but make their money by placing a markup on the wholesale prices quoted to them by lenders. Without argument, mortgage brokers provide an important service, and their expertise is in high demand as the mortgage industry has become increasingly complex. However, it is crucial to establish that mortgage brokers are trained, and typically licensed professionals who provide a service, rather than sell a product. Once this fiduciary relationship is defined, borrowers can feel confident that their agent will uphold this duty to broker the best deal that meets the borrowers' needs.