

INSIDER OUTLOOK

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Yield Spread Premiums: Valid lender payments or fees that violate RESPA?

The Federal Real Estate Procedures Act (RESPA) was enacted, in part, to outline for borrowers the closing costs associated with the financing and purchase of a residential home. RESPA provides, among other things, that the payment of referral fees and kickbacks among providers in the residential finance industry is prohibited.

For years, mortgage brokers have been collecting a fee from the lending institutions with whom they place mortgage loans. These fees, called "Yield Spread Premiums," have been properly disclosed on the HUD-1 Settlement Statements at closing, however recent court decisions have determined that the payment of such a fee is prohibited by RESPA. In one particular case, *Mentecki v. Saxon Mortgage and Crestar Mortgage*, a Federal District Court Judge in Virginia stated that a yield spread premium is a referral fee prohibited by RESPA as a kickback or unearned fee to those involved in a transaction. Typically, a yield spread premium is paid to the mortgage broker by the lender, and the lender benefits by obtaining a higher than necessary interest rate. The court, in *Mentecki*, believed that the premium rewards the broker for referring the loan and the borrower pays because the loan is above par. In addition, the court stated that the premium cannot be deemed as compensation to the broker, since the broker has already charged the borrower directly for services provided.

The judge's unexpected comments in *Mentecki* have caused somewhat of a panic in the mortgage broker industry. When a motion was made by a lender to clarify the decision, the same court stated that the January 10, 1997 decision "Went further than strictly required... Certainly the court has not reached a final decision about the legality of yield spread premiums, nor was the order of January 10, 1997 intended to suggest this." The supplemental opinion also granted the lender's motion to appeal the yield spread premium issues to the Fourth Circuit Court of Appeals. The *Mentecki* litigation has not been finalized and the supplemental opinion by the court does not resolve the legality of yield spread premiums.

The fear among mortgage brokers is that attorneys around the country will commence class action litigation against the brokers. This litigation will cost the mortgage brokers substantial legal fees to defend these actions and will cost the borrowers and home buyers by limiting loan choices and availability. Well in excess of a dozen class action lawsuits have been commenced against mortgage brokers and lenders alleging that the payment of a yield spread premium is in violation of RESPA. If a mortgage broker is named in a class action lawsuit, a brokerage company can spend thousands or even tens of thousands of dollars defending themselves in these cases.

Since mortgage brokers originate more than half of the loans in the country, these suits, if allowed to go forward, may lessen compensation and reduce consumer choice of loan options. Consumers, it appears, may ultimately bear the cost of this litigation.

The current cases commenced against mortgage brokers allege an assortment of theories: (1) brokers breach their fiduciary duty to their customers by accepting yield spread premiums; (2) brokers fail to disclose on both good faith estimates and HUD-1 Settlement Statements the amount

lenders interfere with the contractual agreement between mortgage brokers and their customers by inducing brokers to charge customers higher than normal interest rates; (4) brokers commit mail fraud, since mortgage brokers use the United States mail for mortgage business; (5) brokers commit wire fraud, since mortgage brokers use telephones for mortgage business; (6) brokers violate RICO, based on the theory that these practices consist of criminal conspiracy; and (7) brokers violate state consumer protection laws which protect against unfair and deceptive practices.

The most evident claim of a possible violation of RESPA is the payment made by a lender to a mortgage broker in exchange for directing a borrower to an interest rate that is higher than the lender's lowest wholesale rate. It has been suggested that such a payment benefits the lender and the mortgage broker at the expense of the borrower. Another claim is that a mortgage broker is an agent of the borrower and owes a fiduciary duty to obtain the lowest rate for the borrower. New York's Banking Law is not clear on this point and there are no clear court holdings that state that mortgage brokers have a fiduciary duty to borrowers.

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Mortgage brokers contend that lender-paid broker fees are legitimate and constitute the established method of compensation received by mortgage brokers. The theory is that mortgage brokers are responsible for all the costs of providing retail services to the borrower and the lender including, but not limited to, substantial personal services, marketing, provision of facilities, reduction of costs to consumers and increases the consumer choice in home loan products. The yield spread premium, according to brokers, allows the brokers to offer a wider variety of affordable loan options to borrowers, including no point loans.

Mortgage brokers have been urging Congress and the Department of Housing and Urban Development (HUD) to take prompt action to confirm the legality of yield spread premiums. A joint petition for rule-making was recently filed with HUD by the Mortgage Brokers Association of New Jersey, the Mortgage Bankers Association of Pennsylvania and the Mortgage Council of New Jersey, proposing that HUD create an exemption from violations of RESPA for the payment of yield spread premiums.

It is the hope that such a petition would result in a rule which would resolve ambiguity regarding yield spread premiums and eliminate any further class action lawsuits. A HUD clarification may not address totally whether lender paid fees, prior to the case, would be considered a violation under RESPA. It is not yet certain whether any future HUD clarification would apply to pending litigation or be issued in time to stop the lawsuits.

Mark Pappas, a principal of IPI Financial

Services, Inc., one of New York's largest mortgage brokers, has seen the effect of the *Mentecki* decision. Pappas has seen two of IPI's national institutional lenders being threatened with class action lawsuits for "moderate" yield spread premiums that had been paid in transactions involving IPI.

"Provided the applicant receives the 'benefit of the bargain' and the rate and fees promised were delivered, there implicitly cannot be a violation of RESPA or any other law," Pappas said. "Many class action lawyers are too eager to jump onto an illicit gravy train and neglect the very tenant of law: substance over form."

New York law requires that the borrower be told if the mortgage broker will receive premium pricing of their interest rate and, if not known at the time, the maximum fee payable must be disclosed.

It is unclear how *Mentecki* may effect the current mortgage broker market. Brokers have felt the pinch of the case, but no lawsuits against the major brokers in the city have been commenced. An adverse decision by HUD or a New York court could turn the entire mortgage broker industry upside down.