

U.S. SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

Hearing on "Predatory Mortgage Lending Practices: Abusive Uses of Yield Spread Premiums."

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9:30 a.m., Tuesday, January 8, 2002 - Dirksen 538

Chairman Sarbanes, distinguished Members of the Committee, thank you for inviting me to testify on the abusive uses of yield spread premiums. By way of introduction, I am a lawyer in private practice in Birmingham, Alabama. I represent the plaintiff class in Culpepper v. Irwin Mortgage Corporation, a damages suit brought under the Real Estate Settlement and Procedures Act (RESPA). A 1998 federal court of appeals decision in Culpepper led to HUD's 1999 Statement of Policy (SOP). Another decision by that same court in June of 2001 resulted in HUD's 2001 SOP that this Committee has asked me to discuss here today.

I would like to begin by expressing my deep appreciation to this Committee for its efforts to examine and curb abusive and deceptive lending practices. The mortgage industry's current yield spread premium practices that are reflected in HUD's 2001 SOP Statement are an integral part of the well-documented predatory problem that is crying out for examination and remedy.

Irwin and many other lenders currently offer brokers yield spread premium payments whenever brokers are able to convince borrowers to accept higher interest-rate loans. Consumers are, in effect, being encouraged to borrow money that lenders use to bribe brokers to do business with them. Consequently, brokers who have been fully compensated by loan origination fees and other "direct" payments also receive unearned additional "compensation" that costs homeowners thousands of additional dollars in mortgage payments over the duration of their loans.

RESPA outlaws all kickbacks and referral fees. Under Culpepper, a yield spread premium can be legal if the evidence demonstrates that the yield spread premium was paid in exchange for the broker's services. HUD's 2001 SOP seeks to delete the "for services" requirement and thereby legalize "reasonable" referral fees even when no additional compensation is owed to the broker. I believe HUD's recent actions to be misguided, irrational and in direct conflict with Congress's express intent in passing RESPA.

1. Yield Spread Premiums Are Not Being Used To Lower Closing Costs.

HUD's ostensible reason for the 2001 SOP was its claim that Culpepper might prevent borrowers from using yield spread premiums to lower their up-front closing costs. The court's Culpepper decisions, however, expressly allow borrowers to finance closing costs through yield spread premiums. A yield spread premium could be legal under Culpepper III if the lender's form contract with the mortgage broker required the broker to use the yield spread premium payment to

reduce borrowers' up-front closing costs. HUD's and the industry's "consumer benefit" arguments are clearly "red herrings." Under HUD's "reasonableness test," YSPs are legal regardless of whether they are used to lower closing costs. Moreover, lenders and brokers do not, in fact, use yield spread premiums to lower borrowers' closing costs. At the outset of the Culpepper litigation, Irwin claimed that "the yield spread premium was simply the market-driven payment to [the broker] for an asset--the loan itself." It was only after the courts rejected that argument that industry lawyers concocted the idea that yield spread premiums were used to lower borrowers' closing costs. My colleagues and I have examined thousands of Irwin's borrowers' loan documents, and I have yet to find a single class member whose closing costs were reduced as a result of yield spread premiums. Among class members in other cases, I am only aware of a tiny handful of settlement statements reflecting credits against the borrowers' obligations resulting from yield spread premiums.

If yield spread premiums were actually being used to lower borrowers' closing costs, the lenders could expect to prevail in the litigation. Indeed, if they are not violating the law, they will prevail in court. But it is highly improper for HUD to attempt to overrule the Courts, alter the plain meaning of Congress' statute, and, indeed, interfere with both procedural and evidentiary issues in the judicial system. HUD has no such power, nor should it.

2. HUD's 2001 SOP Does Nothing To Curb Abusive YSP Payments.

HUD and mortgage industry representatives have publicly admitted that mortgage brokers frequently tack on unexpected charges at closing when it is too late for borrowers to obtain other financing. This should come as no surprise since the National Association of Mortgage Brokers (NAMB) takes the position that brokers should be allowed to hide yield spread premiums from borrowers. While the Culpepper court's "fee for services" approach would help curb these nefarious "bait and switch" tactics, HUD's "reasonableness" test encourages brokers to tack on additional charges at closing. Since the "reasonableness" of a charge is measured by what other brokers charge, no referral fee or kickback can be illegal under HUD's test as long as the practices are widespread.

3. HUD's "Reasonableness" Test Amounts to Illegal Rate Regulation.

When Congress passed RESPA, it expressly rejected HUD's proposals for authority to impose caps on settlement charges. Congress chose to allow the market to set prices and rejected HUD's request for a "large bureaucracy" within HUD to set rates for various types of loans in various locales. Since HUD lacks the legal authority and the staff to set caps on settlement charges for various loans, it surely cannot examine millions of individual loan transactions to determine if individual broker payments are "reasonable." HUD's "reasonableness" rule ignores the fact that allowing the "market" to set prices is a two-way street. If brokers are free to set their own charges, they must also be prohibited from collecting more than borrowers agree to pay.

4. The 2001 SOP Test For Yield Spread Premium Payments To Brokers Is Inconsistent With The Test For Other Types of Mark-Ups by other Settlement Service Providers.

The 2001 SOP is also internally inconsistent in the way it treats yield spread premium payments to mortgage brokers as opposed to other types of mark-ups charged by other service providers. While imposing a "reasonableness" test for YSP payments to brokers, the 2001 SOP states that other settlement service providers violate RESPA whenever they mark up the cost of a third party's services without providing additional settlement services over and above the services for

which the provider has already been paid. For example, the 2001 SOP states that a RESPA violation occurs when a lender collects \$200 from the borrower for an appraisal fee, pays an independent appraiser \$175 and pockets the \$25 mark-up. The "reasonableness" of the \$200 charge is presumably irrelevant. HUD has recently (and with great fanfare) brought several RESPA enforcement actions arising from a variety of contexts unrelated to yield spread premiums. None of these recent enforcement actions would have been possible under HUD's "reasonableness" test for yield spread premiums. Conversely, under the test applied to appraisals and other settlement charges, if a broker charges a loan origination fee and then marks up a borrower's interest rate a RESPA violation would occur. There is no legal or logical basis for this inconsistent treatment.

5. HUD has Tacitly Admitted That Its 2001 SOP is Inadequate to Protect Consumers.

HUD recognizes that its "reasonableness" test is inadequate to protect borrowers. On the same day that HUD released its 2001 SOP, it also sent a letter to all FHA approved lenders setting out HUD's views on "best practices" regarding yield spread premiums. HUD urges lenders to disclose the total amount of the broker's compensation, including the yield spread premium and to obtain a written acknowledgment by the borrower. HUD also suggested that lenders reflect yield spread premiums as credits on borrower's HUD-1s.

6. HUD's Claim That The 2001 SOP is a "Clarification" Is Unsupportable.

HUD's claim that the 2001 SOP reflects its earlier intent is disingenuous. In the 1999 SOP and in correspondence between HUD's former General Counsel and members of Congress, including a member of this Committee, HUD expressly stated that the 1999 SOP was not intended to change existing law, which was expressed in the appellate court's previous Culpepper decisions.

Five years ago when the Culpepper case was filed, Irwin did not even require brokers to disclose yield spread premium amounts on borrowers' good-faith estimates. It was not until after the 1998 Culpepper decision that Irwin began requiring brokers to disclose yield spread premium amounts on GFEs. Although the industry has been forced by the ongoing yield spread premium class action litigation to make at least minimal yield spread premium disclosures to consumers, much more is needed if consumers are to be able to have any hope of protecting themselves in mortgage loan originations.

Obviously, HUD is correct in the view expressed in its recent mortgagee letter that brokers should disclose their total compensation and that borrowers should be given credit against whatever is owed to the broker when the broker receives a yield spread premium. Even with that disclosure, however, it is doubtful that any but even the most sophisticated borrower could make an informed decision about yield spread premiums without additional disclosures being required. To make an informed decision about yield spread premiums, borrowers would also have to know how much their rates are being increased to generate the yield spread premium and have to know how much additional monthly interest payments they would incur as a result of the mark-up. Moreover, in order to prevent unscrupulous brokers from overcharging and to prevent borrowers from "bait and switch" tactics where yield spread premiums are disclosed for the first time at closing on the HUD-1, HUD must require the mortgage industry to use yield spread premiums to lower closing costs as it now claims to be doing.

Finally, I would be remiss if I failed to point out my personal opinion that current yield spread premium practices encourage discrimination. After spending five years of looking at numerous borrowers' closing documents it is clear to me that borrowers who are black, female or Hispanic pay higher total broker "compensation" than white males. That opinion is also supported by a recent Urban Institute Study

financed by HUD which found that "[t]here is no question that minorities are less likely than whites to obtain mortgage financing and that, if successful, they receive less generous loan amounts and terms." HUD News Release, No 99-191, New Reports Document Discrimination Against Minorities by Mortgage Lending Institutions, at 1 (Sept. 15, 1999). The Urban Institute Study also found that African-Americans and Hispanics tend to pay higher YSPs than whites and that women pay more than men. Urban Institute Study at 95 n.11. One of the Culpepper plaintiffs, Beatrice Hiers, is an African-American female from Baltimore whose broker received over \$10,000 for assisting in her origination of a \$160,000 FHA mortgage. The \$4,500 YSP would never have been paid under the Culpepper rule. According to Irwin, that payment was legal because it was "reasonable."

Federal regulators require banks and other depository institutions to implement safeguards to prevent racial and other types of discrimination by their employees. Mortgage brokers, however, are often nothing more than an individual or small group of individuals acting as independent contractor loan officers. They are not subjected to any oversight by institutional lenders or by regulators. Current yield spread premium practices that base "compensation" on the broker's ability to convince borrowers to accept higher interest rates encourage discrimination.

Thank you again for inviting me and for your attention to these important issues.

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