**DATE:** April 15, 1999

**SUBJECT:** Compensating Mortgage Brokers Under New HUD Guidelines

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Reeling from a Congressional mandate and persistent mortgage industry prodding to clarify its position on the legality under RESPA, Section 8, of lender-paid compensation to mortgage brokers, the Department of Housing and Urban Development (HUD) at last has ruled that the payment of so-called *yield spread premiums* or other back-funded lender payments to mortgage brokers are not illegal *per se* and may be authorized under RESPA so long as the total of payments to the broker consists only of reasonable compensation for settlement services performed or goods or facilities furnished. Section 8 prohibits the payment of referral fees, kick-backs or other things of value as consideration for the referral of settlement services in connection with federally related mortgage loans, but expressly permits payments for services actually performed or goods or facilities actually furnished.

The new interpretive rule, known as Statement of Policy 1999-1, was issued under the authority of Section 19(a) of the Real Estate Settlement Procedures Act (RESPA), which provides lenders protection from liability under RESPA when acting in good faith reliance on a rule, regulation or interpretation of the statute by HUD, and was effective upon its publication in the Federal Register (64 F. R. 10079) on March 1, 1999. The ruling applies only to payments made to mortgage brokers in *table funding* transactions or *intermediary* brokered transactions, in which the mortgage broker is not the real source of funds, and does not apply to *secondary market transactions*, which are exempt from RESPA coverage. HUD's new ruling has been hailed by mortgage bankers and brokers nationwide for removing a cloud of alleged illegality over the common industry practice of wholesale lenders' compensating mortgage brokers for their loan origination services in these transactions through the payment outside of closing (P.O.C.) of back-end fees, which are typically denominated "yield spread premiums", "yield differentials", or "servicing released premiums". The ruling is also hoped to undermine the claims of *per se* illegality of yield spread premiums in over 150 law suits pending against lenders across the country seeking *class action* certification.

### *HUD's Two-Part Test*

As espoused by the rule, HUD does not consider the payment of so-called *yield spread premiums* or other back-funded lender payments to mortgage brokers to be illegal *per se*. HUD recognizes that methods of compensating mortgage brokers may vary, and in any particular transaction a broker may receive compensation directly from the borrower, indirectly in back-funded fees paid by the wholesale lender funding the loan, or through a combination of both. In determining whether a payment by a lender to a mortgage broker is permissible under RESPA, Section 8, HUD will apply a two-part test:

> First – HUD will determine whether services were actually performed or goods or facilities were actually furnished in exchange for the compensation paid;

Second – If so, HUD will next determine whether the amount of the payments are reasonably related to the value of the services actually performed or the goods or facilities actually furnished.

### ***Test for Services Actually Performed . . .***

In determining whether compensable services were actually performed, HUD will look for the types of services described in its informal opinion letter to the Independent Bankers Association of America (IBAA Opinion) dated February 14, 1995, regarding the nature and extent of loan origination services that a mortgage broker or other agent or contractor must perform to justify compensation under RESPA, Section 8. This 1995 informal opinion enumerated 13 distinct services, in addition to the taking of the loan application, that are normally performed in the origination of a residential mortgage loan. These services generally include pre-qualifying prospective borrowers to determine their eligibility for the loan and the maximum mortgage loan amount they can afford, counseling them on the home buying and financing process, collecting financial information needed to underwrite the loan, verifying the information, ordering related settlement services such as appraisals, inspections, flood zone determinations and legal documents, providing applicants regulatory disclosures about settlement costs and procedures, assisting them in clearing credit problems, maintaining contact with them throughout the application process, and participating in the loan closing. The IBAA Opinion was generally regarded as creating a "safe harbor" of sorts against an enforcement action in any case in which HUD, when scrutinizing a broker payment for Section 8 compliance, would find that the mortgage broker or other lender's agent or contractor had taken the loan application and had performed at least five (5) additional services from this list of 13 and that the payment reasonably related to the value of the services actually performed. In applying the first of the two-part test set out under the new ruling, Statement of Policy 1999-1 adopts this same standard for reviewing whether sufficient origination work has been performed in any case to justify compensation. Services other than these 13 also may be evaluated and acknowledged as compensable by HUD if they are meaningful services akin to those set out in the IBAA Opinion.

[NOTE: Under the IBAA Opinion, HUD set out more stringent standards for qualifying for payment when relying on the taking of an application and performing *only* counseling type services: HUD in that instance must conclude that *meaningful* counseling was provided the borrower and that the borrower was given the opportunity to consider loan products of at least three different lenders from which the broker, agent, or contractor stood to receive essentially the same compensation. Furthermore, while *taking the application* is generally required to qualify for compensation under the IBAA Opinion, a subsequent HUD opinion clarified that the *substantially equivalent* service in that case of obtaining income and debt information, which is used together with an in-file credit report to develop a worksheet showing loan programs and maximum loan amounts for which the applicant may qualify, may be substituted for the act of filling out the loan application.]

### ***. . . Or Goods or Facilities Furnished***

HUD also recognizes that, in addition to services, mortgage brokers may furnish goods or facilities to the lender for which the broker is entitled to compensation. For example, appraisals, credit reports, and similar documents needed to complete a loan file may be regarded as *goods* and a portion of the brokers' retail premises, or "store front" operation, as *facilities* for this purpose. However, consistent with recent federal case law, the loan itself arranged by the mortgage broker cannot be regarded as a *good* that the broker can be said to sell to the lender for its market value based upon the loan's yield or other value as a secured debt instrument.

The mortgage broker's compensation must reasonably relate to the value of goods or facilities actually furnished, of course. In that regard, HUD in its earlier Statement of Policy 1996-3 established a *general market value* standard for measuring the reasonable value of facilities furnished to be assured that the rent of facilities furnished was not in part a disguised referral fee. In a rental context, the general market value is the rent that a non-settlement service provider, such as a dentist, would pay for the same amount of space and facilities in the same or a comparable building — not the higher rent that a settlement service provider, such as a lender, may be willing to pay in anticipation of receiving loan referrals. Under that policy, HUD indicated that when such a settlement service provider is renting space from a person who is referring settlement services to that provider, any rental payments either exceeding the *general market value* of the facilities or based in any way on the number or value of referrals made would be considered unlawful referral fees in violation of Section 8.

### *Test for Reasonableness of Compensation*

In applying the second part of the test — whether the payments by the lender to the mortgage broker reasonably relate to the value of the services actually performed or goods or facilities furnished — HUD will scrutinize the *total compensation* received by the broker, including direct origination and other fees paid by the borrower, yield spread premiums and similar lender-paid fees derived from the interest rate (which HUD regards as paid indirectly by the borrower), and any volume-based compensation (the latter of which HUD notes it generally regards as illegal referral compensation when based on the volume or value of business transacted). It is neither necessary nor feasible according to HUD to attempt to identify or allocate which goods or services are provided for the benefit of the borrower or that of the lender because all services, goods and facilities benefit both the borrower and lender in the sense that they make the loan possible. Instead, HUD will evaluate total compensation paid the broker in relation to total services performed and goods or facilities furnished. In this regard, HUD considers that higher interest rates *alone* cannot justify higher total compensation to the broker. Rather, total compensation must be evaluated in light of the price structures and practices for compensating brokers for similar transactions in the same or similar market area to determine reasonableness of the compensation.

### *Expanded Disclosures Urged . . . Though Not Mandated*

HUD reiterates that current RESPA regulations require as a minimum that all fees or other compensation paid to a mortgage broker be clearly labeled and estimated on the Good Faith Estimate at loan application and the actual amount of the compensation and broker's name be clearly labeled and listed on the HUD-1 or HUD-1A settlement statement at closing. While not mandating disclosures beyond that currently required by RESPA, HUD believes that mortgage brokers nevertheless should provide loan applicants with information about the broker's services and compensation as early as possible in the loan shopping process and obtain agreement by the borrower to the arrangement before the borrower makes application for the loan. The true market price for the mortgage broker's services could be best attained, HUD believes, under practices of this kind in which the fee a borrower will pay (along with its relationship to the interest rate and points charged by the lender and lender-paid compensation to the broker) is fully disclosed by the broker and agreed upon before application is made.

### *A Compliance Strategy . . . Emerges*

While Statement of Policy 1999-1 breaks very little new ground — seemingly stating the maddening equivalent of "yield spread premiums are not illegal if they don't violate RESPA" — HUD's stated policies regarding lender-paid compensation to mortgage brokers at least now are cloaked in the protections of its interpretive rulemaking authority delegated by Congress under RESPA. When pieced together like a mosaic with the findings of federal courts in the celebrated *Culperrper v. Inland Mortgage* decision and other cases challenging the legality of lender-paid mortgage broker compensation, an ongoing compliance strategy for mortgage lenders and brokers begins to emerge that is patterned on the following broad conclusions:

***1. Lender's Payment Must Be "For Actual Services Performed" Pursuant to Recognized Exemption:*** Any fee paid by a lender to a mortgage broker in connection with a federally related mortgage loan must come within a recognized exemption to RESPA, Section 8, prohibitions against kick-backs, referral fees, and unearned fees. Specifically, the fee should be characterized as payment to the mortgage broker, generally or as the lender's duly appointed agent or contractor, for services actually performed in the origination, processing, or funding of a loan, as expressly permitted under § 3500.14(g)(1)(iii) and (iv) of RESPA regulations (Regulation X). The loan origination, processing, and closing services to be performed by the mortgage broker should be set forth in a written mortgage loan brokerage agreement with the lender and, in any case, consist in scope of taking the loan application and performing at least five (5) additional services from a list of 13 distinct services enumerated in the IBAA Opinion. While HUD recognizes that a lender may additionally compensate a mortgage broker for the reasonable value of goods or facilities actually furnished, these amounts should prove to contribute comparatively little in the overall *reasonableness* analysis of total compensation — considering the *general market value* standard established by HUD in earlier rulemaking. The notion that the loan itself is a *good* that may be sold for the value of the so-called yield spread premium has been rejected by the courts and now by HUD rulemaking.

***2. Total Compensation Must Be Reasonably Related to the Value of the Actual Services Performed.*** The total compensation paid to a mortgage broker in connection with a federally related mortgage loan must reasonably relate to the values of services actually performed, and any excessive amounts may be deemed as unlawful compensation for the referral, or "steering" of the loan under Section 8. Total compensation under this *reasonableness* test includes direct origination and other fees paid by the borrower, indirect fees paid by the lender derived from the interest rate to be paid by the borrower, such as yield spread premiums, and, when applicable, volume-based compensation. Total mortgage broker compensation from all sources must be reasonable in relation to "price structures and practices in similar transactions and in similar markets". This appears to be a sort of "mainstream marketplace" standard under which HUD will compare total broker compensation, in any case, with the norm for fees, or the range of fees, charged by mortgage brokers for comparable services performed in connection with similar loan transactions in the same or similar market areas. Broker pricing that is not commensurate with this norm presumably would have to be justified based upon the scope or quality of services performed. In this regard, a percentage fee outside this norm that takes into effect the "spread" between *par* rates quoted by a wholesale lender and the rate actually delivered by a broker would seemingly be difficult to defend based on this "actual services performed" standard since HUD has now ruled that higher interest rates alone cannot justify higher broker compensation.

Seemingly duplicative fees charged by a mortgage lender and broker would also be evaluated by HUD and reconciled under this same *reasonableness* test. If the mortgage broker separately charges the borrower an origination fee and various underwriting, processing, and other fees at loan closing, it undermines the characterization of the mortgage broker's fee paid outside of closing by the lender as payment for services actually performed. Courts could conclude that the lender's payment in that case was for other than "actual services performed" since arguably the broker had already been fully compensated by the borrower for its services, or, if the lender's payment is deemed to be for services, was clearly excessive or duplicative, and, in either case, outside the express § 3500.14(g)(1)(iii) or (iv) exemptions. If both front-end and back-end fees are to be collected by the mortgage broker for its services, therefore, the separate sources and amounts of its compensation must be properly disclosed to the borrower and the total amount of compensation must be reasonably related to the value of services actually performed by the broker.

***3. Lender's Payment Should Be Denominated a "Mortgage Broker Fee" and Clearly Disclosed:*** Any back-end fee paid by a lender to a mortgage broker for its services should be denominated a "mortgage broker fee" – and clearly labeled and disclosed on both the Good Faith Estimate and in the 800 series of the HUD-1 or HUD-1A Settlement Statement as paid outside of closing (P.O.C.). Any confusing labels and code-like abbreviations, such as "YSP to DBG, POC" should be eliminated in favor of clear and understandable disclosures. While HUD in some respects appears indifferent to the precise label given the fee in these disclosures, the better practice would seem to avoid secondary market terms, such as "yield-spread premium" and "servicing release premium," suggesting payment is being made for other than services performed. It is noteworthy in that regard that HUD's own recommendation for proper disclosure given in its new rule describes the payments as *mortgage broker* fees:

"Mortgage Broker Fee from Lender to XYZ Corporation (P.O.C.)" $ _________

If the mortgage broker delivers the Good Faith Estimate, a narrative statement such as "a mortgage broker fee ranging from $ ____ to $ ____ is being paid by the lender to [mortgage broker] for this transaction" would satisfy the GFE disclosure requirement, based on past rulemaking. If both front-end and back-end fees are to be collected by the mortgage broker for its services, of course, the separate sources and amounts of its compensation must be properly disclosed to, and ideally acknowledged by, the borrower.

***4. Mortgage Brokers and Lenders Should Disclose More and Earlier:*** Although HUD's new rule does not mandate disclosures beyond those currently required by RESPA and Regulation X, the better practice urged by HUD calls for more and earlier disclosures to be given prospective borrowers so that they may evaluate the scope and nature of the mortgage broker's services and costs before making loan application. The lender should additionally and separately disclose to the consumer at the application stage not only that the lender is paying a mortgage broker fee but that the borrower is being indirectly charged the broker fee through the lender's charging of a premium interest rate on the loan sufficient to allow the lender to recoup that cost. The disclosure ideally would also give the borrower the option of paying the broker fee directly at loan settlement or accepting the premium rate offered. Reminiscent of its earlier 1997 Proposed Rule soundly rejected by the industry, HUD reiterates that these early disclosures should provide information that allows the loan applicant to evaluate the scope and nature of the services the broker would perform, including whether the broker will be serving as the prospective borrower's agent, and all costs of the brokered transaction. Under this practice, receipt of these written disclosures would be acknowledged and agreed to by the borrower before loan application and retained in the permanent loan file. While disclosure in this manner would provide the lender no protections from RESPA sanctions if the disclosed payment in fact is unlawful (i.e., for other than "services performed"), it should be useful in any case to insulate the mortgage broker or lender from claims of breach of contract and deceptive trade practices under state laws that inevitably accompany allegations of RESPA violations as well as in forestalling customer dissonance when the precise amount of the fee is first disclosed at loan closing.

***5. Mortgage Lenders and Brokers Should Seek Shelter in the "Semi-Safe Harbor" of HUD Guidelines or the "Safe Harbor" of the Secondary Market Transaction Exemption:*** RESPA provides a defense against liability under its provisions for acts performed or omitted by any party subject to RESPA when conforming in good faith with any rule, regulation, or interpretation by HUD, even though thereafter the rule, regulation, or interpretation relied upon is amended, rescinded, or determined by the courts or other authority to be invalid for any reason. As defined in §19(b), Statement of Policy 1999-1 constitutes such a "rule, regulation, or interpretation" entitling mortgage lenders and brokers these special protections. These "reliance on rule" protections, however, are limited to the extent the rule itself is vague, ambiguous, or highly subjective in its application — such as in the determination by HUD of *reasonableness* in any case under Statement of Policy 1999-1. And the courts seem uneven in their willingness to show HUD interpretations any special deference in their deliberations.

The only "safe harbor" for mortgage lenders and brokers seeking to insulate themselves from potential liability under HUD enforcement actions or *Culpepper*-inspired class-action claims appears to be the *secondary market transaction* exemption. Bona fide transfers of loans in the secondary market are exempt from RESPA coverage under the provisions of Regulation X, § 3500.5(b)(7). Thus, amounts paid by mortgage investors as yield-spread and servicing-released premiums when purchasing a loan in the secondary market are not subject to Section 8 scrutiny.

But the common practice of *table funding* in which a loan originated by a mortgage broker is actually funded at closing by a wholesale lender who receives a contemporaneous assignment of the loan, expressly does not qualify as a secondary market transaction for purposes of this exemption. Even though the mortgage broker is the named payee in the note instrument in table funded transactions, the wholesale lender to whom the note and other documents are initially assigned at or after settlement is defined as the lender and the broker's assignment is not recognized as a bona fide transfer of the loan obligation in the secondary market.

For an assignment of a note and other loan documents to qualify as an exempt secondary market transaction, it is necessary that the mortgage originator both close the loan in its own name (i.e., the originator is the named creditor in the debt and security instruments) and fund the loan with its own capital or funds advanced from a *bona fide* warehouse line of credit or other credit facility for which it is liable. Once the loan transaction is consummated and the mortgage originator is the *bona fide* holder of the note, a subsequent transfer and sale of the loan to a mortgage investor is then an exempt secondary market transaction.

Attempts to qualify a loan as a secondary market transaction through funding arrangements in which the loan originator's funds are not actually utilized to disburse the loan (e.g., where there is an exchange or offsetting of funding checks) or in which funds are advanced from a purported warehouse line for which the loan originator has no actual risk of liability (e.g., where the loan originator is given immediate credit for loans that are sold to the warehouse lender itself or its affiliate) likely would be disregarded under HUD's enforcement policy as mere shams. Thus, to be assured of qualifying for exemption under this provision, the wholesale lender's purchase of loans from third-party originators on a flow basis should be transacted through the independent warehouse lender funding the loan, and not through the settlement agent as in a table funding. An elapse of time of a day, or more, between the date of the primary loan closing and the subsequent transfer of the loan would also be desirable to establish evidentially that the two transactions are distinct and that the transfer of the loan to the wholesale lender qualifies as a secondary market transaction. ✍

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