

# No Shades of Gray - HUD's New Statement of Policy Hurts Homeowners and Will Cost Millions

## Consumer Analysis [1](#) of HUD's 2001 Policy Statement on Lender Payments to Mortgage Brokers

Despite HUD and the mortgage industry's claims to the contrary, there should be no doubt that HUD's Statement of Policy on Lender Payments to Mortgage Brokers, issued October 15, 2001, will have one result - homeowners will continue to pay thousands of dollars in extra interest expense as a result of illegal lender paid broker fees.

The unambiguous intent of HUD's new Statement of Policy was to shield the industry from class action law suits challenging the legality of these fees. HUD attempted to mitigate this anti-consumer action by proclaiming that a "new" rule would require that additional information provided to consumers would change the predatory practices of some brokers and actually provide protection to consumers. However, the new disclosure recommended by HUD is not new - it was specifically recommended by HUD in the 1999 Statement of Policy. If the industry had wanted to comply with RESPA's requirements and avoid liability, the industry could have adopted the practices HUD recommended two years ago.

More importantly, if HUD's action of October 15, 2001 withstands judicial scrutiny, it will have the effect of insulating the mortgage industry from all liability. If consumers have no effective way of enforcing a rule, than the rule provides consumers with no protection. HUD stated repeatedly in the 2001 Statement of Policy that each case must be individually reviewed to determine compliance. The intent and effect of requiring individual case analysis is to prohibit class actions. Unfortunately, without class actions, there will be no effective enforcement of any consumer protection under RESPA - the few individual actions brought will not provide any incentive to the industry to comply with the law. Proof of this is found in the fact that the industry continued to balk at compliance with the rules recommended in the 1999 Statement of Policy, because the industry believed at that time that they were immune for class action liability.

### Consumers' Position

For many years attorneys and advocates for consumers have been challenging the insidious use of lender paid broker fees. Lender paid broker fees can have the relatively modest effect of increasing the interest rate of a loan by one eighth or one quarter of one percent, which still will cost the homeowner thousands of dollars in excess interest over the course of the loan. On the other hand, lender paid broker fees are often a major component of predatory lending - providing the incentive to brokers to refinance loans, and justifying the use of onerous prepayment penalties.[2](#)

Consumers who do business with mortgage brokers generally have the understanding that the brokers will provide them the loan at the lowest rate which the broker finds for them. Consumers have generally understood and agreed to a specific broker's fee to be paid directly by them - either in cash or by borrowing more - to the mortgage broker to compensate the broker for obtaining the loan. What consumers do not understand, and have not agreed to, is when the mortgage broker receives an additional fee from the lender. These fees are generally paid by the lender to the broker solely in compensation for the higher rate loan. In other words, the lender would have made the consumer a loan at a lower rate, but because the loan is provided at a higher rate, the broker is paid a fee, or kickback. These fees are solely an extra fee the broker is able to extract from the deal. The result is the borrower will have a higher interest rate for the life of the loan.

Not all lender paid broker fees are bad or illegal. We agree with the oft-stated premise in HUD's and the industry's pronouncements that when the lender paid fee is used to reduce the closing fees owed by the borrower, borrowers can benefit from the payment of these fees. However, these are not the types of loans which are the subject of either the class actions, or our concerns. We are concerned with the cases where the homeowners' fees are not reduced by the

lender paid fees - so that the broker is paid twice for the same services, increasing the overall cost of the loan to the borrower. The supposed reduction in closing costs in exchange for the yield spread premium rarely occurs. Generally the borrower ends up paying both the closing costs and the higher interest rate caused by the yield spread premium. This practice occurs both in the prime and subprime mortgage market.

Pursuant to Congress's directive to HUD in 1998 to write a Statement of Policy, consumer representatives worked with the mortgage industry and HUD to develop the language.<sup>3</sup> One of the reasons that consumer representatives agreed with the Statement of Policy that was issued by HUD in 1999 was the explicit direction provided to the industry on how to avoid challenge for the lender's payment of a broker fee:

Mortgage brokers and lenders can improve their ability to demonstrate the reasonableness of their fees if the broker discloses the nature of the broker's services and the various methods of compensation at the time the consumer first discusses the possibility of a loan with the broker.

...

[T]he most effective approach to disclosure would allow a prospective borrower to properly evaluate the nature of the services and all costs for a broker transaction, and to agree to such services and costs before applying for a loan. Under such an approach, the broker would make the borrower aware of . . . the total compensation to be paid to the mortgage broker, including the amounts of each of the fees making up that compensation. If indirect fees are paid, the consumer would be made aware of the amount of these fees and their relationship to direct fees and an increased interest rate. If the consumer may reduce the interest rate through increased fees or points, this option also would be explained.(Emphasis added.)<sup>4</sup>

With this clear direction on how to avoid liability for paying broker fees, one would think that the mortgage industry would immediately adopt these recommendations and employ them in all future loans. One would be wrong. Instead the industry continued as before - lenders continued to pay broker fees without evaluating either the services provided by the broker or whether the payment of the lender fee reduced the fees otherwise owed by the borrower. The strategy of the mortgage industry was to pay off the few individual actions and mount a massive effort to fight class certification of any case challenging the payment of these fees.

### **Culpepper Case**

After the issuance of the 1999 Statement of Policy most federal courts generally denied class certification, requiring an intensely factual analysis to determine legality,<sup>5</sup> while a few federal district courts did permit the class actions to proceed.<sup>6</sup> This scene changed significantly however, when the 11th Circuit Court of Appeals issued a comprehensive analysis of RESPA's requirements regarding referral fees, the 1999 Statement of Policy, and upheld class certification, on June 15, 2001.<sup>7</sup>

The crux of the analysis in the Culpepper case is that for HUD's Statement of Policy to be consistent with RESPA, a two part test is necessary to determine the legality of the lender paid broker fees. First, whether the lender paid fee was for goods, services or facilities provided. Second, whether the total fee paid was reasonable.<sup>8</sup> The court found class certification appropriate because -

the terms and conditions under which a lender pays the broker a yield spread premium can determine whether the yield spread premium is compensation for referring loans rather than a bona fide fee for services. There is no suggestion from the evidence or the argument here that Irwin negotiates yield spread premiums loan-by-loan, rather than paying them according to terms and conditions common to all the loans.<sup>9</sup>

As the first step of the two part test - whether the lender paid fee was for services - could be answered without performing a factual analysis of each individual loan, the court found no reason that the case could not proceed as a class action. The court noted that the formula by which a lender paid broker fee is paid "does not take into account the amount of work the broker actually performed in originating the loan or how much the borrower paid in fees for the broker services."<sup>10</sup>

### **Industry Position**

The mortgage industry has consistently stated that it wants to ensure that yield spread premiums remain legal so that borrowers can benefit from their use - such as by reducing the up-front closing costs required to be paid from cash or equity. Yet, there have been no changes in policy or practice which would dictate that a lender fee should only be paid when there was a determination that this was the case.

The mortgage industry responded to the Culpepper case by immediately going to HUD and seeking a "clarification" of the 1999 Statement of Policy removing all references to language which would support the 11th Circuit court's analysis. The stated rationale was simply to "clarify" the "ambiguity" in the Policy Statement.<sup>11</sup> Despite the fact that the 1999 Statement of Policy was unambiguous regarding how the industry could legally pay yield spread broker fees, the industry coyly requested:

HUD must issue decisive and clear rules that benefit both borrowers and lenders by creating a regulatory environment in which consumers can make informed choices and lenders can operate their businesses, without the constant prospect of having industry practices that benefit consumers challenged in litigation.<sup>12</sup>

The industry portrayed a "clear rule" for the future as an appropriate trade-off for the requested "clarification of the 1999 Statement of Policy."<sup>13</sup> This completely ignored the obvious - that HUD had already provided a clear rule, just as the industry is now requesting, in the 1999 Statement of Policy, which the industry had simply ignored.

### **HUD's Actions**

In the weeks preceding the issuance of the 1999 Statement of Policy, HUD officials met with consumer representatives on dozens of occasions to work through many of the complex issues involved in this problem. Many of these meetings were also attended by representatives of the mortgage industry. In contrast, prior to the 2001 Statement, HUD officials met with consumer representatives three times, despite numerous requests and offers by these representatives to engage in a more substantial dialogue.<sup>14</sup>

The consumer representatives tried to make clear to HUD officials these essential points:

- Providing the "clarification" of the 1999 Statement as sought by the mortgage industry would have the effect of completely eliminating class actions as a form of redress for illegal lender paid broker fees.<sup>15</sup>
- Without class actions as a means to litigate the legality of these fees, the industry has no incentive to change their practices or even to comply with a new regulation - because there are insufficient legal resources in this nation to represent consumers in individual actions involving claims of only a few thousand dollars.
- The "new" disclosures offered by the industry - and proposed by HUD - provide fewer actual protections for consumers than those recommended by HUD in the 1999 Policy Statement. Unlike the 1999 recommendations which include the consumer's agreement to the lender paid broker fee, the 2001 proposal only mentions "disclosure."<sup>16</sup>
- Limiting illegal lender paid broker fees is an essential step in redressing predatory mortgage lending.

The mortgage industry provided specific language to HUD to "clarify" the 1999 Policy Statement. HUD adopted every recommendation made by the industry. The crux of HUD's "clarification" comes on page 11, with the statement:

HUD's position is that in order to discern whether a yield spread premium was for goods, facilities or services under the first part of the HUD test, it is necessary to look at each transaction individually. .<sup>17</sup>

Such a position, if deferred to by the courts, would almost certainly preclude class action suits, thus removing the only effective legal recourse to challenge this practice. In fact the 2001 Statement of Policy collapses the two-part test articulated in the 1999 Statement into a single analysis; which represents a serious departure from not only the 1999 Statement, but also from the Congressional directive in RESPA.<sup>18</sup>

HUD's action is absolutely crippling to consumer rights, as it removes any incentive the industry has to cooperate with any future action that HUD might take to address the egregious practice of upselling mortgage loans. In his press release, Secretary Martinez claims to be pursuing a reform to require full up-front disclosure of all total compensation

to be paid to the broker. However, even if HUD initiates a proposed rulemaking to do this (which was not proposed in the October 15 Statement), and even if the regulation goes beyond the meaningless recommendations in the 2001 Statement, it will be a regulation without any effective enforcement mechanism.

There are no shades of gray in HUD's action of October 15, 2001: the mortgage industry requested and received everything it wanted to enable it to avoid past and future liability for blatantly ignoring REPSA's prohibitions against referral fees. HUD's gift to the mortgage industry will be paid for by American homeowners.

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1 This analysis was written by Margot Saunders, National Consumer Law Center.

2 The line between these types of cases is often blurred. Consider the facts of one of the named plaintiffs in the case of *Culpepper v. Irwin Mortgage Corp.*, 253 F. 3d 1324 (11th Cir. 2001). Beatrice Hiers used the services of a mortgage broker to obtain an FHA loan. Despite her credit rating which qualified her for a 7% fixed rate loan, and the fact that she paid the broker a \$1,544 as a loan broker fee, and loan discount points of \$4,736, the broker "upsold" her into a 7% variable rate loan. By increasing the cost of the loan to Ms. Hiers, the broker received an additional \$4,539 as a lender paid broker fee. Ms. Hiers paid the broker a total of \$10,819 in fees on a \$159,570 loan - almost 7% of the loan amount.

3 "The conferees expect HUD to work with representatives of industry, Federal agencies, consumer groups, and other interested parties on this policy statement." See the Conference Report on the Departments of Veterans Affairs and Housing an Urban Development, and Independent Agencies Appropriations Act, 1999, H.R. Conf. Rep. No. 1050769 at 260 (1998).

4 Real Estate Settlement Procedures Act Statement of Policy 1999-1 Regarding Lender Payments to Mortgage Brokers. 64 FR 10080 (March 1, 1999) at 10087.

5 See e.g. *Golan v. Ohio Sav. Bank*, 1999 U.S. Dist. LEXIS 16452 (N.D. Ill. Oct. 15, 1999); *Brancheau v. Residential Mortgage*, 187 F.R.D. 591 (D. Minn. 1999); *Levine North Am. Mortgage*, 188 F.R.D. 320 (D. Minn. 1999); *Smitz v. Aegis Mortgage Corp.*, 48 F. Supp. 2d 877 (D. Minn. 1999).

6 *Heimermann v. First Union Mortgage*, 188 F.R.D. 403 (N.D. Ala. 1999); *Briggs v. Countrywide Funding Corp.*, 188 F.R.D. 645 (M.D. Ala. 1999).

7 *Culpepper v. Irwin Mortgage Corp.* 253 F. 3d 1324 (11th Cir. 2001).

8 A significant basis for this rationale is not only HUD's 1999 Statement of Policy, but also the language of RESPA's provision distinguishing between legal fees and referral fees. Section 8(c) of RESPA permits "the payment of a fee . . . by a lender . . . for services actually performed." 12 U.S.C. § 2607(c)(1)(C). 253 F. 3d at 1328. (Emphasis added.)

9 253 F. 3d at 1329.

10 The factual basis for the court's conclusion was stated in this way:

The "yield spread premiums" at issue in this case . . . are payments from [the lender] to its mortgage brokers that the written agreement between them contemplates, but does not define. Each business day, Irwin distributes a rate sheet to its brokers, listing the terms of the loans Irwin is offering that day. The loans' interest rates are set with reference to a "par rate." If the broker originates a loan at a below-par rate, it gets no compensation from Irwin. On the other hand, originating a loan at an above-par rate garners the broker a yield spread premium, whose amount is determined by a formula that includes the amount of the loan and the difference between the loan rate and the par rate. The formula does not take into account the amount of work the broker actually performed in originating the loan or how much the borrower paid in fees for the broker's services. 253 F.3d at 1325.

11 See letter from Anne Canfield, Executive Director of the Consumer Mortgage Coalition, to Secretary Mel Martinez, dated September 25, 2001. <http://www.houselaw.net/alerts/092801a.pdf>.

12 *Id.*

13 See memorandum from Howard Glaser, Mortgage Bankers Association, entitled "What we are asking for."

14 On July 11, 2001 consumer representatives met with General Counsel Richard Hauser and other HUD representatives. On September 11, 2001 consumer representatives met for a few minutes with Secretary Martinez, FHA Commissioner Weicher, Mr. Hauser, and others. Given the tragic occurrences of the day, this meeting was aborted and resumed on September 19. On October 11, after numerous requests, consumer representatives again met with Mr. Hauser, Commissioner Weicher, and others.

15 This assumes that a court agrees that the 2001 HUD Statement of Policy should be provided deference. There is substantial legal question regarding the extent of reliance that a court may place on an agency's interpretative statement which has not been subject to notice and comment. The Supreme Court has distinguished between the deference due regulations promulgated by formal notice-and-comment rulemaking or formal adjudications and those made informally. See *Christensen v. Harris County*, 529 U.S. 576, 120 S. Ct. 1655, 1662, 146 L. Ed. 2d 621 (1999).

16 Consumer representatives maintain that requiring the consumer to agree to the payment of a lender paid broker fee is an essential element in a regulatory structure that would truly protect consumers from illegal yield spread premiums.

17 Department of Housing and Urban Development, RESPA Statement of Policy 2001-1:Clarification of Statement of Policy 1999-1 Regarding Lender Payments to Mortgage Brokers, and Guidance Concerning Unearned Fees Under Section 8(b) at 11.

18 The new test "requires that total compensation to the mortgage broker be reasonably related to the total set of goods or facilities actually furnished or services performed." *Id.* at 13. Although HUD says there is still a two part test, the two tests appear identical.