



Yield Spread Premiums: A Powerful Incentive for Equity Theft

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\$2.9 BILLION

THE CENTER FOR RESPONSIBLE LENDING ESTIMATES THAT EXCESSIVE INTEREST RATES COST 600,000 FAMILIES \$2.9 BILLION EACH YEAR.

Today hundreds of mortgage lenders and thousands of brokers specialize in refinancing subprime mortgage loans for families with less-than-perfect credit. In a high percentage of these subprime loans -- as many as 90% -- brokers receive a kickback known as a "yield spread premium" (YSP). A YSP is a cash bonus that a broker receives from a lender for placing borrowers in a loan with a higher interest than the lender would accept. The higher the interest rate, the higher the premium received by the broker.

These kickbacks provide brokers a strong incentive to charge borrowers a higher interest rate when they could qualify for a less expensive loan. The effect of YSPs is to steal equity from struggling families.

Not all loans with YSPs are abusive, but because they are permitted and easy to hide, unscrupulous brokers can make excessive profits without adding value to borrowers.

Struggling Families Pay More than Necessary

From our case files: A single mother paid a broker over \$9,000 in settlement charges on a \$43,750 mortgage loan. The borrower thought the interest rate was 10%, but the actual rate was 13.74%. This rate earned the broker a generous kickback from the lender, a "yield spread premium" of \$2,680. The broker's total compensation was more than 13% of the loan amount.

The Strategy – Steering Vulnerable Borrowers into Costly Loans

Brokers and lenders frequently overcharge borrowers through a practice known as interest rate steering – i.e., setting rates on the basis of perceived financial sophistication rather than risk. Elderly, minority, and low-income homeowners are the prime targets. Studies show that a significant percentage of subprime borrowers could qualify for mainstream mortgage loans.

The Myth – Kickbacks Help Borrowers

Many brokers say that YSPs help borrowers who otherwise could not afford to pay closing costs, but this claim is not supported by facts (see "Fast Facts"). In fact, a typical borrower receives very little benefit from the YSP – only 25 cents of benefit for each dollar paid.

The Double Whammy – YSPs and Prepayment Penalties

The vast majority of borrowers in the conventional mortgage market can pay off their mortgage anytime they choose without incurring a penalty. However, subprime loans commonly feature prepayment penalties, especially loans that include a YSP. Because lenders who pay a YSP want to make sure they recover the cost of the kickback, they have added incentive to impose prepayment penalties. These penalties -- which typically cost several thousand dollars -- pose a significant obstacle to families who establish good credit and want to refinance to get a loan with better terms.

Because YSPs encourage prepayment penalties, these kickbacks not only make loans more expensive from the beginning, they also effectively penalize borrowers for developing good credit over time.

FAST FACTS *

- Yield spread premiums (YSPs) are included in 85 to 90% of all subprime mortgages.
- Loans that include YSPs cost borrowers an additional \$800 to \$3,000 more than loans without YSPs.
- The average amount of a YSP is about \$1,850 per loan, making these payments the largest part of a broker's compensation.
- There is no legal requirement to inform borrowers about the connection between the YSP and the interest charged on a loan.
- More than 75% of the borrowers with loans that included YSPs could have used a less expensive method to help pay closing costs.
- On average, mortgage brokers earn \$1,046 more on loans with YSPs – adding further evidence that most of the value goes to the broker rather than the borrower.

About the Center for Responsible Lending

The Center for Responsible Lending is dedicated to protecting home ownership and family wealth by working to eliminate abusive financial practices. The CRL is a national nonprofit, nonpartisan research and policy organization that promotes responsible lending practices and access to fair terms of credit for low-wealth families. For additional information, please visit our website at www.responsiblelending.org or call us at **919-313-8500 / 202-349-1850**

* Many of the facts included in this piece come from research conducted by Howell E. Jackson and colleagues at Harvard Law School. See, e.g., "Kickbacks or Compensation: The Case of Yield Spread Premiums" by Howell E. Jackson and Jeremy Berry (January 8, 2002).