Yield spread premium

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The **yield spread premium** (YSP) is the cash rebate paid to a mortgage broker based on selling an interest rate above the wholesale par rate that the borrower qualifies for.

For example, If a mortgage broker offers a borrower a loan of $100,000 at an interest rate of 6.25%, and the par rate is 6%, the broker may earn a YSP equal to 1.0% of the loan amount. This $1,000.00 fee is paid by the lender directly to the broker as a "rebate." The mortgage broker earns "one point" directly from the lender "POC" (Paid outside Closing). Although the borrower is not charged the fee directly, the borrower does pay the fee indirectly by accepting a higher interest rate in exchange for lower fees.

In the U.S., mortgage brokers are required to disclose YSP as a fee "POC" (Paid Outside Closing) on page 2 of the HUD1 Settlement statement, inside the margin, away from the column marked "Paid from Borrower's funds at Settlement."

YSPs as a financial instrument are not controversial. What is controversial is how they are applied, and how and when brokers and lenders have to disclose their existence and their amount to the borrower.

Consumer groups such as the Center for Responsible Lending contend that disclosing the YSP to borrowers informs borrowers that the broker might be charging them a higher interest rate than they might otherwise qualify for.[1] They point out that the YSP amount to a fee paid to the broker, and therefore its exact amount should be made known when the borrower commits to a broker ("locks in the rate"), rather than later in the loan process.

Some mortgage brokers contend that this disclosure requirement puts them at a disadvantage when compared to Institutional ("Retail") Lenders, who do not have to disclose their YSP. In addition, they point out that there are truly legitimate reasons for a YSP, such as help in offsetting closing costs for borrowers who are short of cash. For those borrowers, brokers use the YSP to help pay closing costs, as outlined below. Conventional mortgage brokers also point out that if only they were required to disclose their YSP, borrowers might not save money, but simply steered to retail lenders who would charge the same amount for a loan, but would appear better at first glance because they did not have to list those fees explicitly.

These arguments are further outlined below.

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Banks versus Mortgage Brokers and YSP

Lenders that fund loans and then sell them after closing do not need to disclose the amount of the yield spread premium they make. This is a HUD rule. On the other hand, brokers are forced to disclose the amount of yield spread they get from the bank. HUD's stated rationale is that Institutional lenders sell their loans in a true "Secondary Market Transaction" sometime after the loan is closed. This means that the loan is sold at a later time and their true "Yield Spread" or additional revenue is not yet known. Although the exact amount they earn may not be known, the fact is that they are earning revenue that they do not have to disclose to the borrower.

This difference gives institutional lenders an unfair advantage over a mortgage broker because when a borrower closes a loan with a mortgage broker, the borrower is fully aware of the revenue that the broker business earns on their loan.

Another disadvantage is that a mortgage broker, unlike an institutional lender, also has to disclose that he earns YSP on the Good Faith Estimate. There are two separate Good Faith Estimates, one for the broker, one for the institutional lender. The only difference is ONE SECTION, only on the Good Faith Estimate used by the mortgage broker. It states:

"COMPENSATION TO BROKER, Not Paid Out Of Loan Proceeds"

The broker must disclose a range, typically 0%-4% of the loan amount. Institutional lenders are exempt from this requirement. The broker is required to disclose an estimated dollar amount, such as $2,500.

"Giveaway to Big Business?"

Sometime on or around 2002, The Secretary of HUD, now Senator Mel Martinez, R-Florida, tried and failed to pass sweeping RESPA (Real Estate Settlement Procedures Act) reform legislation that would have further put mortgage brokers at a disadvantage by requiring mortgage brokers to credit borrowers the amount of yield spread premium that they earned, and then charge the borrowers a fee to recover the yield spread premium. Lenders would have still been exempt from that requirement.

For example, if a borrower went to his regular bank or to a large lender, they may receive a quote from them of 6.25%, Zero Points. The lender presumably would earn additional compensation when they sold the loan at some later date. For the sake of this example, we'll call it 1%.

If a mortgage broker offered the borrower the same rate, 6.25%, the borrower would receive the one point YSP as a "Lender Credit to Borrower" Then, in order to earn the same fee as the institutional lender does above, the mortgage broker would have to charge the borrower a 1% "mortgage broker fee".

So, the mortgage broker deal would be 6.25%, 1 Pt. Fee paid by borrower to broker, plus 1 points paid by lender to borrower, whereas the institutional lender could offer the equivalent at 6.25%, zero points. It is likely that borrowers would prefer the simpler deal from the lender, even though they would pay the same number of points (zero), and get the same interest rate. These concerns are corroborated by an FTC study, which found customers more likely to take a more expensive non-broker product under this disclosure method.[2]

HUD proposed broker compensation disclosures as part of its July 2002 RESPA reform proposal (HUD 2002a, 49134). Mortgage brokers would be required to disclose, in the Good Faith Estimate (GFE) provided to borrowers, any compensation received from the lender in connection with the origination of the loan. A major part of the **compensation is any Yield spread premium (YSP) paid by the lender for a loan originated at an above-par interest rate**. The YSP reflects the additional value to the lender of a loan originated at the higher interest rate. The proposed disclosure was motivated by a concern that brokers were placing borrowers in above par loans without their knowledge, and keeping the YSPs rather than passing them through to consumers in the form of reduced settlement costs. Direct lenders would not be required to make the same disclosure, even though they may be charging the same interest rate and settlement costs and earning the same compensation as a broker.

The compensation disclosures had a significant adverse impact on the respondents perception of loan costs and on respondents’ choice of loans. The disclosures caused a significant proportion of respondents to choose more expensive loans by mistake and caused a substantial bias against broker loans even when the broker loans cost the same or less than direct lender loans.

The findings of this study indicate that broker compensation disclosures are likely to harm rather than help consumers and competition in the mortgage market. --The disclosures are likely to lead a significant proportion of borrowers to choose more expensive loans by mistake. --The disclosures are likely to cause a substantial bias against broker loans that may reduce competition and increase the cost of all mortgages. --All three versions of the compensation disclosure tested in the study resulted in significant consumer confusion about loan costs and a substantial bias against broker loans. This included versions that moved the disclosure to a second page of the cost information.[2]

No Closing Cost Loans Explained

YSP can also be used by a mortgage broker to offer "No Closing Cost" loans. For example, if a borrower takes a $800,000 loan and the total closing costs amount to $5,000, the broker could increase the interest rate that pays the broker a YSP of say 1% and the broker could then credit the borrower $5,000 of the $8000 made in YSP towards his closing costs. The broker would still earn a $3,000 -paid by the YSP. This is almost always the case for loans advertised as "no closing cost" or "no fee." The only way for a broker to provide a loan without fees (and stay in business) is to charge the borrower a rate which pays a sufficient YSP to cover the closing costs, as well as earn some money for themselves.

Note that in that example, the key expression is "could" - the broker is under no obligation to share their YSP with the borrower, though it is disclosed on the est. HUD-1 by law. So, if the broker steers the borrower towards a mortgage with a higher interest rate, the broker might receive a YSP of say 1.5%, resulting in $12,000 paid by the lender to the broker. Subtracting the $5,000 spent towards closing costs, the broker would have made $7,000 rather than $3,000 as in the original example. The borrower should always check his/her estimated HUD-1 at the time he/she signs loan documents in order to ensure the loan fees and charges are in line with what they were told/expected. Unlike a Good Faith Estimate (which is provided by the broker), a HUD-1 is a document provided by the escrow company handling escrow for the loan. Though technically an estimate until the loan is funded, an est HUD cannot be changed after loan docs have been signed unless the borrower resigns certain documents disclosing finance charges associated with the loan ("re-disclosure").

During the refinancing boom in 1998-2005, rogue mortgage brokers used the YSP to defraud wholesale lenders by colluding with borrowers as follows. A borrower would accept a much higher interest rate that would result in a huge YSP paid to the broker. For instance, for the $800,000 loan discussed above, a YSP of 3 points would result in a $24,000 cash payment to the broker. The broker would share the YSP with the borrower. Shortly after closing the loan, the borrower would refinance the loan at a lower interest rate, essentially avoiding paying back the YSP received in a higher interest rate over time. This practice, if used intentionally, defrauds the investors who paid the YSP in expectation of receiving higher interest payments while the loan is being paid back.

Wholesale lenders have introduced practices to combat this type of fraud. Most wholesale mortgage broker agreements specifically require that borrowers make at least 4 payments on their new loan, or the broker receives an Early-Pay-Off notice (EPO). An EPO requires the broker (subject to their wholesale brokerage agreement with the lender) to pay back the entire rebate they earned. It is the case that many brokers will refinance the same clients over and over again, typically in 6 month increments, and they will share the YSP with the borrower, while the borrower agrees to a higher rate on what amounts to a permanent basis, since they keep refinancing the same type of loan the same way. However, with the current softening of housing values (as of 4-2007) much of that type of refinancing has come to an end. Another measure is that most lenders (and many states) have limits on the amount of YSP they will pay out (typically, this number is between 3 and 5 points for 'A' paper loans, and higher for 'subprime' loans). Lastly, brokers who repeatedly refinance borrowers in this way will almost certainly be cut off from doing business with lenders who they had been approved with.

Upfront mortgage brokers

Upfront mortgage brokers (UMBs) are a group of mortgage brokers who have agreed to disclose the total fee they earn upfront. At closing time, they will refund any YSP they receive to the borrower, except that which is required to cover their fee, which is negotiated upfront. In essence, UMBs practice voluntarily what the 2002 RESPA reform would have required all mortgage brokers to do. Contrary to the belief that this would result in customers choosing too expensive loans, UMBs provide loans at wholesale ("at par") rates to consumers with a known markup negotiated between the borrower and the broker. A UMB typically provides the borrower with direct access to the lender's wholesale price sheet, allowing the borrower to decide what interest rate to buy and whether to pay points to receive a lower rate, or whether to accept a higher rate in exchange for a YSP from the lender. In both cases, the broker's fee is the same. Therefore, the broker has no interest in steering the borrower towards higher interest loans that might result in higher YSPs, and therefore a higher fee for the broker. The borrower can pick exactly what rate to buy and how many - if any - points to pay for a lower interest rate or receive in exchanging for accepting a higher rate. Non-UMBs (aka traditional mortgage brokers) only provide the interest rate and points and hide how much YSP they will receive until closing, in effect hiding their true fees until it is too late (or very difficult for the borrower to back out.)

The argument for UMBs was made by Jack M. Guttentag, Professor of Finance Emeritus at the Wharton School of the University of Pennsylvania. Prof. Guttentag's argument is that preparing a mortgage is providing a service, and as such, should be subject to a negotiated fee. The opposing argument is that brokering a mortgage is like selling a product, in which case the broker doesn't have to make known their markup upfront. In addition, non-UMBs point out, having to declare their fee might put them at a competitive disadvantage when compared to institutional lenders who are allowed to roll the costs associated with the loan preparation into the interest rate without having to disclose that fact, as outlined above.

References

1. **^** Yield Spread Premiums: A Powerful Incentive for Equity Theft. Center for Responsible Lending.
2. ^ ***a*** ***b*** The Effect of Mortgage Broker Compensation Disclosures on Consumers and Competition: A Controlled Experiment. Federal Trade Commission.

External links

Howell E. Jackson and Jeremy Berry: Kickbacks or Compensation: The Case of Yield Spread Premiums, Harvard Law School

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