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Why the CFPB Should Reconsider Dodd-Frank's Prohibition on Yield Spread Premiums

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) is touted as the most “sweeping” change to United States financial regulation since the Great Depression.¹ Among many other changes, Dodd-Frank changes the operation and regulation of residential mortgage brokers. This Note evaluates the provisions in Title XIV of Dodd-Frank that ban the use of a payment called a yield spread premium (YSP).

The pertinent sections of Title XIV were passed in an effort to keep mortgage closing costs as low as possible and to prevent mortgage broker abuses. These provisions have received significant criticism from the mortgage industry. In addition to exploring these provisions, this Note will evaluate several criticisms of the YSP ban and offer an alternative approach for the Bureau of Consumer Financial Protection (CFPB) to consider. This Note contends that the ban on YSPs is an overreaction to evidence that these payments were used abusively, and that there are alternatives that would maintain the benefits associated with YSPs while eliminating the dangers.

Part II gives a short history of YSP law² and the changes following the passage of Dodd-Frank³ and Federal Reserve Board (Fed) rulemakings.⁴ Part III details some of the primary criticisms of the YSP ban.⁵ Next, Part IV of this Note will offer some reasons why the prohibition on YSPs deserves reconsideration by the CFPB.⁶ Lastly, Part V offers an alternative to a complete ban on YSPs and explains how this approach will maintain the benefits associated with YSPs and protect against abuses.⁷

1. President Barack Obama, Remarks by the President on 21st Century Financial Regulatory Reform (June 17, 2009).

2. *See infra* Part II.A.

3. *See infra* Part II.B.

4. *See infra* Part II.C.

5. *See infra* Part III.

6. *See infra* Part IV.

7. *See infra* Part V.

I. INTRODUCTION

A YSP is a payment from a lender to a mortgage originator, when a residential mortgage loan is closed that is either (1) purchased by the mortgage originator at a wholesale rate and sold to the consumer at the retail rate (par rate), or (2) the mortgage originator purchases a loan and sells it to the consumer at a rate above the par rate.⁸ A YSP can most easily be thought of as reverse or negative points that allow the borrower to defer upfront costs in exchange for a higher interest rate on their mortgage loan.⁹ As the interest rate increases above the broker's wholesale rate, the amount of the YSP increases as well.¹⁰

A YSP can be a useful tool for homebuyers, providing them with greater flexibility in financing their mortgage broker's compensation.¹¹ Ways in which a YSP can be utilized include: (1) compensation for the mortgage broker;¹² (2) application toward a borrower's closing expenses;¹³ (3) cash back return to the borrower;¹⁴ (4) payment for seller closing concessions;¹⁵ or (5) in some combination of the preceding options.¹⁶

Previous to the mortgage broker compensation changes, brokers could receive compensation from two sources: the borrower and the lender.¹⁷ The borrower could choose to pay all the costs associated with their mortgage closing to the mortgage broker directly.¹⁸ Alternatively, the lending institution could compensate the mortgage broker in part or

8. See Alan M. Tarter & Christopher J. Gulotta, *Yield Spread Premium*, THE GULOTTA LAW GROUP (Jan. 19, 1999), http://thegulottalawgroup.com/pub_yield_spred.htm.

9. See *id.*

10. Howell E. Jackson & Laurie Burlingame, *Kickbacks or Compensation: The Case of Yield Spread Premiums*, 12 STAN. J.L. BUS. & FIN. 289, 292 (2007).

11. See Real Estate Settlement Procedure Act 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), 66 Fed. Reg. 53,052, 53,054 (Oct. 18, 2001) (to be codified at 35 C.F.R. pt. 3500) [hereinafter RESPA's 2001 Statement of Policy] ("The availability of [a YSP] fosters homeownership.").

12. Ron Gitter, *Has Dodd-Frank Slayed the Mortgage Monster?*, HUFFINGTON POST (Mar. 15, 2011, 7:00 PM), http://www.huffingtonpost.com/ron-gitter/has-doddfrank-slayed-the-_b_835246.html (listing some common uses for YSP proceeds).

13. *Id.*

14. *Id.*

15. *Id.*

16. *Id.*

17. See Tarter & Gulotta, *supra* note 8.

18. *Id.*

entirely with a YSP.¹⁹ Most frequently, borrowers chose to compensate their mortgage brokers with a combination of the two sources of payment.²⁰ This practice of splitting broker compensation is called dual-compensation because the mortgage broker receives their total compensation from two sources: the borrower and the lender. When used, the YSP was typically the largest component of a mortgage broker's compensation and significantly offset upfront fees.²¹ Related to the prohibition on YSPs and dual-compensation, Dodd-Frank also prohibits a practice called mortgage steering.²² Mortgage steering occurs when a mortgage originator or broker steers or directs a borrower into a loan that is not in the borrower's best interest because the broker will receive greater compensation.²³

Pursuant to Dodd-Frank, authority for the Real Estate Settlement Procedures Act (RESPA) and the Truth in Lending Act (TILA) was transferred to the CFPB on July 21, 2010, when the CFPB came into existence. As part of that transfer, Dodd-Frank granted the CFPB explicit authority to waive or create exemptions to the YSP prohibition if it finds such action would be in the consumers' best interest.²⁴ The CFPB should reconsider Dodd-Frank's ban on YSPs primarily because consumers have fewer choices available to finance their mortgage closing costs,²⁵ and banning YSPs will place

19. *Id.*

20. See Susan E. Woodward & Robert E. Hall, *Diagnosing Consumer Confusion and Sub-Optimal Shopping Effort: Theory and Mortgage-Market Evidence* 5 (Nat'l Bureau of Econ. Research, Working Paper No. 16007, (2010), [hereinafter *Diagnosing Consumer Confusion*], available at <http://www.nber.org/papers/w16007>).

21. Jackson & Burlingame, *supra* note 10, at 291-92.

22. See 15 U.S.C. § 1639b(c)(1) (Supp. IV 2010) ("For any residential mortgage loan, no mortgage originator shall receive from any person and no person shall pay to a mortgage originator, directly or indirectly, compensation that varies based on the terms of the loan (other than the amount of the principal).").

23. See Regulation Z, 75 Fed. Reg. 58,509, 58,534 (Sept. 24, 2010) (to be codified at 12 C.F.R. pt. 226).

24. Congress prohibited YSPs and dual compensation structures and in the very same breath gave the CFPB authority to limit or waive these prohibitions. See 15 U.S.C. § 1639b(c)(2)(B) (Supp. IV 2010) ("[T]he Bureau may, by rule, waive or provide exemptions to this clause if the Bureau determines that such waiver or exemption is in the interest of consumers and in the public interest.").

25. *Dodd-Frank and Mortgage Reform – Fixing What Isn't Broken*, Exclusive Capital Consultants, Inc. (Feb. 21, 2011), <http://exclusivecapitalconsultants.com/dodd-frank-and-mortgage-reform-fixing-what-isn%E2%80%99t-broken> [hereinafter *Fixing What Isn't Broken*].

homeownership outside the reach of some qualified buyers.²⁶ Many commentators and mortgage brokers believe the rigid changes to compensation signal an unnecessary overreaction since the number of brokers has dramatically decreased²⁷ and, presumably, many of the “rotten apples” have left the market.²⁸ Moreover, Dodd-Frank created barriers to keep the unscrupulous mortgage brokers from reentering the market and returning to abusive practices.²⁹ Prohibiting YSPs runs counter to RESPA’s policy regarding closing cost control, and more importantly, the ban on YSPs is incompatible with the overall goal of Dodd-Frank and the CFPB; both were intended to help consumers and protect them from abuses, not to eliminate borrower options related to the home financing process.

26. See *infra* Part IV.C.

27. See Chuck Marunde, *Traditional Brokers Quitting*, THE FUTURE REAL ESTATE AGENT: THE VIRTUAL AGENT, <http://www.futurerealestateagent.com/traditional-brokerage/traditional-brokers-quitting> (last visited Dec. 27, 2011) (“This recession is not good news for real estate agents, but when the dust settles, consumers of real estate services will be left with agents who are full time professionals committed to their clients. For consumers this means agents with more experience, better track records, and greater longevity than the ‘flock’ of licensees who got licensed and made money in easier times. I also believe that more consumer oriented brokers will evolve, which is also to the benefit of consumers.”); Lew Sichelman, *Weeding Out Bad Brokers*, CHI. TRIB., (Sept. 8, 2011, 12:00 AM), <http://www.chicagotribune.com/classified/realestate/buy/sc-cons-0908-mortgage-brokers-20110908,0,5135802.story> (“William Matthews, [President of the Illinois State Regulatory Registry,] believes that rogue mortgage brokers have been removed from the lending business.”).

28. See Gitter, *supra* note 12 (“Although many of the rotten apples that facilitated the housing crash are gone, and in many respects, the originators have themselves to blame for the legislative overreaction, those remaining in loan origination are being forced to accept changes that may no longer have relevance in today’s restricted lending environment.”).

29. Dodd-Frank requires mortgage originators to submit their loan documents to the Nationwide Mortgage Licensing System and Registry with a unique identifier number. The identifier number allows the CFPB to oversee the activities of independent mortgage originators. The Nationwide Mortgage Licensing System and Registry enables potential borrowers to see if their mortgage originator has been subject to disciplinary action by the CFPB. 12 U.S.C. § 5101(Supp. IV 2010). Dodd-Frank increases disclosures requirements for mortgage brokers. 15 U.S.C. § 1638(a)(16)-(19) (Supp. IV 2010).

II. THE STATE OF YSP LAW

A. *A Brief History of the Real Estate Settlement Procedures Act*

Congress passed RESPA in 1974.³⁰ The U.S. Department of Housing and Urban Development (HUD) was responsible for enacting and enforcing regulations under RESPA,³¹ codified in Regulation X.³² Congress enacted RESPA after a report revealed the rampant use of kickbacks among real estate professionals.³³ The report concluded that these kickbacks increased the cost of a home purchase for consumers.³⁴ In an effort to keep these costs as low as possible and facilitate consumer comparison, RESPA required the standardized disclosure of settlement costs for all federally related mortgage loans.³⁵

As enacted, RESPA employed an indirect, multi-pronged approach to keep settlement costs low, rather than setting explicit maximum fee limits or rate restrictions.³⁶ Two of RESPA's prongs are

30. Real Estate Settlement Procedures Act of 1974, Pub. L. No. 93-533, 88 Stat. 1724 (1974) (codified as amended at 12 U.S.C. §§ 2601-17).

31. *Id.*

32. *Id.*

33. In 1970, Congress enacted the Emergency Home Finance Act of 1970. Pub. L. No. 91-351, 84 Stat. 450 (1970). This Act vested the HUD Secretary and Administrator of Veteran's Affairs (VA) with temporary authority to place rate caps for settlement costs on federally ensured mortgages. The Act required that the HUD Secretary and VA Administrator conduct a study to determine how to reduce the cost of residential real estate financing. Among other issues, the report focused on kickbacks, finding "an elaborate system of referral fees, kickbacks, rebates, commissions, and the like as an inducement to those firms and individuals who direct the placement of business. These practices are widely employed, rarely inure to the benefit of the home buyer, and generally increase total settlement costs." The results of the report, released in 1972, led to the enactment of RESPA two years later. Section 8 of RESPA prohibits kickbacks in real estate transactions. S. COMM. ON BANKING, HOUS. AND URBAN AFFAIRS, 92d CONG., REP. ON MORTGAGE SETTLEMENT COSTS (2d. Sess. 1972).

34. *Id.*; see also Real Estate Settlement Procedures Act, Pub. L. No. 93-533, 88 Stat. 1724 (1974) (codified at 12 U.S.C. § 2601(a)) ("The Congress finds that significant reforms in the real estate settlement process are needed to insure that consumers throughout the Nation are protected from unnecessarily high settlement charges caused by certain abusive practices that have developed in some areas of the country.").

35. Use of HUD-1 or HUD-1A settlement statements, 24 C.F.R. § 3500.8 (2011) (requiring that the settlement agent give the borrowers a HUD-1 statement that itemizes all the charges and fees associated with a federally related mortgages). "Federally related" is defined at *id.* § 3500.2.

36. Jackson & Burlingame, *supra* note 10, at 298 ("The Committee ultimately chose the [multi-pronged strategy] stating that outright rate regulations were disfavored so long as other solutions were available. Thus, RESPA as ultimately enacted in 1974 rejected rate

of particular significance to YSP regulation.³⁷ First, section 8 prohibits the payment of “any fee, kickback, or thing of value” for the referral of a settlement service,³⁸ but subsection (c) provides an exception for “bona fide salary or compensation.”³⁹ Second, the statute requires disclosure of all settlement charges, including YSPs,⁴⁰ imposed upon the borrower in a timely and standardized manner.⁴¹

In the 1992 Regulation X amendment, HUD explicitly avoided categorizing YSPs as either compensation or kickbacks,⁴² only requiring disclosure of YSPs. Critics and trade organizations disagreed about how to categorize YSPs. Critics characterized YSPs as kickbacks, prohibited under RESPA, and trade organizations insisted YSPs fell under RESPA’s Section 8 exception for bona fide compensation.⁴³

In HUD’s regulatory silence, courts began interpreting the legality of YSPs under RESPA themselves. In practice, YSPs were difficult for courts to categorize,⁴⁴ and courts were split on the legality of YSPs.⁴⁵ Some courts held that the YSPs were permissible as a matter

regulation and relied instead on a multi-pronged strategy for constraining the costs of settlement services.”); *see also* S. REP. No. 93-866, at 4-5 (1974), *reprinted in* 1974 U.S.C.C.A.N. 6546, 6550 (finding that federalism and efficiency were additional reasons to reject a direct rate regulation).

37. Jackson & Burlingame, *supra* note 10, at 298 (“For purposes of the controversy over yield spread premiums, the most important elements of this strategy are disclosure requirements and a legal prohibition against . . . kickbacks and unearned fees . . .”).

38. 12 U.S.C. § 2607 (Supp. IV 2010).

39. *Id.* § 2607(c)(2) (“Nothing in this section shall be construed as prohibiting . . . the payment to any person of a bona fide salary or compensation or other payment for goods or facilities actually furnished or for services actually performed.”).

40. In 1992, HUD amended Regulation X in response to the increased usage of YSPs in mortgage financing and explicitly required the disclosure of YSPs on the HUD-1 Settlement Statement. *See* 24 C.F.R. § 3500, app. B, para. 12 (2011) (“Also, any other fee or payment received by the mortgage broker from either the lender or the borrower arising from the initial funding transaction, including a servicing release premium or yield spread premium, is to be noted on the Good Faith Estimate and listed in the 800 series of the HUD-1 Settlement Statement.”).

41. *See* 12 U.S.C. § 2603 (a)-(b) (Supp. IV 2010) (“The [CFPB] shall publish a single, integrated disclosure for mortgage loan transactions (including real estate settlement costs) The purpose of such model disclosure shall be to facilitate compliance with the disclosure requirements of this chapter and of the Truth in Lending Act, and to aid the borrower or lessee in understanding the transaction by utilizing readily understandable language to simplify the technical nature of disclosures. [. . .] The form prescribed under this section shall be completed and made available for inspection by the borrower at or before settlement by the person conducting the settlement.”).

42. *See* Jackson & Burlingame, *supra* note 10, at 299.

43. *See id.* at 289.

44. *See id.* at 299-311.

45. *See* Culpepper v. Inland Mortg. Corp., 953 F. Supp. 367, 372 (N.D. Ala. 1997)

of law,⁴⁶ while others held that they were impermissible.⁴⁷ In an effort to resolve this uncertainty, Congress ordered HUD to clarify its position on YSPs, and, in response, HUD released a Statement of Policy in 1999.⁴⁸ HUD released a second Statement of Policy in 2001 to resolve remaining ambiguities following the holding in *Culpepper v. Irwin Mortgage Corp.*⁴⁹

In 1999 and 2001, HUD stated that YSPs were not illegal per se, and offered courts a two-prong test to determine the validity of a specific YSP.⁵⁰ The test required (1) that a mortgage broker provided a service to the borrower, and (2) that the mortgage brokers' total compensation, including any YSP, had a "reasonable relationship to the market value of the goods or services provided."⁵¹ HUD provided a non-inclusive list of "covered services and goods" in these statements. The definition of "covered services and goods" was so broad⁵² that mortgage brokers nearly always provided some covered service to potential buyers, thus shifting the focus of the test entirely to the second prong.⁵³

rev'd in part, vacated in part, 132 F.3d 692 (11th Cir. 1998) [hereinafter *Culpepper I*] ("Thus, even if plaintiffs are correct that the yield spread premium technically falls within the definition of a 'referral fee,' the more specific exception for 'payment for goods' in § 2607(c) renders the premium permissible as a matter of law."); *Culpepper v. Inland Mortg. Corp.*, 144 F.3d 717, 720 (11th Cir. 1998) [hereinafter *Culpepper II*]; *Barbosa v. Target Mortg. Corp.*, 968 F.Supp. 1548, 1552 (S.D.Fla.1997) (holding that YSPs were permissible as a matter of law).

46. See *Culpepper I*, 132 F.3d at 696, 699.

47. See *Culpepper v. Irwin Mortg. Corp.*, 491 F.3d 1260 (2007) [hereinafter *Culpepper III*] (holding that YSPs were prohibited under RESPA and they did not fall under the Section 8 exception).

48. See Real Estate Settlement Procedures Act (RESPA) Statement of Policy 1999-1 Regarding Lender Payments to Mortgage Brokers, 64 Fed. Reg. 10,080 (Mar. 1, 1999), [hereinafter RESPA's 1999 Statement of Policy].

49. See *Culpepper III*, 491 F.3d at 1267 (finding RESPA's 1999 Statement of Policy ambiguous and misapplying).

50. See RESPA's 1999 Statement of Policy, *supra* note 48, at 10,084.

51. 24 C.F.R. § 3500.14(g)(2) (2011).

52. The following is a portion of the list of covered services provided in the 1999 Statement of Policy: "(a) Taking information from the borrower and filling out the application; (b) Analyzing the prospective borrower's income and debt and pre-qualifying the prospective borrower to determine the maximum mortgage that the prospective borrower can afford; (c) Educating the prospective borrower in the home buying and financing process, advising the borrower about the different types of loan products available, and demonstrating how closing costs and monthly payments could vary under each product; (d) Collecting financial information (tax returns, bank statements) and other related documents that are part of the application process . . ." RESPA's 1999 Statement of Policy, *supra* note 48, at 10,085.

53. See *Jackson & Burlingame*, *supra* note 10, at 303 ("[M]ortgage brokers will almost

As to the second prong, HUD said that the total compensation, including any YSP, should be reasonably related to the value of the goods and services actually provided.⁵⁴ In making this determination, HUD instructed courts to consider objective factors such as broker compensation in a specific market and subjective factors such as the amount of work or difficulty presented by a particular loan.⁵⁵ For instance, some applicants, perhaps those with lower credit ratings, higher levels of debt, or uncertain employment, would require additional work from their mortgage broker to qualify for particular loan programs.⁵⁶ According to HUD's 1999 and 2001 guidance, it was appropriate and reasonable for a broker to receive greater compensation when the situation demanded more effort on the part of the mortgage broker.⁵⁷ Likewise, a court should have considered the particular demands of a wholesale lender on the broker. If a particular lender required more than other lenders, that additional effort should have factored into the reasonableness determination as well.⁵⁸

Soon after HUD issued its 2001 Statement of Policy several circuit courts held that private cases challenging YSPs could not be treated as class actions because the two-prong analysis required a case-by-case analysis.⁵⁹ This prohibition on class certification severely limited the viability of any future YSP litigation because of the relatively small amounts involved in any one case and the limited resources of individual borrowers.⁶⁰

B. *Dodd-Frank's Changes to YSP Law*

Several sections of Dodd-Frank restrict the amount and sources of mortgage broker compensation. Section 1403(c)(4)(A) of Dodd-Frank provides that "[n]o provision . . . shall be construed as permitting any yield spread premium . . . that would, for any residential mortgage

invariably have performed services in connection with the origination of their loans . . .").

54. RESPA's 2001 Statement of Policy, *supra* note 11, at 53,054.

55. *See id.* at 53,055.

56. *Id.*

57. *Id.*

58. *Id.*

59. *See, e.g.,* Jackson & Burlingame, *supra* note 10, at 302 n. 28.

60. *See id.* at 305 n. 34 ("While theoretically possible, successful individualized private litigation over YSPs is likely to be rare, but as a practical matter, such cases are unlikely to be brought.").

loan, permit the total amount of direct and indirect compensation from all sources permitted to a mortgage originator to vary based on the terms of the loan (other than the amount of the principal).⁶¹ Section 1403(c)(2) prohibits the common practice of dual-compensation for mortgage brokers.⁶² Section 1403(c)(3)(A) prohibits mortgage originators from steering borrowers into a non-Qualified Mortgage loan when the borrower qualifies for a Qualified Mortgage.⁶³ In section 1412(b)(2)(A)(vii), Dodd-Frank indirectly limits the amount of compensation a mortgage broker can receive on a Qualified Mortgage by placing a three percent cap on all points and fees.⁶⁴ A Qualified Mortgage is a residential home mortgage where the ability-to-repay is presumed as long as the loan meets the demands of section 1412 of Dodd-Frank, including a three percent cap on all points and fees. Lenders are not required to make Qualified Mortgages, but are strongly incentivized to do so.⁶⁵

In addition to limiting the amount and source of income, Dodd-Frank placed increased disclosure and reporting requirements on mortgage brokers.⁶⁶ Dodd-Frank required the establishment of a Nationwide Mortgage Licensing System and Registry (NMLS) in an

61. See 15 U.S.C. § 1639b(c) (Supp. IV 2010).

62. See *id.* § 1639b(c)(2)(A) (“For any mortgage loan, a mortgage originator may not receive from any person other than the consumer and no person, other than the consumer . . . any origination fee or charge except bona fide third party charges . . .”); *id.* § 1639b(c)(2)(B) (“Notwithstanding subparagraph (A), a mortgage originator may receive from a person other than the consumer an origination fee or charge, and a person other than the consumer may pay a mortgage originator an origination fee or charge if (i) the mortgage originator does not receive any compensation directly from the consumer; and (ii) the consumer does not make an upfront payment of discount points, origination points, or fees . . .”).

63. See *id.* § 1639b(c)(1) (“For any residential mortgage loan, no mortgage originator shall receive from any person and no person shall pay to a mortgage originator, directly or indirectly, compensation that varies based on the terms of the loan (other than the amount of the principal).”).

64. *Id.* § 1639c (amending TILA to reflect a presumption of the ability to repay if the loan in question is a Qualified Mortgage).

65. *Id.*

66. 15 U.S.C. § 1638(a)(16) (Supp. IV 2010) (requiring that disclosures include the full first month payment and fully indexed monthly payment for variable rate residential mortgages with escrow accounts); *id.* § 1638(a)(17) (requiring that disclosure include the aggregate amount of settlement charges for all services and the approximate wholesale rate of the funds); *id.* § 1638(a)(18) (requiring that disclosures include the aggregate amount of fees paid to a mortgage originator); and *id.* § 1638(a)(19) (requiring disclosure include the total amount interest that the borrower will pay over the life of the loan as a percentage of the principal, loan assuming there are no extra payments applied to the loan balance).

effort to enhance consumer protection and reduce fraud. NMLS was implemented the year following the enactment of Dodd-Frank.⁶⁷ All mortgage professionals, including those within depository institutions and their affiliates, are required to submit their loan documents to NMLS with a unique identifier.⁶⁸ The identifier enables NMLS to oversee the activities of mortgage professionals by tracking disciplinary actions taken against the broker, consumer complaints, and their licensing information.⁶⁹ NMLS has also created a consumer website where prospective borrowers can look up any mortgage professional, including mortgage brokers, to see where the individual is licensed.⁷⁰ Additionally, NMLS anticipates adding disciplinary information to the website for consumer access in 2012. Dodd-Frank granted the CFPB Director back-up authority to create and maintain a similar registry if the Director finds that NMLS is failing to maintain sufficient oversight over mortgage professionals, including mortgage brokers.⁷¹

The effective dates of Dodd-Frank's Title XIV provisions vary, but most become effective when the CFPB issues its final rules. Dodd-Frank required that the CFPB prescribe any final rules within an eighteen-month period following the designated transfer date, by January 21, 2013.⁷² The rules should become effective no later than twelve months after the issuance of the final rule, January 21, 2014 at the latest.⁷³ If the CFPB does not issue a final regulation within eighteen months after the designated transfer date, those sections without final rules will become effective as written in Dodd-Frank on

67. See 12 U.S.C. § 5101 (Supp. IV 2010).

68. *Id.*

69. *Id.* §§ 5101, 5108.

70. As of Sept. 2011 there were almost 16,500 licensed mortgage companies, 109,000 licensed mortgage brokers, 10,500 licensed depositories are listed online at NMLS's consumer access website. NATIONWIDE MORTGAGE LICENSING SYS. & REGISTRY: CONSUMER ACCESS, <http://nmlsconsumeraccess.org> (last visited Feb. 11, 2012).

71. See 12 U.S.C. § 5108 (Supp. IV 2010) (granting back-up authority to the CFPB's Director to establish and maintain a registry at any time if the Director finds the "Nationwide Mortgage Licensing and Registry System is failing to meet the requirements and purposes of this chapter for a comprehensive licensing, supervisory, and tracking system for loan originators.").

72. See 15 U.S.C. § 1601 (Supp. IV 2010).

73. See *id.* The effective dates for provisions under Title XIV of Dodd-Frank are complicated and can be unclear. See generally DIANE E. THOMPSON & ELIZABETH RENUART, NAT'L CONSUMER LAW CTR., TRUTH IN LENDING 13-15 (7th ed. 2007) (explaining some of the challenges associated with determining the effective date of provisions under Title XIV of Dodd-Frank).

January 21, 2013.⁷⁴ Presently, the provisions in Dodd-Frank banning YSPs are not yet effective.

C. *Federal Reserve Board Finalizes Pre-Dodd-Frank Rulemaking*

After Dodd-Frank was passed, but before the majority of provisions under Title XIV became effective, the Fed published its Final Rule amending loan originator compensation and steering practices.⁷⁵ The Fed exercised its authority under TILA to enact the Final Rule before the Fed's regulatory authority transferred to the CFPB.⁷⁶ The Final Rule on loan originator compensation is slightly narrower and less detailed than parallel provisions under Title XIV of Dodd-Frank. For instance, Dodd-Frank's definition of loan originator is broader because it includes those who advertise services traditionally associated with loan originators, whereas the Final Rule does not.⁷⁷ The Fed acknowledged that additional changes would be necessary to fully

74. See 15 U.S.C. § 1601 (Supp. IV 2010).

75. See Regulation Z, 75 Fed. Reg. 58,509 (Sept. 24, 2010) (to be codified at 12 C.F.R. pt. 226).

76. See *id.*

77. Compare 15 U.S.C. § 1601 ("The term 'mortgage originator' – (A) means any person who, for direct or indirect compensation or gain, or in the expectation of direct or indirect compensation or gain – (i) takes a residential mortgage loan application; (ii) assists a consumer in obtaining or applying to obtain a residential mortgage loan; or (iii) offers or negotiates terms of a residential mortgage loan; (B) includes *any person who represents to the public, through advertising or other means of communicating or providing information (including the use of business cards, stationary, brochures, signs, rate lists, or other promotional items), that such person can or will provide any of the activities described in subparagraph (A); (C) does not include any person who is (i) not otherwise described in subparagraph (A) or (B) and who performs purely administrative or clerical tasks on behalf of a person who is described in any such subparagraph [. . .] (E) does not include, with respect to a residential mortgage loan, a person, estate, or trust that provides mortgage financing for the sale of 3 properties in any 12-month period to purchasers of such properties, each of which is owned by such person, estate or trust, and severs as security for the loan, provided that such loan (i) is not made by a person, estate, or trust that has constructed, or acted as a contractor for the construction of, a residence on the property in the ordinary course of business of such person, estate, or trust; (ii) is fully amortizing; (iii) is with respect to a sale for which the seller determines in good faith and documents that the buyer has a reasonable ability to repay the loan; (iv) has a fixed rate or an adjustable rate that is adjustable after 5 or more years, subject to reasonable annual and lifetime limitations on interest rate increases; and (v) meets any other criteria the Board may prescribe;") (emphasis added), with Regulation Z, 75 Fed. Reg. at 58,533-34 ("For the purposes of this section, the term 'loan originator' means with respect to a particular transaction, a person for compensation or other monetary gain, or in expectation of compensation or other monetary gain, arranges, negotiates, or otherwise obtains an extension of consumer credit for another person").*

implement Title XIV of Dodd-Frank,⁷⁸ but the Fed believed, given the likely delay in the implementation of Dodd-Frank, that it would benefit consumers to enact some restrictions on loan originator compensation and steering practices as soon as possible.⁷⁹

The Fed's Final Rule made significant and immediate changes to mortgage broker compensation. Similar to Dodd-Frank's provisions, the Final Rule prohibited the use of all YSPs,⁸⁰ and prohibited dual-payment of mortgage originator compensation.⁸¹ Following the changes, mortgage brokers may receive compensation from the lender or the borrower, but not both.⁸² In addition to restricting the source of payments, the Final Rule requires that mortgage brokers present borrowers with loan options for each type of loan borrower that expresses an interest.⁸³ The options presented to the consumer must include the following: (1) the loan with the lowest interest rate; (2) the loan with the lowest interest rate without any risky features,⁸⁴ and (3) the loan with the lowest dollar amount of fees including discount points, and origination fees and points.⁸⁵ Brokers must collect loan options from a "significant number" of the creditors with whom they "regularly" conduct business, and present loan options to the consumer.⁸⁶ In the event that the broker presents more than three options for each loan type, the broker must highlight the three loans the

78. See Regulation Z, 75 Fed. Reg. at 58,509.

79. See *id.* at 58,512 ("[T]he Board finds that the benefits to consumers of an earlier effective date for rules pertaining to loan origination compensation and steering greatly outweigh any potential savings [to members of the residential lending market].").

80. See *id.* at 58,534.

81. See *id.*

82. See *id.* (requiring originators be paid by consumers or lenders, not both).

83. See *id.* ("[T]he term 'type of [loan]' refers to whether (i) A loan has an annual percentage rate that cannot increase after consummation; (ii) A loan that has an annual percentage rate that may increase after consummation; or (iii) A loan is a reverse mortgage.").

84. Risky features include negative amortization, a pre-payment penalty, interest-only payments, a balloon payment within the first seven years of the loan, a demand feature, shared appreciation, or shared equity. In the case of consumer interest in a reverse mortgage, the originator must provide the consumer with a loan without a prepayment penalty, shared equity, or shared appreciation. See Regulation Z, 75 Fed. Reg. at 58,534.

85. See *id.*

86. The regulation requires that the loan originator obtain "loan options from a significant number of the creditors with which the originator regularly does business" The terms "significant number" and "regularly does business" are not clearly defined in the regulation or in the official staff interpretation. See *id.* at 58,534, 58,537-38.

regulation requires.⁸⁷ Finally, the originator must have a good faith belief that the consumer will likely qualify for all the loans presented.⁸⁸ It is unknown if the CFPB will require brokers to present options when it implements the related provisions in Dodd-Frank.

III. CRITICISMS OF YSPs

In a perfectly transparent and informed market, mortgage brokers would use YSPs for the benefit of consumers.⁸⁹ Indeed, HUD extolled YSPs as a useful mechanism to foster homeownership.⁹⁰ However, there is compelling evidence that YSPs were used abusively, hurting the homeowners associated. Consumer advocacy groups and homebuyers protested their use, claiming that the practice created a perverse incentive for brokers to offer loans to consumers above the lowest rate a consumer could otherwise qualify.⁹¹ Nevertheless, the dangers associated with YSPs do not outweigh their utility, particularly because most of the dangers can be easily treated while preserving the benefits of YSPs.

A. *Under Regulated and Overpriced*

The YSP system was largely unregulated by HUD and wholesale lenders.⁹² Without regulation or oversight, some mortgage brokers charged unnecessarily high fees and wholesale lenders funded these loans. Wholesale lenders delegated a lot of the decision-making authority to individual mortgage brokers, including allowing individual mortgage brokers to set their own compensation.⁹³ Even worse, lenders

87. *Id.* at 58,534.

88. *Id.*

89. See RESPA's 2001 Statement of Policy, *supra* note 11, at 53,054.

90. *Id.*

91. Lenders gave incentives to brokers who sold loans to consumers above the par rate, thus creating a YSP for the mortgage broker and the borrower's mortgage had a higher rate than they could otherwise receive. See SUSAN E. WOODWARD, THE URBAN INST., A STUDY OF CLOSING COSTS FOR FHA MORTGAGES 4 (2008), http://www.huduser.org/Publications/pdf/FHA_closing_cost.pdf [hereinafter STUDY OF CLOSING COSTS].

92. See KEITH ERNST ET AL., CTR. FOR RESPONSIBLE LENDING, *Steered Wrong: Brokers, Borrowers, and Subprime Loans* 4-6 (2008), available at <http://www.responsiblelending.org/pdfs/steered-wrong-brokers-borrowers-and-subprime-loans.pdf> (discussing brokers' pricing patterns).

93. *Id.* at 6, 8.

gave incentives to brokers who sold loans to consumers above the par rate—the higher the rate over par, the higher the YSP proceeds for the mortgage broker.⁹⁴

Perhaps not surprisingly, there is convincing evidence that, on average, mortgage brokers charged consumers more than direct lenders.⁹⁵ One study found that, all other things being equal, brokered loans cost the consumer roughly \$425 more than a mortgage loan from a direct lender.⁹⁶ Another study revealed even greater discrepancies, finding evidence that consumers who borrow from non-bank lending institutions pay interest rates two to four percent higher than those who borrow from banks, thrifts, or credit unions without assistance from a mortgage originator.⁹⁷

B. *Nondisclosure and Discrimination*

According to RESPA, brokers were responsible for disclosing YSPs to their customers on a HUD-1 Settlement Statement.⁹⁸ A HUD-1 Settlement Statement is a standardized form developed by HUD's Secretary that itemizes all charges associated with a refinance or purchase of a one-to-four family residential property.⁹⁹ The HUD-1 Statement was developed¹⁰⁰ to provide meaningful disclosure of costs

94. See STUDY OF CLOSING COSTS, *supra* note 91, at 4 (finding that YSPs gave brokers an incentive to charge consumers as much as possible).

95. See generally *id.* at 53. This study examines 7,560 FHA-insured 30-year fixed rate loans. The pool of loans includes loans for purchase of an owner occupied dwelling (no refinances) and the loans were all originated in May and June of 2001. *Id.* at 2. The average balance of these loans is just over 105,000. *Id.* The study gathered information from the consumer's HUD-1 Settlement Statements and the FHA loan files, and analyzes how borrower characteristics affects that type and cost of loan they receive. *Id.* at 1-2.

96. See *id.* at 53. This study found that the simple difference between brokered loans and non-brokered loans was \$714 on average. However, after adjusting for the differences in the two bodies of loans, the study concluded that brokers on average were charging their borrowers \$422 more than a substantially similar non-brokered loan.

97. See Victor Stango & Jonathan Zinman, *How a Cognitive Bias Shapes Competition: Evidence from Consumer Credit Markets*, DARTMOUTH UNIVERSITY, 3 (Sept. 5, 2006), http://www.dartmouth.edu/~jzinman/Papers/Stango&Zinman_CognitiveBias&Competition.pdf.

98. See 24 C.F.R. pt. 3500, app. B, para. 32 (2011) (“[A]ny other fee or payment received by the mortgage broker from either the lender or the borrower arising from the initial funding transaction, including a servicing release premium or yield spread premium is to be noted on the Good Faith Estimate and listed in the 800 series of the HUD-1 Settlement Statement.”).

99. See *id.*

100. The CFPB is in the process of redesigning and testing a new HUD-1 form to

associated with a home purchase or refinancing.¹⁰¹ However, since YSPs were paid directly to the broker, bypassing the borrower, it was easy for brokers to fail to disclose a YSP accurately on the HUD-1 Statement or to rely entirely on the HUD-1 Statement to discharge the duty of disclosure.

Before Dodd-Frank, experts believed the HUD-1 Statement had significant potential for ineffective disclosure to borrowers for two reasons: (1) there was very little oversight to monitor the accuracy of reported YSPs;¹⁰² and (2) the manner of fee disclosure on the HUD-1 Statement made it difficult for borrowers to understand the breakdown of fees or to identify the presence of a YSP.¹⁰³ Mortgage broker compensation was disclosed on HUD-1 Statements, but the total compensation was split between various fees, sometimes as many as thirty-two separate fees.¹⁰⁴ For instance, mortgage broker compensation frequently includes fees called origination fees, commitment fees, and application fees.¹⁰⁵ Experts contend that borrowers, many of whom will only buy one or two homes during their lifetime, were not in a position to understand which of these fees were mandatory or negotiable, and which fees were compensation to the broker or otherwise.¹⁰⁶ This information disparity created an environment where mortgage brokers could take advantage of less informed buyers.¹⁰⁷

YSP disclosure on the HUD-1 Statement was particularly problematic because of how it was disclosed on the form. YSPs were disclosed in Block 2, in a box entitled “credit.”¹⁰⁸ The term “yield spread premium” or “YSP” did not appear on the HUD-1 Statement at

improve disclosure. See *Know Before You Owe: Mortgages*, CONSUMER FIN. PROTECTION BUREAU, <http://www.consumerfinance.gov/knowbeforeyouowe> (last visited Jan. 10, 2012).

101. See 12 U.S.C. § 2601 (2006); 24 C.F.R. § 3500.8 (2011).

102. *Diagnosing Consumer Confusion*, *supra* note 20, at 15.

103. See *id.* at 11.

104. See STUDY OF CLOSING COSTS, *supra* note 91, at 3 (finding that there were thirty-two standard categories of fees, but thousands of additional categories of charges in residential home transactions).

105. See *id.* at 12.

106. See *id.*

107. See *id.*

108. CONSUMER FIN. PROTECTION BUREAU, SUPERVISION AND EXAMINATION MANUAL, PT. 2 REAL ESTATE SETTLEMENT PROCEDURES ACT 7 (2011), available at http://www.consumerfinance.gov/wp-content/themes/cfbp_theme/images/supervision_examination_manual_11211.pdf.

all.¹⁰⁹ For instance, if the loan had a YSP then that amount of YSP would appear in the “credit” box as a negative number.¹¹⁰ Following the closing, the lender paid the YSP directly to the broker without any other disclosure or notice to the borrower. Even a well-informed borrower, looking specifically for a YSP on the HUD-1 Statement would have difficulty locating it, and even if discovered, some commentators suggest that a borrower would not have wanted to protest its presence or do anything that might delay their closing.¹¹¹ In short, YSP disclosure on the HUD-1 Statement was ineffective.

The potential for discrimination was an additional concern regarding YSPs.¹¹² A recent study revealed that, all other factors constant, the brokered loans of Latino borrowers cost \$1,043 more than loans for similarly situated non-Latino borrowers working with a mortgage broker, and African American spent \$756 more than non-African American buyers.¹¹³ The education bias was even higher than race-based biases;¹¹⁴ consumers with at least a bachelor’s degree paid \$1,500 less than those who did not have equivalent education when working with a mortgage broker.¹¹⁵ In the absence of federal regulatory oversight, wholesale lender oversight was not sufficient to protect consumers from the abusive use of YSPs by some mortgage brokers.¹¹⁶

109. *Id.*

110. *Id.*

111. See STUDY OF CLOSING COSTS, *supra* note 91, at 83-84.

112. See Alan M. White, *Borrowing While Black: Applying Fair Lending Laws to Risk-Based Mortgage Pricing*, 60 S.C. L. REV. 677, 694 (2009) (providing expert opinion of the likelihood of discrimination when minority borrowers used mortgage brokers).

113. See STUDY OF CLOSING COSTS, *supra* note 91, at 43-45.

114. See *id.* In the study, researchers found that consumers with at least a bachelor’s degree paid \$1,500 less than those who did not have equivalent education. The education bias was three times that of the bias present for (\$756) African American buyers compared to non-African American buyers. Latino borrowers’ bias was \$1,043. In addition to different rates, minority and less educated borrowers experienced other risky terms. The author says that even within one company rates differ based on the channel you work with, perhaps because they are targeting areas that traditionally have more difficulty with direct lenders or maybe because nobody else will lend to this area, a disadvantaged borrower may accept anything they are offered because they believe it is better than nothing.

115. See *id.*

116. See *supra* Part III.B.

C. *Complicated Loans versus Simple Loans*

In a fully informed market, one would expect that consumers would receive a dollar-for-dollar trade-off for either method of compensation and that consumers would pick the most convenient and economical method of compensating their broker.¹¹⁷ However, a recent study revealed that an increase in YSP did not correlate with a decrease in upfront cash payments.¹¹⁸ Instead, there was a positive correlation between YSP and upfront costs; as YSP increased, upfront costs increased as well.¹¹⁹ This was the exact opposite relationship one would expect to find if YSPs were used as a means to reduce upfront costs.¹²⁰

Choosing between paying higher costs upfront or deferring those costs and paying a higher monthly payment is not analytically difficult for borrowers to understand.¹²¹ The difficulty lies in knowing exactly how much of a monthly payment is appropriate to offset a specific reduction in upfront costs.¹²² Compounding this problem is the tendency of consumers to underestimate the long-term effect of an increase in interest rate,¹²³ and many borrowers mistakenly believe that a broker will find the best deal for the borrower.¹²⁴

Evidence supports the finding that consumers are ill-equipped to identify a bad deal when using a dual method of compensation.¹²⁵ A recent study found that borrowers with no-cost loans (where the broker receives only a YSP) saved \$1,200 on average compared to borrowers who split costs between a YSP and an upfront payment.¹²⁶ Another study found a slightly greater discrepancy in their sample of FHA loans, placing the difference between a no-cost loan and a loan that splits costs at \$1,493.¹²⁷

Researchers believe that borrowers with no-cost loans get better

117. See STUDY OF CLOSING COSTS, *supra* note 91, at 24.

118. *Id.* at 28.

119. *Id.*

120. See *id.* at 28-29.

121. *Id.* at 3.

122. *Id.*

123. See Stango & Zinman, *supra* note 97, at 3.

124. See *Diagnosing Consumer Confusion*, *supra* note 20, at 29.

125. *Id.* at 32.

126. See STUDY OF CLOSING COSTS, *supra* note 91, at 73.

127. *Diagnosing Consumer Confusion*, *supra* note 20, at 32.

deals because borrowers can more easily compare and negotiate the terms of their loan.¹²⁸ No-cost loans are easier to compare because consumers only have to consider one factor—the increase in their rate.¹²⁹ On the other hand, a complicated loan using a dual payment method requires consumers to consider both the YSP and interest rate. Even better, these no-cost loans revealed almost no race or education bias.¹³⁰

IV. WHY THE CFPB SHOULD RECONSIDER COMPENSATION REGULATION

Mortgage brokers have existed in some capacity since the turn of the nineteenth century, but it was not until the 1970s that brokers achieved importance in the residential mortgage market.¹³¹ By 2001, mortgage brokers originated sixty-five percent of the residential mortgage loans.¹³² Clearly, brokers are a significant part of the modern residential real estate market, and they offer a service that continues to attract customers. However, between 2006 and 2010, more than 100,000 mortgage brokers left their jobs.¹³³ The decreased demand for mortgage origination accounts for much of the decline, but the change in compensation is also a significant contributing factor to the flight of brokers.¹³⁴ The CFPB should reconsider the rigid prohibitions on broker compensation and YSPs because these changes eliminate a mortgage broker's flexibility to structure borrower's closing costs and

128. See STUDY OF CLOSING COSTS, *supra* note 91, at 14-15.

129. See *id.* at 70.

130. *Id.* at 70-71, 73.

131. See Alex Nackoul, *Mortgage Brokering: A Short History (Part 1 of 2)*, SCOTSMAN GUIDE (Mar. 2006), available at <http://www.scotsmanguide.com/default.asp?ID=1299> (discussing Sonnenblick-Goldman, one of the first mortgage brokerages, founded in New York in 1893).

132. See OFFICE OF POLICY DEV. AND RESEARCH, U.S. DEP'T OF HOUS. AND URBAN DEV., ECONOMIC ANALYSIS AND INITIAL REGULATORY FLEXIBILITY ANALYSIS FOR RESPA PROPOSED RULE TO SIMPLIFY AND IMPROVE THE PROCESS OF OBTAINING MORTGAGES TO REDUCE SETTLEMENT COSTS TO CONSUMERS 12 (2002) (estimating that by 2001 mortgage brokers occupied sixty-five percent of the market).

133. The article mentions other dramatic reductions in the number of mortgage brokers in Oregon, Illinois, Florida, and Washington. See Marunde, *supra* note 27 ("The National Association of Realtors recently announced they lost more than 100,000 members since 2006."); Mary Ellen Podmolik, *Mortgage Brokers Ditching Day Jobs*, CHI. TRIB., Oct. 31, 2008, http://articles.chicagotribune.com/2008-10-31/entertainment/0810290871_1_metrocities-mortgage-llc-wholesale-lending-loan-originations (statement by the Illinois Department of Financial and Professional Regulation) (finding that between 2005 to 2008 the number brokers licensed in Illinois fell thirty-one percent, from 2,308 to 1,593, and brokers continue to exit the market daily).

134. See Podmolik, *supra* note 133.

unnecessarily restrict a consumer's choices.¹³⁵ Additionally, the changes may make it more difficult for borrowers who need extra attention to find a broker willing to work with them, place homeownership outside the reach of some qualified consumers,¹³⁶ and further stifle an already lethargic mortgage market.¹³⁷ Dodd-Frank created barriers for mortgage brokers seeking to enter the market and established procedures for nationwide oversight further reducing the danger posed to consumers.¹³⁸

One of Dodd-Frank's goals is to protect consumers from unfair or abusive practices without inhibiting responsible and sustainable lending practices.¹³⁹ So long as YSPs are not used in an unfair or abusive manner, there is little need to ban them because, according to HUD, YSPs foster homeownership.¹⁴⁰ The CFPB should exercise its explicit authority to modify laws relating to YSPs and mortgage broker compensation.¹⁴¹

A. *Changes Reduce Mortgage Broker Flexibility*

Prior to the changes to loan originator compensation, a mortgage broker could offer consumers a number of choices in financing.¹⁴² Following the changes, these options are significantly

135. See *infra* Part IV.A.

136. See *infra* Part IV.C.

137. See Charles Hugh Smith, *New Mortgage Regulations Could Bruise Housing Market*, DAILYFINANCE (Mar. 23, 2011, 11:00 AM), <http://www.dailyfinance.com/2011/03/23/new-mortgage-regulations-could-hurt-housing/> (statement of Mark Helling, a licensed loan officer based in Ohio) ("After April 1st, a loan officer will have to be paid the same rate whether it is an easy loan that takes two weeks to close or a foreclosed property in need of rehabbing for marginal borrowers that takes three months of work to close. Just when the country need the most experienced and knowledgeable mortgage professionals to help liquidate the flood of foreclosed homes, the Fed is making it unprofitable for loan officers to accept these deals.").

138. See *infra* Part IV.B.

139. See Regulation Z, 75 Fed. Reg. 58,509, 58,509 (Sept. 24, 2010) (to be codified at 12 C.F.R. pt. 226).

140. See RESPA's 2001 Statement of Policy, *supra* note 11, at 53,054.

141. Congress prohibited YSPs and dual compensation structures and in the very same breath gave the CFPB authority to limit or waive these prohibitions. See 15 U.S.C. § 1639b(c)(2)(B) (Supp. IV 2010) ("[T]he Bureau may, by rule, waive or provide exemptions to this clause if the Bureau determines that such waiver or exemption is in the interest of consumers and in the public interest.").

142. See *Fixing What Isn't Broken*, *supra* note 25.

limited.¹⁴³ Consider the following example:

Assume that the loan is a \$200,000, standard 30-year fixed-rate loan, with an interest rate at 5%, and that each .25% increase in interest rate yields a YSP that is 1% (\$2,000) of the loan balance. Also, assume that the broker and homebuyer agree on a 1.5% (\$3,000) commission for the mortgage broker. Before the Fed's Final Rule and Dodd-Frank, a mortgage broker could offer the following options to a borrower: (1) lock in at the 5.0% rate—the lender would pay none of the broker's commission, and the borrower would pay the entire 1.5% (\$3,000) commission to the broker; (2) lock the interest rate at 5.125%—the lender would pay a 0.5% YSP (\$1,000), and the borrower would be responsible for the remainder of the broker's commission, 1.0% (\$2,000); (3) lock the rate at 5.25%—the lender would pay a 1.0% YSP (\$2,000) and the borrower would be responsible for the remaining 0.5% compensation (\$1,000); (4) lock the rate at 5.375%—the lender would pay the broker's entire commission of 1.5% (\$3,000) and the borrower would owe no additional compensation to the broker; or (5) lock the rate at 5.5%—the lender would pay the broker 2.0% YSP (\$4,000), the broker would take a 1.5% commission (\$3,000) and return the 0.5% YSP (\$1,000) to the borrower as a credit.¹⁴⁴ Following the changes to broker compensation, only options (1), (4), and (5) are authorized under Dodd-Frank. Experts note that option (1) is not favored by many consumers.¹⁴⁵ Elimination of options (2) and (3) leaves consumers with the decision of paying their mortgage broker's compensation in full at closing or amortizing their loan at an elevated rate that reflects such compensation.¹⁴⁶

Many borrowers may find options (2) and (3) convenient and economical ways to compensate their mortgage broker.¹⁴⁷ In fact, a recent study of FHA thirty-year fixed-rate loans originated over six weeks in 2000 indicated that about half of the consumers took advantage of the dual method of compensation, paying some cash at closing and deferring the rest of their payment through a YSP;¹⁴⁸ when a YSP was used it was typically the largest component of a mortgage

143. *See id.*

144. *See id.*

145. *See id.*

146. *See id.*

147. *Diagnosing Consumer Confusion*, *supra* note 20, at 5.

148. *Id.*

broker's compensation.¹⁴⁹ Restricting these options to protect consumers forecloses the benefits the option offers. As long as there are effective ways to protect consumers without limiting their access to credit or inhibiting their choices regarding broker fee financing, the CFPB should preserve consumer choice in the mortgage market particularly because the availability of these options promotes greater access to homeownership.¹⁵⁰

B. Most "Fly-By-Nighters" Are Already Gone

Following the mortgage crisis, the residential real estate and mortgage market experienced a litany of changes including national licensing requirements for originators¹⁵¹ and more accurate disclosures of good faith estimates.¹⁵² Experts suggest that as demand for residential mortgage origination decreased and broker regulation increased, the market was no longer appealing to unscrupulous brokers, who appeared during the mortgage boom to make quick money.¹⁵³ The mass exit of brokers,¹⁵⁴ some believe, will result in better brokers with more experience and cleaner records, and that these changes will result in better service for consumers.¹⁵⁵ Those brokers that left the market will have a difficult time reentering when mortgage demand increases because of the educational requirements mortgage brokers are now required to satisfy, including a national licensing exam.¹⁵⁶ Also, NMLS's database is available online for consumers to find licensing, educational, and soon, disciplinary information to aid in their selection of a mortgage broker.¹⁵⁷ This database will make mortgage brokers more accountable and give consumers tools they need to avoid bad

149. See Jackson & Burlingame, *supra* note 10, at 292.

150. RESPA's 2001 Statement of Policy, *supra* note 11, at 53,504 ("The availability of [a YSP] fosters homeownership.").

151. See 12 U.S.C. § 5491 (Supp. IV 2010) (transferring authority from federal bank regulators to the CFPB).

152. See *supra* Part II.B.

153. See Marunde, *supra* note 27; Sichelman, *supra* note 27.

154. See Sichelman, *supra* note 27 (estimating that the number of individuals and companies in the mortgage broker business has decreased by a whopping fifty percent).

155. See *id.*; Marunde, *supra* note 27.

156. 12 U.S.C. § 5104(c)-(d) (Supp. IV 2010); see Sichelman, *supra* note 27 (stating that NMLS "'has created a strong barrier to entry . . . that will make for a stronger industry in the long run.'").

157. See *supra* Part II.B.

brokers.

In the post-mortgage crisis environment, some in the industry are marketing themselves as honest mortgage brokers, employing transparent and consumer friendly broker-buyer agreements to eliminate consumer worry about steering.¹⁵⁸ For example, at UpFront Mortgage Brokers Association (UpFront),¹⁵⁹ the compensation agreements are negotiated before service is rendered, eliminating temptation to put consumers in loans that are not ideal for them.¹⁶⁰ Also, UpFront brokers agree to abide by UpFront's Mortgage Broker Commitment.¹⁶¹ The commitment requires brokers to work in the consumer's best interest, give full and complete disclosure of all broker fees received from borrowers and third parties, and brokers must disclose wholesale and marked up rates.¹⁶² Indeed, with heightened standards of entry into the mortgage broker business and organizations like UpFront, it appears that there are still some "good apples in the mortgage industry."¹⁶³

C. Difficulty Finding a Broker and Further Damage to the Mortgage Market

To the extent that Dodd-Frank imposes limits on points and fees for Qualified Mortgages,¹⁶⁴ brokers will have incentive to help only those borrowers with the strongest applications. These borrowers are most likely to qualify and quickly close with minimal effort on the broker's behalf. Before the changes to broker compensation, HUD allowed brokers to charge higher fees on loans that required greater work.¹⁶⁵ The increase in compensation serves to offset the expenses

158. See UPFRONT MORTGAGE BROKERS, UPFRONT MORTGAGE BROKERS INFORMATIONAL BROCHURE, [hereinafter UPFRONT BROCHURE], available at <http://www.upfrontmortgagebrokers.org/docs/UMBInformationalBrochure.pdf> (last visited Jan. 26, 2012).

159. See generally *About UMBA*, UPFRONT MORTGAGE BROKERS, http://www.upfrontmortgagebrokers.org/what_is_umba.asp (last visited Dec. 29, 2011) (stating that UpFront Mortgage Brokers Association, formed in August 2006, seeks to align the interests of borrowers and brokers by educating borrowers and negotiating fees at the beginning of the mortgage searching process to avoid broker steering).

160. See UPFRONT BROCHURE, *supra* note 158.

161. *About UMBA*, *supra* note 159.

162. See UPFRONT BROCHURE, *supra* note 158.

163. See *id.*

164. 15 U.S.C. § 1639c (Supp. IV 2010).

165. RESPA's 2001 Statement of Policy, *supra* note 11, at 53,055.

associated with qualifying a borrower with an imperfect credit application or a property requiring more attention, thus making it economically feasible for a mortgage broker to help almost any borrower.¹⁶⁶ Critics contend that the rigid cap on mortgage broker compensation will make labor-intensive loans unprofitable and prevent borrowers who require more attention or extra work from finding a broker willing to work with them.¹⁶⁷ Any unwillingness to process difficult loans is concerning with so many vacant foreclosed properties available following the mortgage crisis.

D. The YSP Ban is Inconsistent with RESPA and Dodd-Frank

RESPA has always maintained that the best way to control closing costs is through an indirect approach, rather than a flat fee or fixed calculation.¹⁶⁸ To the extent that lenders respond to the strong regulatory incentives to discontinue risky loan products, and offer only Qualified Mortgages, fees for mortgage brokers will be limited by the three percent cap for all fees associated with a Qualified Mortgage.¹⁶⁹ This three percent cap on all fees runs directly counter to RESPA's preference for indirect control of costs.¹⁷⁰ More importantly, prohibiting YSPs directly conflicts with Dodd-Frank's aim of helping consumers. Dodd-Frank expressly seeks to protect consumers from abusive practices that helped cause the mortgage crisis. However, by banning YSPs, Dodd-Frank hurts those same consumers by taking away some of their options for home financing.

V. A POTENTIAL ALTERNATIVE TO RIGID YSP REGULATION

During the last several years, trade organizations, consumer protection agencies, and regulatory agencies have proffered numerous alternatives to protect consumers from abusive lending practices. Some of these proposals include: (1) mortgage industry self-regulation;¹⁷¹ (2)

166. *Id.*

167. See Smith, *supra* note 137.

168. See Jackson & Burlingame, *supra* note 10, at 298.

169. See 15 U.S.C. § 1639c (Supp. IV 2010).

170. See Jackson & Burlingame, *supra* note 10, at 298.

171. *Protecting Homeowners: Preventing Abusive Lending While Preserving Access to Credit: Testimony Before the H. Subcomm. on Hous. and Cmty. Opportunity, and the Subcomm. on Fin. Insts. and Consumer Credit*, 108th Cong. 37 (2003) (statement of A.W.

increasing state and federal broker regulation;¹⁷² (3) imposing a fiduciary duty on brokers;¹⁷³ (4) regulating products in lieu of compensation regulation;¹⁷⁴ and (5) increasing the number of borrowers required to seek consumer debt counseling.¹⁷⁵ However, many of these solutions are problematic or burdensome to the industry. For example, mortgage industry self-regulation may not provide strong enough protection for borrowers, mortgage brokers strongly oppose a fiduciary duty imposed upon them, and there are significant costs associated with debt counseling programs.

A study in the automotive industry involving two different promotions may provide a model for inexpensive and effective YSP regulation reform. The study found that, in negotiations, the party with more information generally received a better deal than the party with less information.¹⁷⁶ In the study, there were two separate groups of car salespeople and promotions.¹⁷⁷ The first promotion was a \$1,000 rebate from the auto manufacturer to the consumer if the consumer purchased one of the manufacturer's automobiles.¹⁷⁸ In this scenario, both negotiating parties, the consumer and the salesperson, knew about the promotional offer.¹⁷⁹ As to the second promotion, the manufacturer offered a \$1,000 rebate to the seller for each automobile sold.¹⁸⁰ In this second scenario, only the salesperson knew about the promotion; the

Pickel, III, President, National Association of Mortgage Brokers).

172. See Stango & Zinman, *supra* note 97, at 4 (suggesting that perhaps traditional lenders are less willing to exploit customer confusion because they are heavily regulated whereas, non-regulated entities, like brokers and broker firms, are less regulated and more willing to exploit consumer confusion in their pricing).

173. See *Solutions to the Mortgage Lending Crisis*, NAT'L ASS'N OF MORTGAGE FIDUCIARIES (June 12, 2008), <http://mortgagefiduciaries.com/2008/06/solutions-to-the-mortgage-lending-crisis> (suggesting brokers adopt a fiduciary role to align the interests of the broker and consumer).

174. See Amy Hoak, *New Rules for Home-Loan Brokers*, WALL ST. J., Apr. 10, 2011, <http://online.wsj.com/article/SB10001424052748704302704576253453390061280.html>.

175. See STUDY OF CLOSING COSTS, *supra* note 91, at 20 (suggesting that additional studies are warranted before dismissing the value of debt counseling).

176. See *id.* at 35; Meghan Busse et al., *\$1,000 Cash Back: The Pass-Through of Auto Manufacture Promotions*, 96 AM. ECON. REV. 1253, 1254 (2006) (discussing the effect of information asymmetry and its influence on the relative bargaining powers of parties).

177. See Busse et al., *supra* note 176, at 1254.

178. See *id.* at 1263.

179. See *id.* ("One striking difference between customer cash and dealer cash is that the two bargaining parties are symmetrically informed about customer case, while the customer is typically uninformed about dealer cash.").

180. See *id.*

buyer was not aware of the incentive to sell that particular manufacturer's car.¹⁸¹ When the consumer knew about the rebate, they received far more of the benefit; seventy to ninety percent of the rebate was passed to the consumer, compared to only thirty to forty percent of the amount of the rebate when only the salesperson knew about the rebate in negotiations.¹⁸²

If we analogize the findings of the auto rebate study to YSPs, we find that consumers who understand the compensation structure are more likely to receive a better deal when compared to borrowers who do not understand the broker's incentives.¹⁸³ If YSP payments were paid directly to the borrower from the lender it would ensure that borrowers were aware of the presence of a YSP on their loan, that they would receive full disclosure regarding the YSP, and that borrowers know how much compensation their broker received in total compensation. Furthermore, it would eliminate the potential for broker abuse of the YSP system, and it would preserve consumer flexibility in mortgage broker compensation. Following the disbursement of any YSP, the borrower could use the proceeds for any purpose, including compensating their broker.

Applying this practice, a regulation restricting YSPs would be unnecessary because the potential for abuse would be nearly non-existent. The issues associated with non-disclosure or faulty disclosure and overpricing of the YSP could be corrected by funneling the payment through the borrower, rather than the broker. Moreover, the direct rate restrictions disfavored by RESPA, but imposed by Dodd-Frank, would be unnecessary because broker compensation, which accounts for more than half of the average fees and costs associated with a loan closing, would be fully and effectively disclosed.

VI. CONCLUSION

Reducing mortgage broker abuses and protecting residential homebuyer are important goals. The ban on YSPs and dual compensation, however, does more harm to consumers than

181. *See id.*

182. *See id.*

183. *See supra* Part III.C.

necessary.¹⁸⁴ Eliminating YSPs following the mortgage crisis was an unnecessary overreaction. Focusing on improving disclosure and eliminating consumer confusion will solve the most significant problems associated with YSPs and preserve the benefits of dual-compensation for future consumers.¹⁸⁵ Eliminating the YSP prohibition is entirely possible at this time,¹⁸⁶ but a failure of the CFPB to consider the advantages of YSPs will result in negative effects within the residential mortgage market.¹⁸⁷ So long as there are sufficient safeguards in place to protect consumers, the CFPB should lift the ban on YSPs and dual-compensation.

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184. *See supra* Part IV.

185. *See supra* Part III.

186. *See* 15 U.S.C. § 1639b(c)(2)(B) (Supp. IV 2010) (granting authority to the CFPB to waive or create exemptions to the YSP prohibition).

187. *See supra* Part IV.