IMMAAG
Impact Mortgage Management Advocacy & Advisory Group

Consumers, Compensation & Confusion

A clarification and solution supporting TILA's & Regulation Z objectives

In its August 26, 2009 final proposed rule offering changes to Regulation Z the Federal Reserve Board proposed on page 42379 to include:

"36(d) Prohibited Payments to Loan Originators: The Board is proposing to use its authority in HOEPA to prohibit unfair or deceptive acts or practices in mortgage lending to restrict certain practices related to the payment of loan originators."

This section of the proposed rule finally illuminates the Board's perceived source of a problem created by misconception and misperception that has persisted in the mortgage industry for decades.

The purpose of this position statement is to present an argument for reconsideration of a longstanding misunderstanding in order to create solutions that have a serious chance to achieve the purposes of TILA as cited in the above mentioned rule.

It seems fair to expect that when facts are presented that refute myths those facts, especially when they are supplemented with realistic, focused solutions will receive reasonable consideration. It is with that expectation in mind that this position statement, discussion and alternative solution to the proposed "prohibited payments to loan originators" is offered.

Background

The Board's proposed rule asserts that certain practices related to the payment of loan originators are unfair or deceptive. (See, Federal Register, Vol 74, No. 164, page 43279, August 26, 2009) In fact, this is the only justification the Board can invoke to support any action to deal with loan originator compensation. Absent creating a nexus between unfair/deceptive, the Board is without legislative authority to suggest such broad powers under TILA. But arguing the Board's authority is not the purpose of this paper.

Earlier in the proposed rule (page 43240) it refers to the offending practice as the payment of "yield spread premiums".

It is our position that a fundamental misperception of mortgage based revenue has both created and perpetuated a variety of counterproductive, misdirected regulatory requirements. An unwillingness to accept irrefutable facts and focus the debate on how to achieve the goal of simplicity and clarity has resulted in the implementation of obstructive rules in both Regulation X and Regulation Z. As a primary result of the misunderstanding, these regulations now contain requirements and disclosures that not only do not further the purposes of goals of the RESPA or TILA, but rather cause and perpetuate the use of confusing, obscure and counter productive disclosures. Further, the misperceptions have redirected the national debate away from enabling the accomplishment of the goal expressed by all, i.e. to produce simpler, clearer, more easily understood and useable disclosure to protect consumers to an irrelevant and unproductive debate about how lenders use of their revenue must be controlled.

In this brief paper we intend to explain what is flawed in the representation of the term "yield spread premium", how that has caused the debate to be misdirected and more importantly we will provide a simple, easily understood alternative that allows consumers to understand the relevant information necessary to make informed decisions without distracting them with irrelevant information.

<u>Compensation Confusion</u>

The balance of this paper provides background and a solution. While we begin with the term "Yield Spread Premium" the issue is not YSP per se, but rather how the misunderstanding of what YSP is intended to represent has caused an industry to evolve in a direction that has become counter productive and laden with unnecessary "corrections and concerns", not the least of which is the Board's fallacious consideration of fully disclosed revenues to be "deceptive practices or unfair".

The term "Yield Spread Premium", thrust into the mortgage industry taxonomy over 17 years ago, is a misnomer. The term has caused so much debate and effort in the name of clarification and transparency, that we have collectively lost focus on the real issue – to make it easier for consumers to effectively comparison shop and to make informed decisions.

The misconception that created the acronym "YSP" has given rise to disclosures which now obscure rather than illuminate and confuse rather than clarify. Studies cited by the Federal Reserve Board (FRB) and other governmental agencies have demonstrated that the current disclosures do not achieve their objectives with respect to improving the consumer's comparative shopping experience. The result of the flawed idea about "YSP" has led to a new Good Faith Estimate implemented January 1, 2010 which hurts consumers by reducing rather than increasing transparency and reducing choice while it hurts mortgage loan originators by forcing estimates that will necessarily be higher and will disserve the very goal of accurate estimating. It is our fervent hope that this paper will be catalytic in causing an immediate, meaningful, public interaction among the industry, the FRB and the HUD to accomplish a truly useable integrated consumer tool.

The FRB has proposed changes to Regulation Z which will prohibit certain payments to loan originators. The primary motivation, and statutory authorization for that matter, for the changes are based on a long standing misconception that a "premium" or "discount" value assigned to one interest rate versus another represents a "kickback" or "rebate". Herein lies the core of the problem. The premium or discount available simply represents the calculated present value of the expected future revenue generated by the asset. This facilitates valuation of the asset and allows lenders to determine the overall profitability of a particular loan. That profitability, like it or not, is driven by the loan's terms and conditions.

The revenue earned by a lender, either over the life of a loan from periodic interest payments or in the form of a lump premium is just that, it is revenue. The multi-decade focus on how lenders choose to use the revenue generated from their mortgage loans has only distracted from the important issues of competitive pricing and consumer protection, while it has sabotaged the intended goal of creating disclosures which allow simple, clear consumer loan comparison shopping.

<u>How does the Yield Spread Premium Misconception Hurt Consumers and Loan Originators?</u>

Somewhere in the debate it appears a simple reality has been lost. Loans are made to consumers for the simple reason that they are revenue producing assets which lead to profitable results. The revenue produced from the combination of closing costs and the interest payments is used to pay for the costs associated with mortgage sourcing, marketing, origination, and servicing processes; including collection, credit risk management and of course, some amount of profit. Regardless of whether the lender or a third party performs any or all of these functions, the consumer ultimately bears these costs either on the front end or through the interest paid over the life of the loan. This simple fact has become mired in the unproductive debate about the artificially created and carved out item called Yield Spread Premium.

With the emergence of independent mortgage brokers and originators, lenders gained access to a large, efficient and competitive variable expense based third party distribution channel to market and originate the lenders' loan products. In response, lenders created "rate sheets" which are functionally similar to any other product manufacturer's price sheets. The rate sheets facilitate the lenders' need to communicate the amount they are willing to pay the third party for the performance of its services based on the revenue the lender expects to receive from the loan at any given price. In this case the lender's price is represented in the interest rate. In its simplest form, the consumer pays the lender in some combination of front end costs plus interest and the lender must pay for all expenses associated with marketing, originating and servicing from those consumer payments. It goes without saying that if the lender receives more revenue, e.g. from a higher interest rate, everything else being equal that loan is more valuable. The lender may reward the originator for that value in the form of a higher payment for the services provided. But, while that loan bears a higher interest rate the rate is fully disclosed to the consumer. The consumer has every opportunity to choose another source with a lower rate. There is absolutely nothing hidden, deceptive or unfair since the consumer may choose another lender with a lower rate at any point in the transaction. And, with our proposed disclosure the borrower also has full visibility to all other costs as well. Nothing deceptive, nothing hidden, nothing unfair.

If this payment for services is rendered to a third party the Board refers to as “indirect compensation”. The Board calls the same use of revenue when a lender compensates internal staff an “overage”. Regardless of how the revenue is used, the consumer’s cost is unchanged and has been fully disclosed in the interest rate. Whether it is called “Yield Spread Premium” which represents lender compensation to a third party for services rendered through the origination and funding of the loan, or “Service Release Premium” which represents the secondary market’s calculated present value of the future revenue flow negotiated for purchasing either the asset or the servicing rights; disclosing the amount of such so-called “indirect compensation” provides no relevant additional information to improve the consumer’s ability to comparison shop.

Employing a cost effective third party marketing and origination function, instead of building and maintaining this capability internally, is simply a lender’s business decision. Restricting a lender’s ability to decide whether to “build” or “buy” services will damage lender access to a valuable alternative distribution channel, will result in an overall reduction in competition, will drive a derivative increase in consumer front end costs as well as create access issues for home buyers and homeowners attempting to refinance.

The August 26, 2009 proposed changes to Regulation Z demonstrates a fundamental misunderstanding of the overall loan pricing dynamic. It is ironic that while the Board expresses its concern, *“. . . that creditor payments to mortgage brokers are not transparent to consumers . . .”* it suggests that it has no issue with lenders globally increasing their interest rates. This allowable increase requires no justification or transparency, yet if used would represent an increase in the largest component of consumer costs without any required disclosure except that, if a loan originator is compensated that portion paid to the originator must be disclosed. If the originator is an employee this amount may never be disclosed even if the increased rate results in a higher premium payment to the lender when the loan is pooled and/or sold.

As previously observed, all lender and originator compensation is included in the front end costs and in the periodic loan payments derived from the stated interest rate. The interest rate is disclosed to the borrower. Further disclosure of the portion of the lender’s revenue used to pay for services rendered is irrelevant to the consumer’s ability to comparison shop and if disclosed provides no useful consumer information.

The Board has stated that its intention in 226.36 (d) is to prevent deceptive practices and unfairness. In order to implement that “protection” the Board proposes that it will:

- Prohibit certain payments to a mortgage broker or a loan officer that are based on the loan’s terms and conditions.
- Prohibit a mortgage broker or loan officer from ‘‘steering’’ consumers to transactions that are not in their interest in order to increase the mortgage broker’s or loan officer’s compensation.

The Board is only authorized to implement these changes if the change is needed to prevent deceptive practices or unfairness.

On page 43237 in support of what it considers to constitute deceptive or unfair, the Board cites FTC requirements:

“First, there must be a representation, omission or practice that is likely to mislead the consumer.

Second, the act or practice is examined from the perspective of a consumer acting reasonably in the circumstances.

Third, the representation, omission, or practice must be material. That is, it must be likely to affect the consumer's conduct or decision with regard to a product or service."

Since the costs incurred by the borrower are clearly the combination of the front end costs, which the Board cites in its rule are fully and transparently provided by the Good Faith Estimate (See page 43234) and by the disclosure of the loan's interest rate, there is nothing in the compensation paid from a lender to an originator that triggers any of the FTC tests.

Consumers know exactly what their costs are. If the originator offers a higher interest and it happens to provide a higher share of the lender revenue to the originator, the consumer is neither deceived nor treated unfairly because the consumer is fully aware of their costs through the disclosure of the interest rate and the consumer is free to locate another loan source at will. Neither the disclosure of how the lenders use their revenue nor a prohibition of the payment serves the TILA intended purpose. Neither requirement is relevant to the prevention of deceptive practices or unfairness in as much as those conditions are not triggered. Therefore, the Board is not authorized to prohibit such arrangements.

The Board would better serve consumers and the objectives of Regulation Z by abandoning this unproductive debate about "indirect compensation" and instead, by directing its immediate efforts to working with HUD to integrate the requirements of Regulation X to produce one set of disclosures that are easily understood and useful to consumers. The proposed rule on page 43234 eludes to the efforts. Those efforts should be increased immediately instead of spending time creating changes that will achieve the opposite of the intended result. Both agencies' efforts must be turned to creating an integrated, simplified consumer disclosure that allows for an informed consumer shopping experience based on relevant product and financial information.

<u>The Proposed Solution</u>

A simple solution does exist! We suggest adopting the solution that was offered by IMMAAG in its comments to the proposed rule in December 2009. Use a one page addendum to the pre-January 2010 Good Faith Estimate. The solution resolves the issues related to comparison shopping with out the side effects inherent in the newly implemented GFE and without the inappropriate restriction on the market freedom to decide on its own how services should be compensated. The **IMMAAG** solution overcomes the problems created by the misconception detailed in our position statement. We offer a document that delivers a simple, useable attachment for the consumer to compare alternative loan program prices.

If the real objective is to prevent deceptive practices and unfairness while providing the consumer ability to shop for competitive loan alternatives, there are only two costs necessary to evaluate:

First, is the front end cost associated with obtaining the loan,

Second, is the interest rate and its derivative debt service cost over a particular period of time.
(APR, in the context of mortgage loans, lost its usefulness in the 1970's when "discount" loans ceased to exist.)

Nothing else is needed for a consumer to compare prices. To the extent that consumers decide which mortgage product meets their needs based on price, all of the other ostensibly "transparent" fully disclosed financial aspects of the transaction are moot. Certainly how lenders use revenue to pay their bills is only noise.

If one lender offers a $250,000; 30 year fixed rate mortgage with total closing costs of $5,000 at an interest rate of 5.00% and another offers the same mortgage with total closing costs of $4000 at the same 5.00% rate, it does not require disclosures of originator compensation or APR to determine which loan "costs" less over any chosen time frame. Given the absolute front end costs, and the monthly payment derived from the loan terms, all the consumer needs to accurately compare and “shop” these loans is the element of time.

IMMAAG’s proposed disclosure when combined with the details contained on the current Good Faith Estimate can be used by anyone to evaluate the cost aspect of the shopping experience. When the concept is adopted, the proposed disclosure will certainly need to be modified for form.

Conclusion

In conclusion, it is our opinion that if HUD and the Board fail to acknowledge and act on correcting the on-going misconception of “YSP” and “indirect compensation”, the disclosure solutions being forced on consumers and the industry will only continue to cause confusion and added consumer expense while interfering with developing a meaningful solution to the comparison shopping problem and to informed borrower decision making.

We fully realize that in order to implement the changes we support that coordination is required between HUD and the FRB. We also recognize that the Board acknowledges that in their proposed rule and that the Board claims they have already begun more intense work with HUD. While it is too late to delay Regulation X's implementation which is already hurting the industry, as did the adoption of the HVCC by FHFA, it is not too late for the Board to Act prudently and responsively to the facts. Further, the Board can take actions to increase the speed with which it works with HUD to integrate the solution and can leverage the work already done by IMMAAG to make the transition simple.

The industry, through groups such as ours, stands ready to offer assistance to finally achieve the simple, clear, easily understandable, easy to use disclosures that are desired by everyone. But, until it is recognized and accepted by the Board and HUD that the current approach is based on flawed assumptions which have led to flawed conclusions we will spend precious time creating solutions for problems that do not exist, while leaving the real problems in the market to hurt consumers.

Respectfully,

Comparison Shopping Disclosure Example

As indicated in the position statement, a consumer can easily comparison shop when the interest rates are the same and only the front end costs differ.

If the interest rates and costs being compared are different or if costs such as mortgage insurance or prepayment penalties are included in the loans, the consumer needs more information.

By using a table such as the one offered below, these varying loan characteristics may be presented in a very simple, easy to understand format to use to comparison shop.

IMPACT Mortgage Management Advocacy and Advisory Group (IMMAAG)
offers the following disclosure as a simplified mortgage loan comparison shopping tool.

By simply modifying Regulation X to require inclusion of the interest rate and by making this disclosure an addendum to the detail provided on the existing GFE the consumer can identify the total cost of (cash used) for alternative loan programs. For the purpose of the comparison, "cost" is defined as cash used to support the acquisition and payment of the loan.

Total Loan Amount $250,000

Term 360 Months		Loan 1	Loan 2
Interest Rate		5.00%	5.63%
P&I Payments		$1,342.05	$1,439.14
Front End Closing Costs			
Origination Fee		$2,500	$0
Broker Fee		$790	$0
Lender Fees		$1,000	$0
Title Fees		$950	$0
Total Front End Closing Costs		$5,240	$0
Combined Cost to Borrower		Loan 1	Loan 2
Total Cash Used -	36 mos	$53,554	$51,809
Point of Indifference -	54 mos	$77,711	$77,714
Total Cash Used -	60 mos	$85,763	$86,348
Total Cash Used -	120 mos	$166,286	$172,696
Total Cash Used -	240 mos	$327,332	$345,394
Total Cash Used -	360 mos	$488,378	$518,090