

## **Kickbacks or Compensation: The Case of Yield Spread Premiums**

by

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Over the past few years, the federal courts have been inundated with lawsuits challenging the payment of yield spread premiums in residential mortgage originations. The amounts involved are substantial – on the order of hundreds of millions in dollars of payments annually – and as the cases arise under the Real Estate Settlement Procedures Act of 1974 (RESPA or the Act),<sup>1</sup> which provides for treble damages, the stakes are extremely high. Yet within the academic community attention to the controversy has been limited. Most of what has been written on the subject has focused on procedural issues involving class certification. The remaining commentary has explored doctrinal questions regarding the interpretation of section 8 of RESPA,<sup>2</sup> which is the provision

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\*\* Harvard Law School, '03.

<sup>1</sup> Pub. L. No. 93-533, 88 Stat. 1724 (1974).

<sup>2</sup> Section 8 reads as follows:

### Prohibition against kickbacks and unearned fees

#### (a) Business referrals

No person shall give and no person shall accept any fee, kickback, or thing of value pursuant to any agreement or understanding, oral or otherwise, that business incident to or a part of a real estate settlement service involving a federally related mortgage loan shall be referred to any person.

#### (b) Splitting charges

No person shall give and no person shall accept any portion, split, or percentage of any charge made or received for the rendering of a real estate settlement service in connection with a transaction involving a federally related mortgage loan other than for services actually performed.

#### (c) Fees, salaries, compensation, or other payments

Nothing in this section shall be construed as prohibiting (1) the payment of a fee (A) to attorneys at law for services actually rendered or (B) by a title company to its duly appointed agent

under which the cases are typically brought. Almost no academic writing has seriously grappled with the more fundamental question of whether the behavior at issue in these cases is, in fact, harmful and should be prohibited. This article offers one perspective on these issues.

We begin with a brief explanation of yield spread premiums. Today, one of the principal ways that borrowers obtain home mortgage financing is with the assistance of a mortgage broker. These brokers provide a number of services including helping customers complete loan application forms and providing other services, such as property appraisals and credit reports, necessary to obtain mortgages. In addition and of particular relevance to the debate over yield spread premiums, mortgage brokers typically choose a lending institution to fund the customer's mortgage. Most mortgage brokers have correspondent relations with a number – perhaps twenty – lending institutions. Every day and sometimes even several times in the course of a day, these lenders will supply their mortgage brokers prices at which they are willing to fund mortgages. When the broker is ready to lock in the financing terms for a particular customer, the broker must pick among the terms that correspondent lending institutions offer. Almost invariably, the customer accepts the mortgage broker's recommendation.

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for services actually performed in the issuance of a policy of title insurance or (C) by a lender to its duly appointed agent for services actually performed in the making of a loan, (2) 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, (3) payments pursuant to cooperative brokerage and referral arrangements or agreements between real estate agents and brokers, (4) affiliated business arrangements . . . or (5) such other payments or classes of payments or other transfers as are specified in regulations prescribed by the Secretary, after consultation with the Attorney General, the Secretary of Veterans Affairs, the Federal Home Loan Bank Board, the Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System, and the Secretary of Agriculture.

12 U.S.C.A. § 2607 (West 2001).

The controversy over yield spread premiums concerns the manner in which mortgage brokers are compensated for their services. One traditional way brokers are compensated is through the direct payments of various fees from their customers. For example, a mortgage broker might receive an origination fee of one percent of the loan amount. In addition, brokers sometimes supplement their income with various other fees, such as document preparation fees, application fees, and processing fees. All of these fees would typically be paid directly by the borrower at or before closing.

Yield spread premiums constitute a separate and less well known way that mortgage brokers are compensated for their services. Yield spread premiums are paid from lending institutions to mortgage brokers. A number of factors influence the setting of yield spread premiums, but the most significant is the rate of interest on the borrower's loan. In the mortgage banking industry, a "par loan" is a loan that a lending institution funds at 100 cents on the dollar. An "above par" loan is one that bears a somewhat higher interest rate and for which lending institutions are willing to pay more than 100 cents on the dollar, for example 102 cents. Typically, the excess over par is paid to mortgage brokers in the form of a yield spread premium. The average amount of yield spread premiums is typically in the range of \$1000 to \$2000 per loan, and, when present, is usually the largest component of mortgage broker compensation. The more an interest rate charged on an above par loan exceeds the rate for a comparable par loan, the greater the yield spread premium payment to the mortgage broker. Box A on the next page offers a concrete example of these payments.

**Box A****Illustration of the Calculation of Yield Spread Premiums**

To provide a more concrete example of how yield spread premiums are calculated, consider the following illustration drawn from one of the loan files included in the empirical analysis presented in part three of this article. More complete documentation for this file, in redacted form, is reproduced in Appendix A. These materials illustrate how yield spread premiums are determined.

The yield spread premium for this loan was calculated from the rate sheet of one particular lending institution (InterFirst) in effect at 9:39 AM on September 9, 1998. A copy of this rate sheet appears on the next page. At the time, the borrower in question was seeking a 30-year fixed conventional mortgage for \$106,850 with an interest rate of 7.125 percent (This information appears on a rate lock commitment, reproduced in Appendix A, which the lending institution sent to the mortgage broker to confirm the transaction on September 16, 1998.) The loan had a lock term of 30 days, meaning that the proposed rate was available through October 9, 1998. (Again, this information appears on the rate lock commitment.)

Based on the foregoing information, the loan's yield spread premium can be determined by reference to the accompanying rate sheet. Located in the upper right hand corner of the sheet are prices for 30-year fixed conventional mortgages – Program 100. The price for a particular mortgage depends on the interest rate proposed (7.125 percent in this case) and the lock period (30 days). On the accompanying rate sheet, the price for such a loan is 101.625 (circled). This figure means that InterFirst was prepared to pay a premium of 1.625 percent to fund this particular loan. That premium implies a yield spread premium with a base amount of \$1,736.13 (or 1.625 percent of \$106,850).

To determine net adjustments on this premium, one must read the fine print of the relevant rate sheet. Directly to the left of the prices for Program 100 is a note indicating that InterFirst will pay an additional 0.25 premium for conventional conforming loans in excess of \$100,000 (marked with a single star). The loan in question qualifies for this amount because it exceeds the \$100,000 threshold. In addition, at the top of this particular rate sheet is a second incentive premium of 0.125 percent for purchase loans (marked with two stars). Again, the loan qualifies because it is for a home purchase, not a refinancing. (This can be determined from the HUD-1 statement included in Appendix A.) Accordingly, the net adjustment on this loan is \$ 400.69 (or 0.25 percent of \$106,850 plus 0.125 percent of \$106,850).

Based on the foregoing analysis, one would predict a total price for this loan to be 102.0, which is in fact the price reported on the rate lock commitment sheet reproduced in Appendix A. In addition, one would predict a total yield spread premium of \$ 2,137 (the base amount of \$1736.13 plus net adjustments of \$404.69). And, in fact, this is the amount of yield spread premium indicated on the third page (line 816) of the HUD-1 statement for this loan.

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(35 year amortization available)	Rate	15 Day	30 Day	45 Day	60 Day
Conventional	7.475	103.500	103.375	103.250	103.125
Confirming	7.575	103.250	103.125	103.000	102.875
35 BONUS \$100,000 +	7.375	102.250	102.125	102.000	101.875
HomeBuyer's Community Program	7.275	101.250	101.125	101.000	100.875
HomeBuyer's Community Program	7.175	100.250	100.125	100.000	99.875
HomeBuyer's Community Program	7.075	99.250	99.125	99.000	98.875
HomeBuyer's Community Program	6.975	98.250	98.125	98.000	97.875
HomeBuyer's Community Program	6.875	97.250	97.125	97.000	96.875
HomeBuyer's Community Program	6.775	96.250	96.125	96.000	95.875
HomeBuyer's Community Program	6.675	95.250	95.125	95.000	94.875
HomeBuyer's Community Program	6.575	94.250	94.125	94.000	93.875
HomeBuyer's Community Program	6.475	93.250	93.125	93.000	92.875
HomeBuyer's Community Program	6.375	92.250	92.125	92.000	91.875
HomeBuyer's Community Program	6.275	91.250	91.125	91.000	90.875
HomeBuyer's Community Program	6.175	90.250	90.125	90.000	89.875
HomeBuyer's Community Program	6.075	89.250	89.125	89.000	88.875

30 YEAR FIXED JUMBO - Program 102					
Conventional - Jumbo	Rate	15 Day	30 Day	45 Day	60 Day
Conventional - Jumbo	7.475	102.000	101.875	101.750	101.625
Confirming - Jumbo	7.575	101.750	101.625	101.500	101.375
Low Amounts from \$50,000	7.375	100.750	100.625	100.500	100.375
Low Amounts from \$50,000	7.275	99.750	99.625	99.500	99.375
Low Amounts from \$50,000	7.175	98.750	98.625	98.500	98.375
Low Amounts from \$50,000	7.075	97.750	97.625	97.500	97.375
Low Amounts from \$50,000	6.975	96.750	96.625	96.500	96.375
Low Amounts from \$50,000	6.875	95.750	95.625	95.500	95.375
Low Amounts from \$50,000	6.775	94.750	94.625	94.500	94.375
Low Amounts from \$50,000	6.675	93.750	93.625	93.500	93.375
Low Amounts from \$50,000	6.575	92.750	92.625	92.500	92.375
Low Amounts from \$50,000	6.475	91.750	91.625	91.500	91.375
Low Amounts from \$50,000	6.375	90.750	90.625	90.500	90.375
Low Amounts from \$50,000	6.275	89.750	89.625	89.500	89.375
Low Amounts from \$50,000	6.175	88.750	88.625	88.500	88.375
Low Amounts from \$50,000	6.075	87.750	87.625	87.500	87.375

AFFORDABLE GOLD PREMIUM PRICING - Program 100					
Conventional - Confirming	Rate	15 Day	30 Day	45 Day	60 Day
Conventional - Confirming	6.475	104.375	104.250	104.125	104.000

15 YEAR FIXED JUMBO - Program 103					
Conventional - Jumbo	Rate	15 Day	30 Day	45 Day	60 Day
Conventional - Jumbo	7.500	101.875	101.750	101.625	101.500
Confirming - Jumbo	7.600	101.625	101.500	101.375	101.250
Low Amounts from \$50,000	7.300	100.625	100.500	100.375	100.250
Low Amounts from \$50,000	7.200	99.625	99.500	99.375	99.250
Low Amounts from \$50,000	7.100	98.625	98.500	98.375	98.250
Low Amounts from \$50,000	7.000	97.625	97.500	97.375	97.250
Low Amounts from \$50,000	6.900	96.625	96.500	96.375	96.250
Low Amounts from \$50,000	6.800	95.625	95.500	95.375	95.250
Low Amounts from \$50,000	6.700	94.625	94.500	94.375	94.250
Low Amounts from \$50,000	6.600	93.625	93.500	93.375	93.250
Low Amounts from \$50,000	6.500	92.625	92.500	92.375	92.250
Low Amounts from \$50,000	6.400	91.625	91.500	91.375	91.250
Low Amounts from \$50,000	6.300	90.625	90.500	90.375	90.250
Low Amounts from \$50,000	6.200	89.625	89.500	89.375	89.250
Low Amounts from \$50,000	6.100	88.625	88.500	88.375	88.250
Low Amounts from \$50,000	6.000	87.625	87.500	87.375	87.250

20 YEAR FIXED - Program 120					
Conventional - Confirming	Rate	15 Day	30 Day	45 Day	60 Day
Conventional - Confirming	7.125	101.875	101.750	101.625	101.500
Confirming	7.225	101.625	101.500	101.375	101.250
35 BONUS \$100,000 +	6.925	100.625	100.500	100.375	100.250
HomeBuyer's Community Program	6.825	99.625	99.500	99.375	99.250
HomeBuyer's Community Program	6.725	98.625	98.500	98.375	98.250
HomeBuyer's Community Program	6.625	97.625	97.500	97.375	97.250
HomeBuyer's Community Program	6.525	96.625	96.500	96.375	96.250
HomeBuyer's Community Program	6.425	95.625	95.500	95.375	95.250
HomeBuyer's Community Program	6.325	94.625	94.500	94.375	94.250
HomeBuyer's Community Program	6.225	93.625	93.500	93.375	93.250
HomeBuyer's Community Program	6.125	92.625	92.500	92.375	92.250
HomeBuyer's Community Program	6.025	91.625	91.500	91.375	91.250

5-25 EXTENDABLE - Program 105					
Conventional - Confirming	Rate	15 Day	30 Day	45 Day	60 Day
Conventional - Confirming	7.000	101.000	100.875	100.750	100.625
Confirming	7.100	100.750	100.625	100.500	100.375
Low Amounts from \$50,000	6.800	99.750	99.625	99.500	99.375
Low Amounts from \$50,000	6.700	98.750	98.625	98.500	98.375
Low Amounts from \$50,000	6.600	97.750	97.625	97.500	97.375
Low Amounts from \$50,000	6.500	96.750	96.625	96.500	96.375
Low Amounts from \$50,000	6.400	95.750	95.625	95.500	95.375
Low Amounts from \$50,000	6.300	94.750	94.625	94.500	94.375
Low Amounts from \$50,000	6.200	93.750	93.625	93.500	93.375
Low Amounts from \$50,000	6.100	92.750	92.625	92.500	92.375
Low Amounts from \$50,000	6.000	91.750	91.625	91.500	91.375

7-23 EXTENDABLE - Program 107					
Conventional - Confirming	Rate	15 Day	30 Day	45 Day	60 Day
Conventional - Confirming	7.200	100.000	99.875	99.750	99.625
Confirming	7.300	99.750	99.625	99.500	99.375
Low Amounts from \$50,000	7.000	98.750	98.625	98.500	98.375
Low Amounts from \$50,000	6.900	97.750	97.625	97.500	97.375
Low Amounts from \$50,000	6.800	96.750	96.625	96.500	96.375
Low Amounts from \$50,000	6.700	95.750	95.625	95.500	95.375
Low Amounts from \$50,000	6.600	94.750	94.625	94.500	94.375
Low Amounts from \$50,000	6.500	93.750	93.625	93.500	93.375
Low Amounts from \$50,000	6.400	92.750	92.625	92.500	92.375
Low Amounts from \$50,000	6.300	91.750	91.625	91.500	91.375
Low Amounts from \$50,000	6.200	90.750	90.625	90.500	90.375
Low Amounts from \$50,000	6.100	89.750	89.625	89.500	89.375
Low Amounts from \$50,000	6.000	88.750	88.625	88.500	88.375

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 Program 120 7.375 @ .125 point fee funded at par  
 Program 100 7.375 @ .125 point fee funded at 101.250  
 Program 101 7.375 @ .125 point fee funded at 101.250  
 Program 120 7.375 @ .125 point fee funded at 101.250  
 Program 100 7.375 @ .125 point fee funded at par  
 Program 101 7.375 @ .125 point fee funded at 101.250  
 Program 120 7.375 @ .125 point fee funded at 101.250  
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 2/1 Buydown (Program: 103) -2.125 pts  
 1/0 Buydown (Program: 100, 101, 102, 103, 105, 107, 120, 203, 225) -1.875 pts

LTY	PROGRAMS				
	100	101	105	107	120
80.01% - 85%	0.375%	0.350%	0.375%	0.375%	0.350%
85.01% - 90%	0.300%	0.375%	0.300%	0.300%	0.375%
90.01% - 95%	0.375%	0.625%	N/A	N/A	0.625%

This program available on all fixed rate conforming and conforming balloon products. (Programs 100, 101, 105, 107, 120)

Rate Sheet No: 2452-1 Page 1 of 2  
 09:39 AM - WEDNESDAY, SEPTEMBER 9, 1998  
 Files received today are due out by the close of business on: FRIDAY, SEPTEMBER 11, 1998

Rate Lock EXPIRATION Schedule  
 15 Day: 9/21/98 30 Day: 10/5/98 45 Day: 10/19/98 60 Day: 10/30/98  
 75 Day: 10/27/98 90 Day: 11/10/98 120 Day: 11/24/98 180 Day: 1/1/99 270 Day: 6/30/99

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Yield spread premiums are controversial on numerous dimensions. While the existence of these lender payments to mortgage brokers is revealed on government mandated disclosure statements made available to borrowers at closing and sometimes earlier, the form of disclosure is cryptic and does not reveal the relationship between the interest rate charged on the borrower's mortgage and the magnitude of the yield spread premium. In addition to issues of fraud and ethical concerns of such compensation arrangements, the practice raises the unresolved legal question of whether the payments constitute a violation of section 8 of RESPA, which proscribes the payment of kickbacks, referral fees, and unearned payments in connection with real estate settlements. Moreover, there is substantial disagreement about the effect of market forces in this context. A recurring claim of industry representatives is that yield spread premiums do not harm borrowers because market forces demand that compensating reductions be made in other forms of mortgage broker compensation, thus eliminating any additional expense to borrowers. Critics of the practice contest this characterization and argue that yield spread premiums serve principally to enhance the revenues of mortgage brokers and increase the cost of residential mortgage financing.

In this article, we seek to introduce the debate over yield spread premiums to a wider audience. In Part One, we review the legislative background of the Real Estate Settlement Procedures Act, which forms the statutory basis of the yield spread premium litigation. This review illuminates the concerns that motivated Congress to intervene in the area and also provides valuable insight into the kinds of market failures that were widely perceived to exist in the field in the early 1970's. Part One then reviews the actions that federal administrative agencies have so far taken with respect to yield spread premiums and summaries the mounting number of legal decisions address the issue.

In Part Two, we locate the provisions of RESPA in the broader context of financial regulation and argue that the Act's prohibition against kickbacks is characteristic of government interventions in a host of different financial areas. We identify this class of problem as the trilateral dilemma of financial regulation. In brief, this problem arises when a market professional gains de facto control over financial decisions of consumers. In exercising such discretion, the market professional often hires third parties to perform services for which the consumer pays. In such situations, numerous different third party providers may compete among themselves to be chosen to provide these services, and for any particular service provider there will be an incentive to make a side payment to the market professional in order to be selected. Under certain conditions – particularly where consumers are unable to monitor how the market professional selects service providers and are unlikely to police the cost of the provider's services – these practices can become wide-spread and unnecessarily raise costs for some consumers. In addition, the existence of such side payments may permit market professionals to price discriminate among consumers. Part Two concludes with a demonstration of how the practice of paying yield spread premiums shares all of the key ingredients of a trilateral dilemma.

In Part Three we test our theoretical assertions through an empirical investigation of more than two thousand mortgage financings of one affiliated group of lending institutions. The data for this study was obtained through discovery in the case of *Glover v. Standard Federal Bank*, for which one of the authors is serving as expert witness on behalf of the plaintiff class. In our view, this data offers compelling evidence that for transactions involving yield spread premiums, mortgage brokers received substantially more compensation than they did in transactions without yield spread premiums. Depending on the method of comparison, the estimated difference in costs to borrowers

ranges from \$800 to over \$3000 per transaction, and our best guess of the cost impact is approximately \$1046. This difference in mortgage broker compensation and borrower costs is statistically significant at the 99.99% level and robust to a variety of formulations. These findings strongly suggest that yield spread premiums are not a good deal for borrowers, but serve primarily to increase compensation paid to mortgage brokers.

As a separate test of the economic impact of yield spread premiums, we used a series of regression analysis to explore the relationship between yield spread premiums and direct cash payments to mortgage brokers. Industry representatives have argued that yield spread premiums are not harmful to consumers because these payments are recouped through lower direct payments to mortgage brokers. However, our analysis suggests this claims is baseless. With the highest degree of statistical confidence and using multiple formulations, we can reject the notion that consumers fully recoup the cost of yield spread premiums. Our best estimate is the consumers get only twenty-five cents of value for every dollar of yield spread premiums. Seventy-five percent of yield spread premiums serve only to increase payments to mortgage brokers. On average, a very bad deal from consumers.

Our study also provides evidence that the payment of yield spread premiums allows mortgage brokers to engage in price discrimination among borrowers. In transactions where yield spread premiums are not at issue, the vast majority pay mortgage brokers total compensation of not more than 1.5 percent of loan value, and the largest group (on the order of 40 to 45 percent) pay mortgage brokers compensation in the range of 1.0 to 1.5 percent of loan values. In other words, in these markets, there is a pretty clear market price for mortgage broker services. But, when yield spread premiums are present, there is no single market price for mortgage broker services. Most

borrowers pay more than 1.5 percent of loan value; more than a third pay more than 2.0 percent of loan value; and roughly ten percent pay more than 3.5 percent of loan value. This price dispersion strongly suggests that yield spread premiums are not simply another form of mortgage broker compensation, but rather that the payments constitute a deceptive device that the mortgage broker industry employs to extract unnecessary and excessive payments from unsuspecting borrowers.

In an effort to corroborate the hypothesis that compensation practices of mortgage brokers disadvantage less well-educated and less financially sophisticated borrowers, we examined the relationship between mortgage broker compensation and the racial identity of borrowers. The results indicated that mortgage brokers charged two racial groups – African-Americans and Hispanics – substantially more for settlement services than other borrowers. For African Americans, the average additional charge was \$474 per loan, and for Hispanics, the average additional charge was \$580 per loan. While we expect to do more work on this aspect of our analysis, these preliminary results are consistent with our hypothesis that current industry practices allow mortgage brokers to exploit less sophisticated borrowers by imposing higher charges.

## **Part I: The Legal Context of the Yield Spread Premium Controversy**

The controversy over the payment of yield spread premiums can be traced back to the early 1970's when real-estate settlement practices first gained national attention. In this part we begin with a review of the legislative process that led to the enactment of RESPA in 1974 and the adoption of section 8's prohibition on kickbacks and unearned fees in real estate settlements. We then trace HUD's efforts in the past decade to regulate the payment of yield spread premiums under RESPA. The part concludes with a summary of the wave of recent class action lawsuits that have challenged the payment of yield spread premiums as violations of section 8's prohibitions.

### **A. The Enactment of RESPA and Section 8's Prohibitions**

As described below, the legislative history of RESPA demonstrates that Congress was confronted with substantial and uncontroverted evidence that the settlement of real estate transactions in the United States in the early to mid 1970's was characterized by a number of abusive practices, which appeared to be imposing substantial costs on the American public. Various solutions to the problem of settlement costs were proposed, including direct regulation of settlement costs by the federal government. But in the end, Congress chose to impose a less intrusive solution, relying principally on a combination of mandatory disclosure rules and section 8's prohibition of kickbacks and unearned fees. In this section, we describe how Congress reached this compromise, focusing particular attention on facets of the legislative history that were most closely associated with the Act's inclusion of section 8's anti-kickback rules.

#### **1. The 1972 HUD/VA Report on Mortgage Settlement Costs**

Although RESPA was enacted in 1974, the legislative history of the Act dates back several years earlier. In 1970, Congress adopted section 701 of the Emergency Home Finance Act of 1970

in an effort to lower settlement costs in the housing market and assist moderate-income families to purchase homes.<sup>3</sup> Under section 701, which RESPA ultimately superseded, the Department of Housing and Urban Development (HUD or the Department) and the Veterans Administration (VA) were charged with the task of prescribing standards governing the amount of settlement costs on FHA-insured and VA-guaranteed loans.<sup>4</sup> The two agencies were also instructed to undertake a joint study on how best to reduce and standardize settlement costs across the country. That study, completed in March of 1972, greatly influenced congressional actions leading up to the passage of RESPA and affords valuable insight into the contemporaneous thinking about the mortgage settlement business that underlay Congress's decision to enact section 8's prohibition on kickbacks and unearned fees.<sup>5</sup>

One of the 1972 HUD/VA Report's principal findings concerned the payment of referrals and kick-backs in the conveyance (that is, sales) of real estate:

Competitive forces in the conveyance industry manifest themselves in an elaborate system of referral fees, kickbacks, rebates, commissions and the like as an inducement to those firms and individuals who direct payment of business. These practices are widely employed, rarely inure to the benefit of the home buyer, and generally increase total settlement costs.<sup>6</sup>

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<sup>3</sup> Pub. L. No. 91-351, § 701 84 Stat. 450, 537-38 (1970).

<sup>4</sup> S. Rep. No. 866, 93<sup>rd</sup> Cong., 2d Sess. *reprinted in* 1974 U.S. Code Cong. & Admin. News 6546, 6558 [hereinafter 1974 Senate Report].

<sup>5</sup> See Mortgage Settlement Costs: Report of the Department of Housing and Urban Development and Veterans' Administration (Mar. 1972) (Comm. Print of the Senate Committee on Banking, Housing and Urban Affairs, 93<sup>rd</sup> Cong. 2d Sess.) [hereinafter 1972 HUD/VA Report].

<sup>6</sup> *Id.* at 3.

The 1972 HUD/VA Report proceeded to explore the “underlying problems” in the mortgage settlement industry, and among other things documented a substantial amount of “economic waste” in the industry. As the following passage illuminates, the report concluded that competition in this sector was not focused on lowering costs for consumers but rather on benefitting commercial concerns in the position to refer lucrative opportunities to those in the business of offering settlement services:

In most cases, competition in the conveyancing industry is directed toward other participants in the industry, and not toward the home buying public. Lenders compete to get business from realtors or escrow companies. Title companies compete to get business from attorneys, brokers, or lenders, and so on.

The buyer seldom decides who will provide settlement service for him. If there is a choice, he will usually depend on the advice of this broker, escrow agent, or settlement attorney.

The competition that exists in this industry, therefore, is not based on price, because the ultimate consumer has a small voice in that decision. Although the industry is very competitive in many areas, the competitive forces that do exist manifest themselves in an elaborate system of referral fees, kickbacks, rebates, commissions and the like. These practices are widely employed and have replaced effective price competition.

These referrals or kickbacks paid by or to lawyers, lenders, title insurance companies, real estate brokers and others result in unnecessarily high costs. Referral fees, kickbacks, or other similar arrangements explain, in part, why fees for conveyancing services often do not relate to work performed. Information obtained from this study indicates that referral practices are widespread. The system of referral fees has become so entrenched; and frequently, little is done to hide the fact that these fees are paid. . . . <sup>7</sup>

This passage offers a picture of the problem of real estate settlement, as presented to Congress in the early 1970's. According to the report, borrowers either did not participate in the selection of providers of settlement services or were dependent on the advice of a broker or other professionals. Given this power to “direct the placement of business,” these professionals routinely extracted kick-

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<sup>7</sup> Id. at 15-16.

backs and referral fees, thereby increasing total settlement costs.<sup>8</sup> According to the report, the practice of extracting kickbacks and referral fees was so widespread in the industry that little attempt was made to hide the practice. That is, general knowledge that such payments were being made was not, apparently, sufficient to eliminate the practice or to permit borrowers to recoup the cost of kickbacks and referral fees through an off-setting reduction in other expenses.

Another element of the 1972 HUD/VA Report's findings concerned the manner in which settlement charges were calculated: "Settlement charges often are based on factors unrelated to the cost of providing the services. The overall level of charges tends to be significantly lower when the charge for a service is not directly related to the sales price of the property."<sup>9</sup> The Report later elaborated:

[T]he fees for many services are charged on the basis of sales prices. This is seldom justifiable. There is no implicit reason for undiscovered title defects to increase with the sales price; yet the fee for title insurance does. Neither is there any reason for a broker's job to necessarily be more difficult on a more expensive home. These fees are the result of tradition and not the result of economics."<sup>10</sup>

The implication of this aspect of the Report is that settlement costs would have been lower if fees were not calculated in a manner that bore so little relationship to the costs of providing the services in question.

The 1972 HUD/VA Report concluded that practices in the mortgage industry were so

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<sup>8</sup> Id. at 2-3.

<sup>9</sup> Id. at 3.

<sup>10</sup> Id. at 33.

problematic that the federal government should establish maximum allowable settlement costs.<sup>11</sup> This proposal to regulate rates was highly controversial, and the ensuing congressional debate leading up to the enactment of RESPA two years later was largely cast in terms of a choice of whether to adopt the 1972 HUD/VA Report's draconian rate regulation proposal or some more modest form of governmental intervention.

## 2. Contemporaneous Press Accounts

Another important influence underlying the passage of RESPA were contemporaneous press accounts documenting abuses in the real estate settlement practices. Particularly noteworthy were a series of press accounts in the *Washington Post* early in 1972, just before the 1972 HUD/VA Report was released. These articles were introduced at hearings of the subcommittee on Housing of the House Committee on Banking and Currency,<sup>12</sup> and also cited in congressional reports accompanying the Act as ultimately passed.<sup>13</sup> To begin with, the *Washington Post* stories confirmed the existence of market failures of the sort identified in the 1972 HUD/VA Report. According to the

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<sup>11</sup> Id. at 69-70. In addition to this regulation of rates, HUD also proposed to adopt regulations prohibiting the payment of kickbacks in connection with HUD-insured loans: "The proposed regulation is aimed at prohibiting the payment by the mortgagee of fees to realtors and others who refer or place the loan with the lender. . . . The buyer or seller indirectly pays such fees when they are included." Id. at 71.

<sup>12</sup> See Real Estate Settlement Costs: FHA Mortgage Foreclosures, Housing Abandonment, and Site Selection Policies: Hearings Before the Subcomm. on Housing of the House Comm. On Banking and Currency 1 (1972) [hereinafter 1972 House Housing Hearings] (the articles were introduced into the record by Subcommittee Chair Rep. William A. Barrett).

<sup>13</sup> See, e.g., 1974 Senate Report, *supra* note 4, at 6558 (additional views of Senator Proxmire).

*Washington Post*, settlement costs were a “mystery to most home buyers.”<sup>14</sup> There was, moreover, evidence that this ignorance on the part of consumers allowed for substantial variation in settlement costs in different regions of the country, with home buyers in the Washington, D.C., area paying two to three times more than comparable buyers in, for example, Boston.<sup>15</sup> A commonly advanced explanation for this variation in fees was the prevalence of kickbacks and other hidden payments in certain parts of the country. While contemporaneous press accounts revealed that kickbacks were paid in many different contexts, an illustrative example concerned payments made from title companies to settlement attorneys. The *Washington Post* explained the practice in the following terms:

The most common arrangements in the Washington area were found to be kickbacks and other hidden payments given by lawyers and by title insurance companies. . . .

Although some lawyers, title insurance companies, lenders, developers, builders, and brokers will have no part of the deals, many of the practices are so pervasive that it is difficult to find exceptions.

What such kickbacks amount to, says Seymour Glanzer, chief of the U.S. attorney’s fraud unit, is “commercial bribery” that directly inflates settlement costs paid by home buyers.

The purpose of giving kickbacks and hidden payments is to gain referral of home buyers’ settlement business, and the referral methods are not always subtle.

. . . .

Almost without exception, Maryland lawyers pocket a quarter to a third of the title insurance premium that home buyers with mortgages are required to pay. This is their commission for choosing a particular insuring company and accounts for 27 per cent of premiums paid by home buyers to Washington’s four major title insurance companies.

Although they are legal, the commissions, according to bar association

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<sup>14</sup> 1972 House Housing Hearings, *supra* note 12, at 2.

<sup>15</sup> See *id.* In the 1972 HUD/VA Report, government investigators also documented substantial regional variations in settlement costs. See 1972 HUD/VA Report, *supra* note 5, at 2. 32-33.

officials, would violate bar ethics unless lawyers obtain buyers' permission to take them. However, buyers are seldom consulted.<sup>16</sup>

A noteworthy aspect of the *Washington Post* series was the assertion that the payment of kickbacks and unearned referral fees was widespread in certain markets notwithstanding the fact that the practice was in violation of legal norms, in particular standards of professional responsibility. Similar assessments appeared throughout the hearings leading up to the enactment of RESPA.<sup>17</sup>

### 3. Perspectives from Congressional Hearings

Against the background of the 1972 HUD/VA Report and the mounting press coverage of mortgage settlement practices, Congress held a series of hearings between 1972 and 1974.<sup>18</sup> A variety of views were expressed, but a common opinion was that, while rate regulation of the sort advanced in the 1972 HUD/VA Report would be cumbersome and potentially counter-productive, some federal action was needed, particularly to enhance the level of consumer understanding of settlement costs and to alleviate the problems of kickbacks and referral fees. Illustrative of this sentiment was testimony of Representative Robert G. Stevens, Jr., sponsor of one of the bills that eventually formed the basis of RESPA:

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<sup>16</sup> See *id.*

<sup>17</sup> Consider, for example, the following testimony of Thomas R. Bomar, Chairman of the Federal Home Loan Bank Board:

[Referral payments for settlement services] violate anti-kickback statutes. In addition, they are violative of the canons of ethics of the legal and real estate professions. Moreover . . . such actions may well violate existing federal criminal law dealing with commercial bribery . . .”

Real Estate Settlement Costs: Hearings Before the Subcomm. On Housing of the House Comm. on Banking and Currency, 93<sup>rd</sup> Cong. 2d. Sess. 56 (1974) [hereinafter 1974 House Hearings]. See also 1972 House Hearings, *supra* note 12, at 1-19.

<sup>18</sup> See sources cited *supra* notes 12 & 17.

The proponents of federal rate fixing have said that the establishment of maximum charges is needed because of the abuses that exist in the settlement process. I find this line of argument to be totally without merit. If there are abuses, let us correct them; if there are particular problems that give rise to unnecessarily high settlement costs, let us deal with them. The imposition of federal rate regulation on so many businessmen and attorneys cannot be justified when the *underlying problems and abuses* can be dealt with directly by the Congress.<sup>19</sup>

Throughout the hearings, Congress was repeatedly urged to eschew price controls for settlement costs in favor of more targeted regulation aimed at specific abuses.<sup>20</sup>

One of the most frequently cited abuses was the practice of granting kickbacks and referral fees. Witnesses from disparate corners of the real estate industry concurred that kickbacks and referrals in real estate settlements should be outlawed. The following excerpts suggest the tenor of the debate on this point:

“A final provision which we feel to be vital to any legislative package on settlement costs would be a prohibition on kickbacks and unearned fees.”<sup>21</sup>

\* \* \* \*

“In your kickbacks, I am rather shocked at the things that occurred that brought this to public light, and I had no notion they went on.”<sup>22</sup>

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“In the [Montgomery County (Md.) Lawyers Association]’s view, real estate practices involving payoffs, kickbacks, and referral fees should be prohibited because these practices increase costs to home buyers while providing them no additional benefits. . . .

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<sup>19</sup> 1974 House Hearings, *supra* note 17, at 50 (emphasis in original).

<sup>20</sup> See, e.g., *id.* at 305 (testimony of H. Harland Crowell, Jr., National Association of Realtors) (“In this country, we believe that a free market, functioning correctly, is the most efficient and equitable way of allocating goods and services. If the market breaks down, we should try to determine the specific failing and correct it so that the simplicity and essential fairness of the market system can be preserved.”).

<sup>21</sup> *Id.* at 61 (testimony of Sheldon B. Lubar, Ass’t HUD Secretary for Housing Production and Mortgage Credit).

<sup>22</sup> *Id.* at 107 (testimony of William P. Dickinson, Chairman, ABA Special Committee on Residential Real Estate Transactions).

Kickbacks and referral fees represent not only net direct economic loss to the home buyer but a significant obstacle to free market forces as well.<sup>23</sup>

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“The American Land Title Association has already placed itself on record as favoring appropriate regulation to prohibit such considerations and inducements [for other than services rendered].”<sup>24</sup>

Indeed, the hearings leading up to the passage of RESPA display a remarkable consensus of the general contours of the legislation. Price controls were thought to be excessively burdensome and unnecessary; measures to enhance disclosure and consumer understanding were strongly supported; and prohibitions on the sorts of kickbacks and referrals that the 1972 HUD/VA Report and contemporaneous press accounts had uncovered were almost universally acclaimed. Representative of this perspective was the testimony of Thomas B. Bomar, Chairman of the Federal Home Loan Bank Board, which touched upon all of these points:

[1.) On the 1972 HUD/VA Report’s Proposal to Set Maximum Settlement Charges:]

First, rate regulation in this case is merely symptomatic treatment. It is like the administration of a painkiller as a remedy for appendicitis.

Second, rate regulation in this case is likely to create a bureaucratic monstrosity.

Third, rate regulation is contrary to this country’s traditional philosophy regarding the role of the marketplace.

Fourth, generally speaking, rate regulation not only does not work well, but itself creates serious distortions and instabilities in the market.

[2.) On Proposals to Enhance Disclosure:]

First, let me discuss one provision in the bills dealing with increased availability of information. It is almost universally agreed that we must take action to reduce, and eliminate if possible, the imperfections in this market.

It is a fundamental economic concept that a competitive market cannot exist when the buyer is uninformed. For that reason the Board supports the concept . . . relating to special information booklets which describe the nature and costs of real estate statements.

Additionally, the Board supports the provisions of the proposed legislation relating to the development of a uniform settlement statement. Such a statement would better enable buyers to make cost comparisons. . . .

[3.) With Respect to Kickbacks:]

Dealing with kickbacks, the real estate settlement market is characterized by nonprice competition. One of the principal forms of nonprice competition is advertising,

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<sup>23</sup> Id. at 151, 162 (testimony of B. George Ballman, Chairman of the Montgomery County (Md.) Lawyers Association).

<sup>24</sup> Id. at 375 (Memorandum on Behalf of the American Land Title Association).

which has little overt use in the real estate settlement market because of the antisolicitation canons of several of the professions engaged in the market. Recourse is therefore especially made to another classic form of nonprice competition, that is, the use of a system of discounts, rebates, commissions, concessions, and kickbacks.

. . . [B]oth settlement cost bills before the subcommittee provide criminal and civil penalty for such actions. The Board prefers the provisions concerning kickbacks and unearned fees in H.R. 9989 to those of H.R. 11183. In H.R. 11183, a separate [arguably weaker] provision is made for commission to attorneys. It is our preference to use comprehensive language dealing with the elimination of kickbacks across the board as provided in H.R. 9989.<sup>25</sup>

#### 4. Congressional Reports and the Resulting Statutory Provisions

Following the consensus that emerged in the course of hearings, Congress adopted a targeted strategy to address the special problems associated with what were perceived to be excessively high settlement costs. While some members – most notably Senator Proxmire of Wisconsin – remained supportive of more stringent intervention in the form of price controls,<sup>26</sup> the legislation that was enacted relied upon a combination of disclosure requirements and prohibitions of specific practices such as kickbacks and referrals that most witnesses had advocated.<sup>27</sup> The key provision of RESPA was section 8 of the Act. In a section-by-section summary, the principal Senate Report explained

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<sup>25</sup> 1974 Hearings, *supra* note 17, at 51-53.

<sup>26</sup> See 1974 Senate Report, *supra* note 4, at 6557-68 (additional view of Senator Proxmire) (lamenting the Senate Committee's decision not to adopt price controls and noting the substantial role of industry representatives in shaping the structure of the final bill).

<sup>27</sup> For example, the House Report summarized the goals of the legislation as follows:

The bill would proceed directly against the problem [of settlement costs] pointed out above in three basic ways: (1) prohibiting or regulating abusive practices, such as kickbacks, unearned fees, and unreasonable escrow accounts; (2) requiring that home buyers be provided both with greater information on the nature of the settlement process and with an itemized statement of all settlement charges well in advance of settlement; and (3) taking steps toward the simplification of the land recordation process . . . .  
H.R. Rep. No. 1177, 93<sup>rd</sup> Cong., 2d Sess. 4 (1974).

the provision as follows:

*Prohibition against Kickbacks and Unearned Fees –*

Subsection (a) of this section prohibits any person from giving or receiving any fee, kickback, or thing of value pursuant to any agreement that business incident to a real estate settlement involving a federally-related mortgage loan shall be referred to any person.

Subsection (b) prohibits the acceptance of any portion of any charge for rendering of a real estate settlement service other than for services actually performed.

Subsection (c) provides that the section does not apply in certain enumerated situations where services are actually performed.

Subsection (d) imposes a fine of not more than \$10,000 or imprisonment for not more than one year, or both on any person who violates the provisions of this section. In addition, any person who violates the provisions of section (a) is liable in a civil action for treble damages sustained by injured parties.<sup>28</sup>

In enacting RESPA, the responsible committees explicitly relied upon the record developed in the 1972 HUD/VA Report on settlement costs. Among other things, the Senate Report quoted liberally from the 1972 HUD/VA Report's findings regarding "abusive and unreasonable practices in the real estate settlement process" as well as the "lack of understanding on the part of most home buyers about the settlement process and its costs."<sup>29</sup> In justifying the decision to prohibit kickbacks and referral fees, congressional staff drafting RESPA's legislative history drew on precisely the same examples that had previously been uncovered in the 1972 HUD/VA Report and in contemporaneous press accounts:

In a number of areas of the country, competitive forces in the conveyances industry have led to the payment of referral fees, kickbacks, rebates and unearned commissions as inducements to those persons who are in a position to refer settlement business. Such payments may take various forms. For example, a title insurance company may give 10% or more of the title insurance premium to an

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<sup>28</sup> 1974 Senate Report, *supra* note 4, at 6556.

<sup>29</sup> *Id.* at 6547.

attorney who may perform no services for the title insurance company other than placing a telephone call to the company or filling out a simple application. . . . An attorney may give a portion of his fee to another attorney, lender or realtor who simply refers a prospective client to him. . . .

In all of these instances, the payment or thing of value furnished by the person to whom the settlement business is referred tends to increase the cost of settlement services without providing any benefit to the home buyer. While the making of such payments may heretofore have been necessary from a competitive standpoint in order to obtain or retain business, and in some areas may even be permitted by state law, it is the intention of section [8] to prohibit such payments, kickbacks, rebates or unearned commissions.

Section [8](c) makes clear that section [8] is not intended to prohibit the payment by title insurance companies, attorneys, lenders, and others for goods furnished or services actually rendered, so long as the payment bears a reasonable relationship to the value of the goods or services received by the person or company making the payment. . . . The value of the referral itself (i.e., the additional business obtained thereby) is not to be taken into account in determining whether the payment is reasonable.<sup>30</sup>

## 5. Summary of Salient Points About the Legislative History

There emerges from RESPA's legislative history a fairly clear picture of the factors that led Congress to adopt Section 8's prohibition on kickbacks and unearned fees:

- First, the market for real estate settlement services was found to be infected with serious market imperfections:
  - o Home buyers only rarely purchased homes and had little knowledge of the considerable complexities of real estate settlement procedures or the appropriate costs of settlement services.<sup>31</sup>
  - o Home buyers therefore tended to rely heavily on certain industry professionals, including attorneys, brokers, and real estate developers, to select providers of settlement services.<sup>32</sup>

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<sup>30</sup> Id. at 6551.

<sup>31</sup> See text accompanying notes 14, 29. See also 1974 Senate Report, *supra* note 4, at 6557 (“The typical homebuyer is a babe in the woods with pitifully little bargaining power.”) (additional views of Senator Proxmire).

<sup>32</sup> See text accompanying note 7.

- o In many parts of the country, these industry professionals were exploiting their ability to direct the purchase of settlement services in order to extract kickbacks and unearned referral fees from the providers of settlement services.<sup>33</sup>
- Second, substantial evidence presented to Congress suggested that the cost of these kickbacks and unearned referrals fees was borne by the home purchaser (and not offset by the reduction of costs for other settlement services).<sup>34</sup> In other words, market forces were not causing these kickbacks and unearned referral fees to be offset by a reduction of other settlements costs. Rather the ultimate effect of kickback and unearned referral fees was to increase the overall cost of real estate transactions. Thus, the problem of kickbacks and unearned referral fees was directly linked to what were perceived to be excessively high costs of home purchases in certain parts of the country.
- Third, many witnesses attributed the problem of kickbacks and unearned referral fees to the absence of robust competition in certain areas of the real estate settlement industry.<sup>35</sup> In particular, where settlement service providers were unable to compete on the basis of price, industry professionals with the power to select service providers exploited that power to extract kickbacks and unearned referral fees. These payments were demanded and paid notwithstanding the existence of legal and ethical prohibitions in many parts of the country and a general acknowledgment (at least in congressional testimony) that the practices were shocking and unethical.

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<sup>33</sup> See text accompanying notes 7, 14-15, 30.

<sup>34</sup> See text accompanying note 6, 16, 23.

<sup>35</sup> See text accompanying notes 7, 25 30.

- Fourth, the problems associated with real estate settlement industry were sufficiently egregious that simple disclosure of abusive practices were not deemed to be an adequate solution to the problem. This conclusion is implicit in the structure of the legislation ultimately adopted (which includes a prohibition on kickbacks as well as elaborate disclosure rules), but it is also reflected in testimony to Congress that in some markets little effort was made to hide the existence of kickbacks and unearned referral fees and still the practice persisted.<sup>36</sup> In addition, the 1972 HUD/VA Report and contemporaneous press accounts made the practices widely publicized in the two years leading up to the enactment of RESPA and there is no indication in the legislative history – even from industry representatives – that this publicity had eliminated the problem or ameliorated its negative impact on consumers.
- Finally, the legislative history of RESPA suggests that Congress was concerned with all kickbacks and unearned referral fees, not just their payment when the overall compensation of the recipient was unreasonable. Most of the abuses at which section 8 was targeted involved payments to individuals who also provided legitimate settlement services – for example, (i) an attorney retained to handle the settlement who then makes a referral to a title insurance company willing to pay a referral fee or (ii) a real-estate developer that constructed a house and then demanded kickbacks from attorneys selected to handle the closing.<sup>37</sup> Unearned referral fees in these contexts were to be prohibited and were not

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<sup>36</sup> See text accompanying note 7 (“little is done to hide the fact that these fees are paid”).

<sup>37</sup> See text accompanying notes 7, 16, 30.

defensible on the grounds that attorneys or real estate developers performed some other sort of work on the transaction that arguably bore reasonable relationship to the total amount of compensation the recipient earned on the transactions. In other words, the legislative history suggests that Congress did not intend for the legality of payments to be dependent on the reasonableness of a party's aggregate compensation in relationship to all the services that the party provided to a transaction. Rather, the test Congress seems to have envisioned was whether the recipient performed legitimate services in connection with each payment that party received.<sup>38</sup> Indeed, an alternative interpretation would be inconsistent with the clear congressional resolve to outlaw the extraction of kickbacks and unearned referral fees by market professionals who gained the confidence of home purchasers by having some other role in the underlying real estate transactions. Moreover a legal standard that turns on the reasonableness of compensation associated with particular transaction would require courts to engage in just the sort of public rate regulation that Congress expressly eschewed in the legislative compromise under the enactment of RESPA.

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<sup>38</sup> Indeed, if one reviews the portion of the legislative history quoted *supra* note 30, Congress appears to have intended to prohibit referral fees even when the referring party expended a nominal amount of effort, such as "placing a telephone call . . . or filling out a simple application," directly related to the referral.

## **B. The Application of RESPA to Yield Spread Premiums**

### **1. Initial Administrative Response**

When Congress enacted RESPA in the mid-1970s, the practice of paying yield spread premiums to mortgage brokers had not yet developed, and indeed the role of mortgage brokers in residential mortgage financing was extremely limited. Only in the late 1980's did mortgage brokers begin to assume importance in the industry and only then did the payment of yield spread premiums become widespread in the United States until the early 1990's. At that point, the Department of Housing and Urban Development was called upon to consider the relationship between the RESPA and these payments. Initially, the agency chose to address the issue through an amendment to Regulation X, the HUD rules that implement RESPA's disclosure requirements.<sup>39</sup> In particular, the agency amended its regulations in 1992 to require that "[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" be disclosed to the borrower on the HUD-1 Settlement Statement.<sup>40</sup>

The issue that the agency did not address explicitly in 1992 was whether the payment of yield spread premium ran afoul RESPA's prohibition on kick-backs and unearned fees. As subsequent events have demonstrated, the Department's reluctance to address this question is

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<sup>39</sup> 24 C.F.R. § 3500 (1999).

<sup>40</sup> Id. Appendix B, Para. 13 (2001). For a review of this amendment process, see 62 Fed. Reg. 53,912-01 (Oct. 16, 1997) (proposed but as yet unadopted HUD safe harbor for yield spread premiums).

understandable. To begin with, the relevant statutory provisions are difficult to decipher. On the one hand, section 8(a) of RESPA prohibits the payment of “any fee, kickback, or thing of value” for the referral of a settlement service. Section 8(c), however, exempts the payment of “a bona fide salary or compensation.” Critics of yield spread premiums assert that these payments constitute referral fees prohibited under section 8, whereas the mortgage broker industry counter that they constitute “bona fide compensation.” Faced with these competing characterizations, the Department’s response in 1992 was to seek a middle ground of sort, asserting that to qualify as “bona fide compensation” under 8(c), payments must bear a “reasonable relationship to the market value of the goods or services provided.”<sup>41</sup>

*[The Balance of This Section is in Draft Form for Those Interested in the Doctrinal and Institutional Aspects of the Yield Spread Premium Controversy]*

## **2. The Onslaught of Litigation**

*HUD’s initial effort to solve the problem of yield spread premiums through disclosure requirements prove unsuccessful, and the controversy soon move to the federal courts. The early case law on the subject of yield spread premiums revealed extensive confusion over both the correct legal standard to apply and the appropriateness of class actions. One of the first pronouncements on the subject was MentECKI v. Saxon Mortgage, Inc., where, in denying the defendant’s motion to dismiss, the court “concludes that the payment of a yield spread premium is a referral prohibited*

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<sup>41</sup> 24 C.F.R. § 1500.15(g)(2) (1999). [add discussion on the difficulty of reconciling this approach with the statutory language of RESPA.]

by [RESPA Section 8].<sup>42</sup> The court based its reasoning on the fact that the defendant alleged no service that was provided in exchange for the payment, as the broker was already compensated directly from the borrower for all services rendered. Conversely, in *Barbosa v. Target Mortgage Corp.*, the court held as a matter of law that yield spread premiums were just another form of compensation for the broker and did not violate RESPA.<sup>43</sup> In granting the defendant's summary judgment motion, the district court in *Culpepper v. Inland Mortgage Corp. (Culpepper I)* held that yield spread premiums were permissible payments for goods, those goods being loans with yield spread premiums, with prices set by the market.<sup>44</sup> Many courts eschewed a *per se* ruling and, looking to Regulation X, adopted a reasonableness standard. This reasonableness inquiry was generally thought to preclude class action certification under FED. R. CIV. P. 23(b)(3) since individual issues would predominate.<sup>45</sup>

In the past several years, more than 150 lawsuits have been brought seeking class action certification under RESPA to challenge the practice of lenders making indirect payments to mortgage brokers.<sup>46</sup> Despite the fact that Section 8 of RESPA allows awards of treble damages and attorneys fees to prevailing plaintiffs, the relatively small amount of money at stake for any individual plaintiff, combined with the vast costs of litigating the practice of yield spread premiums,

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<sup>42</sup> *Mentecki v. Saxon Mortgage, Inc.*, 1997 WL 45088 (E.D. Va. 1997).

<sup>43</sup> See *Barbosa v. Target Mortgage Corp.*, 968 F.Supp. 1548 (S.D. Fla. 1997).

<sup>44</sup> See *Culpepper v. Inland Mortgage Corp.*, 953 F.Supp. 367 (N.D. Ala. 1997) [hereinafter *Culpepper I*].

<sup>45</sup> See, e.g., *Moniz v. Crossland Mortgage Corp.*, 175 F.R.D. 1 (D.Mass. 1997); *Dubose v. First Sec. Sav. Bank*, 183 F.R.D. 583 (M.D. Ala. 1997).

<sup>46</sup> See Real Estate Settlement Procedures Act (RESPA) Statement of Policy 1999-1 Regarding Lender Payments to Mortgage Brokers, 64 FR 10080, 10083 (Dep't of Housing and Urban Dev't March 1, 1999) [hereinafter HUD Policy Statement].

*renders class action certification particularly crucial in this context. Because Section 8 prohibits both the giving and receiving of any kickback or referral fee, plaintiffs can choose to sue either the mortgage broker or the lending institution.<sup>47</sup> For purposes of class action certification, determining which to sue could in theory be a complicated decision, since each mortgage broker has relationships with dozens of lending institutions, and each lending institution has relationships with many mortgage brokers. However, plaintiffs have generally sought class action certification against a single lending institution, as the outcome of the litigation may eventually turn on the agreement between the mortgage broker and the lending institution, and each lending institution generally uses the same form contract with each mortgage broker with which it has an established relationship.<sup>48</sup> The courts have yet to reach a consensus on whether the legality of yield spread premiums can be determined solely from the form contracts used.*

*Plaintiffs have typically filed for class action certification under FED. R. CIV. P. 23(b)(3), requiring the usual prerequisites of 23(a) [i.e., numerosity, commonality, typicality, and adequacy of representation] as well as a finding by the court that “questions of law and fact common to members of the class predominate over any questions affecting only individual members, and that a class action is superior to other available methods for the fair and efficient adjudication of the controversy.”<sup>49</sup> The requirements of Rule 23(a) have not usually been an impediment for plaintiffs*

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<sup>47</sup> See RESPA Section 8, codified at 12 U.S.C. 2607(a).

<sup>48</sup> See *Brancheau v. Residential Mortgage Group, Inc.*, 177 F.R.D. 655 (D.Minn. 1997) (denying plaintiff’s Motion to Amend Complaint in which it seeks to expand the proposed class to include all loans brokered by the defendant mortgage broker, regardless of the lender, as well as all loans funded by the defendant lender, regardless of the mortgage broker used, because the Motion seeks to redefine the class in such a way as to diffuse the judicial inquiry amongst the divergent loan referral practices of literally scores of brokers and lenders throughout the breadth of the nation).

<sup>49</sup> FED. R. CIV. P. 23.

*challenging yield spread premiums, as Rule 23(b)(3)'s requirement that issues common to the class predominate has been the principal obstacle. Because Rule 23(b)(3) requires the court to determine what questions of law or fact are at issue, the granting of class certification turns on what legal standard the court is to apply to judge the legality of yield spread premiums. Plaintiffs claim that the legality of yield spread premiums can be determined based upon the standard agreement between the lending institution and the its correspondent mortgage brokers. Defendant lending institutions generally argue that class certification is inappropriate because the goods and/or services provided by the mortgage broker will vary with each individual loan transaction, thus requiring individual questions of law and fact to predominate.*

*In January of 1998 the Eleventh Circuit, becoming the first and as yet only Court of Appeals to address the issue of yield spread premiums, reversed the district court's granting of summary judgment in Culpepper I and vacated the denial of class certification.<sup>50</sup> The court held that yield spread premiums could be prohibited referral fees under Section 8(a), and that Section 8(c)'s exemption for compensation for goods provided or services performed was inapplicable in the present case. Interpreting Regulation X, the court articulated a two-pronged test to be used to determine the legality of yield spread premiums. First, were goods or services provided in exchange for the yield spread premium. If not, then the payment is a prohibited referral fee. If goods or services were provided, the court would go on to examine the reasonableness of the fees, presumably on a transaction-by-transaction basis.*

*The Circuit Court first rejected the logic of Moniz and other precedents that yield spread*

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<sup>50</sup> See *Culpepper v. Inland Mortgage Corp.*, 132 F.3d 692 (11<sup>th</sup> Cir. 1998) [hereinafter *Culpepper II*].

*premiums constituted payments for goods, the good being the loans. In rejecting the claim that a good was provided, the court noted that the Culpepper's loan was table-funded, meaning that the mortgage broker did not initially fund the loan and then sell it to the lender. Rather, "in table-funded transactions the lender, not the broker, owns the loan from the outset. [The mortgage broker] could not sell the Culpeppers' loan to [the lender] because [the lender] already owned it." Since the loan itself could not be the good provided in exchange for the payment, the defendant also tried to argue that the right to direct the business constituted an ownership interest that qualified as a good. This argument, too, was rejected by the court, with the court noting that this would have the effect of nullifying Section 8 of RESPA since any referral fee could be justified on these grounds.*

*Having found that the yield spread premium was not a payment for a good, the Circuit Court then went on to find that it was also not a payment for a service rendered. Although the court admitted that the mortgage broker had provided valuable services to the borrower, it noted that the payments to the broker directly from the borrower were intended to compensate the broker fully for these services. In addition, the court noted that the method by which yield spread premiums are calculated (based on the loan's amount of interest above the par rate) proved that the only difference in services provided for a loan with a yield spread premium as opposed to a loan without one is in the value of the referral. Since there is no meaningful difference in services provided, the payment cannot be for any service performed by the mortgage broker.*

*By rejecting other courts' market-value tests in favor of a two-pronged test first requiring that a good or service be provided in exchange for the payment at question, the Circuit Court made the granting of class certification much more likely. Where the reasonableness of a fee is the central*

issue, class certification seems inappropriate since each transaction will inevitably have different services performed by the mortgage broker. However, where the issue is if any good or service was provided in exchange for the payment, questions common to the class could conceivably predominate, thus making class certification possible.

### 3. **The HUD Policy Statement of 1999**

After the Eleventh Circuit issued its decision in *Culpepper II*, there was a flurry of litigation as plaintiffs sought to utilize this new two-pronged test and the favorable precedent to obtain class certification. As a direct result of the uncertainty surrounding the legality of yield spread premiums after *Culpepper II* and its progeny, Congress ordered HUD to make its views on the subject known. The two-pronged test HUD articulated in Policy Statement 1999-1 requires a court to ask, first, “whether goods or facilities were actually furnished or services actually performed for the compensation paid.”<sup>51</sup> “The second question is whether the payments are reasonably related to the value of the goods or facilities that were actually furnished or services that were actually performed.”<sup>52</sup> HUD elaborates that, in utilizing this test, total compensation is to be examined and not simply the yield spread premium payment itself.

In explaining the first prong of the test, HUD provides a non-exhaustive list of services that mortgage providers typically provide that HUD deems compensable.<sup>53</sup> In addition to these services, HUD also recognizes that mortgage brokers may provide goods (such as appraisal, credit reports,

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<sup>51</sup> HUD Policy Statement, 64 FR 10080, 10084.

<sup>52</sup> *Id.*

<sup>53</sup> *Id.* at 10085.

or other documents) or facilities in exchange for the total compensation. HUD has declared that while these and other goods may be compensable, the loan itself cannot be described as a good provided by the broker to the lender, at least not in table-funded transactions.

*In elaborating on the reasonableness test, HUD explains:*

*If the payment or a portion thereof bears no reasonable relationship to the market value of the goods, facilities, or services provided, the excess over the market rate may be used as evidence of a compensated referral or an unearned fee in violation of Section 8(a) or (b) of RESPA. Moreover, HUD also believes that the market price used to determine whether a particular payment meets the reasonableness test may not include a referral fee or unearned fee, because such fees are prohibited by RESPA.<sup>54</sup>*

*HUD also notes that while RESPA is not a rate-making statute, HUD is authorized to ensure that payments such as yield spread premiums are reasonably related to the value of the goods or services provided, and are not compensation for the referrals of business, splits of fees, or unearned fees.<sup>55</sup>*

*The policy statement purports to “provide[] HUD’s views of the legality of fees to mortgage brokers from lenders under existing law,”<sup>56</sup> and sets forth a two-prong test for legality. In a subsequent letter, HUD explained that in accord with this language, it “did not intend for the Policy Statement to create a new legal standard or to change existing law.”<sup>57</sup> Because of this letter, courts*

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<sup>54</sup> Id at 10086.

<sup>55</sup> Id. at 10086.

<sup>56</sup> Id. at 10084.

<sup>57</sup> Letter from Gail Laster, HUD General Counsel, to Hon. Bruce Vento, dated December 17, 1999.

have disagreed on the impact of HUD's Policy Statement and whether it is binding legal authority.

#### 4. *Litigation Since the HUD Policy Statement*

*Although the HUD Policy Statement was in response to a directive from Congress for HUD to clarify its views on the issue of yield spread premiums, the Policy Statement appears to have raised more questions than it answered for the courts. As one court recently put it, "In short, the HUD Policy Statement has not resolved the struggle by the courts to determine the proper legal standard to apply in RESPA yield spread premium cases."<sup>58</sup> The biggest question faced by the courts is whether the tests set out in *Culpepper II* and the HUD Policy Statement conflict, and, if so, which one controls.*

*Faced with this question, the majority of district courts have found that the HUD test is more favorable to the lenders than the *Culpepper II* test.<sup>59</sup> For example, the court in *Levine v. North American Mortgage* stated that, "[w]hile not a model of clarity, the first step in the [HUD Policy] Statement's analysis addresses simply whether any goods or services were actually furnished or performed, rather than, as under analysis suggested in *Culpepper*, whether the goods or services the broker provided can be tied directly to the payment."<sup>60</sup> Courts finding the HUD Policy Statement test to be more favorable to the lenders have also found it to be nonetheless a rational*

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<sup>58</sup> *Marbury v. Colonial Mortgage Co.*, 2001 WL 135719, at \*8 (M.D. Ala. 2001).

<sup>59</sup> See, e.g., *Levine v. North American Mortgage*, 188 F.R.D. 320 (D.Minn. 1999); *Golon v. Ohio Sav. Bank*, 1999 WL 965593 (N.D. Ill. 1999); *Potchin v. Prudential Home Mortgage Co., Inc.*, 1999 WL 1814612 (E.D.N.Y. 1999) (all adopting an interpretation of the HUD Policy Statement that is more favorable than their interpretation of the *Culpepper* test, finding the agency regulation to be binding on them).

<sup>60</sup> *Levine*, 188 F.R.D. at 326.

*agency interpretation of RESPA that is neither arbitrary and capricious nor manifestly contrary to the purposes of the statute, and thus deserving of deference.*<sup>61</sup>

*Conversely, some courts have read the HUD Policy Statement to be in accord with the Culpepper II analysis, and that the Policy Statement was thus a restatement of the law. In disagreeing with the aforementioned courts that a difference exists between the first prong of the two tests, these courts have relied upon a variety of arguments. One line of reasoning argues that the defendant's interpretation of the HUD Policy Statement, requiring merely a showing that services were performed, cannot be what was intended by HUD since to do so would be contrary to the language of RESPA. The argument asserts that this view of the Policy Statement would actually allow some referral fees and kickbacks, those a court later finds to be "reasonable." Section 8 (a), it is argued, bans all kickbacks and referral fees, whether or not they are reasonable. As one court phrased it, "The ultimate result of this system would render the referral fee prohibition moot. Courts could no longer consider the nature of the fee, only the totality of the "compensation".<sup>62</sup> A referral fee could be legal, the argument goes, if the lender can subsequently prove that the total compensation was reasonable, perhaps because of fortuitously finding that an extra settlement service was in fact performed on a loan with a yield spread premium.*

*Another theory advanced by plaintiffs to prove that the two tests are equivalent relies upon a theory about what the HUD Policy Statement means in the first prong when requiring that goods or services be provided for the compensation. Several courts have focused on the word "for" and*

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<sup>61</sup> See note 21, supra.

<sup>62</sup> Heimmermann v. First Union Mortgage Corp., 188 F.R.D. 403, 406 (N.D. Ala. 1999).

read it to mean that HUD requires a payment to be in exchange for services rendered. In requiring this *quid pro quo*, at least one court<sup>63</sup> has focused on a letter sent by HUD to Representative Bruce Vento in which HUD explains:

*HUD's position is that for a payment from a lender to a mortgage broker to be permissible under RESPA: (1) goods or facilities must have been furnished or services must have been performed "for"—i.e., in exchange for—the compensation paid to the broker; and (2) the broker's compensation must be reasonably related to the value of the services performed, or the goods or facilities provided, by the broker.*<sup>64</sup>

One commentator, Robert Jaworski, has criticized this line of reasoning as being faulty on several grounds.<sup>65</sup> For one thing, Jaworski notes, the HUD Policy Statement's first prong requires that goods or services be provided for (indeed, even in exchange for) the total compensation of the broker. Jaworski asserts the court mistakenly interpreted the first prong as requiring that there be a *quid pro quo* for the yield spread premium as opposed to the total compensation. In support of this claim, Jaworski notes that the HUD Policy Statement states that for the first prong, "the threshold question is whether there were goods or facilities actually furnished or services actually performed for the total compensation paid to the mortgage broker."<sup>66</sup> Jaworski also argues that HUD has rationally differentiated between mortgage brokers, whose essential service provided to

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<sup>63</sup> Perry v. Mid South Mortgage, Inc., Civil Action No. CV-98-3205-W (N.D. Ala. Aug. 30, 2000).

<sup>64</sup> Letter from Gail Laster, HUD General Counsel, to Hon. Bruce Vento, dated December 17, 1999. At least one commentator has asserted that this letter constitutes a clear rejection by HUD of the lenders' interpretation of the HUD Policy Statement. See David R. Donaldson, *RESPA Yield Spread Premium Litigation: A Brief History*, Search Term Begin Search Term End 1242 PLI/CORP 203 (2001).

<sup>65</sup> See Robert M. Jaworski, *RESPA Section 8: The YSP Waiting Game Continues*, 56 BUS. LAW. 1207 (May, 2001).

<sup>66</sup> 64 FR 10080, 10085 (emphasis added)

*borrowers is a referral of a loan, and other settlement service providers. Jaworski fails to note that the HUD Policy Statement does not list the referral of a loan to a lender as a compensable service; indeed, the Statement actually states that HUD has expressed “concern that a fee for steering a customer to a particular lender could be disguised as compensation for ‘counseling- type’ services.”<sup>67</sup> Thus, it would appear that HUD has not, in fact, declared the referral of a loan to be an essential and compensable service provided by mortgage brokers.*

*Most recently, the Eleventh Circuit again moved to the forefront of the yield spread premium debate by upholding a class certification by the district court in the Culpepper litigation.<sup>68</sup> In upholding the class certification, the court admitted that in deciding whether class certification was appropriate, it had to settle on a rule of liability for yield spread premiums. The court then proceeded to discuss the defendant’s position (contending, as usual, that the HUD Policy Statement is less stringent and controlling in this context), as well as the plaintiff’s position that the two tests are equivalent. In finding the plaintiff’s position to be the correct one, the court relied upon both the arguments previously discussed that have been used to uphold the Culpepper test. First, the court found that the first prong of the HUD Policy Statement test required a quid pro quo of goods or services provided in exchange for the payment of the yield spread premium. Although not relying on the Laster letter for this finding, the court nonetheless came to the same conclusion as Judge Clemon in *Perry v. Mid South Mortgage, Inc.* In *Culpepper III*, the Court of Appeals also found that the defendant’s reading of the HUD Policy Statement’s first prong, allowing any service provided to be enough to justify payments, as running afoul of the purpose of RESPA Section 8(a). “If*

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<sup>67</sup> Id.

<sup>68</sup> See *Culpepper v. Irwin Mortgage Corp.*, 253 F.3d 1324 (11<sup>th</sup> Cir. 2001) [hereinafter *Culpepper III*].

*[defendant] has read the HUD Statement correctly, however, HUD has now decided that § 8(c) deems some such referral fees legal--that is, referral fees that are paid by lenders and that would be reasonable service fees, if that's what they were.*"<sup>69</sup>

*As Culpepper III makes clear, the debate over the legality of yield spread premiums is far from over. Although a majority of district courts in other circuits have adopted the less stringent interpretation of the HUD Policy Statement generally urged by lenders, the Eleventh Circuit Court of Appeals and a majority of district courts within it have determined that the first prong of the HUD Policy Statement is merely a re-articulation of the first prong of the original Culpepper II analysis. Although most of the recent decisions ostensibly address only the appropriateness of class certification, as the Culpepper III court noted, "[w]hether transaction-specific evidence is necessary or relevant, of course, depends on the rule of liability."*<sup>70</sup>

*As to the merits of paying yield spread premiums, defendants defend the practice by asserting that it allows consumers to obtain loans with reduced/zero upfront costs. Plaintiffs generally argue that the mortgage brokers have already received full compensation for their services from the origination fee and other fees paid directly by the borrower, and so the yield spread premium constitutes a prohibited referral fee or kickback. The fact that the yield spread premium is calculated solely based on the higher interest rate on above-par loans, plaintiffs assert, proves that it cannot be based upon services rendered. One commentator put the plaintiffs' usual claim thusly:*

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<sup>69</sup> Id., at 1330. (emphasis in original).

<sup>70</sup> Id. at 1328 (citations omitted).

*[T]he lenders' argument that YSPs are paid for services rendered is not always true. YSPs vary not by the quantum of services provided, but by how aggressive the broker/lender may be and how little the consumer knows.<sup>71</sup>*

### **5. Pending Reform Initiatives**

*In its policy statement, HUD reiterates that it believes RESPA is in need of reform, and that appropriate reforms would go a long way towards resolving the confusion over the legality of yield spread premiums. In October 1997, HUD published a proposed rule proposing a qualified safe harbor for payments to mortgage brokers under Section 8.<sup>72</sup> The proposal would have HUD presume broker fees, both direct and indirect, to be legal so long as a broker enters into a contract with consumers explaining the broker's functions and the total compensation the broker would receive in the transaction before the consumer applied for the loan. The proposed rule would also require a test, as yet undeveloped, to ensure that the safe harbor would not preclude unreasonable fees.*

*Other proposed reforms HUD feels would resolve the issue of the legality of yield spread premiums are contained in the July 1998 joint report of HUD and the Board of Governors of the Federal Reserve,<sup>73</sup> containing legislative proposals to reform RESPA and the Truth in Lending Act. The HUD/Federal Reserve report recommended that lenders and mortgage brokers give consumers either a guarantee of the closing costs of the loan or a more accurate good-faith estimate. Those*

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<sup>71</sup> Barren E. Ramos, *Materials on Residential Mortgage Litigation Preface*, 1242 PLI/CORP 203, 206 (2001).

<sup>72</sup> Codified at 62 FR 53912.

<sup>73</sup> See Joint Report of HUD and Federal Reserve Board on Reform Proposals for the Truth in Lending Act and Real Estate Settlement Procedures Act, available at <http://www.federalreserve.gov/boarddocs/RptCongress/tila.pdf> (August 09, 2001).

*choosing to provide a guarantee of closing costs would receive a safe harbor from Section 8 litigation challenging the legality of these costs. In general, the report recommends fuller disclosure of all costs related to the mortgage loan, and that such disclosure occur earlier in the mortgage application process to facilitate comparison-shopping by consumers. To date, these proposed reforms have not been adopted, leaving the HUD Policy Statement 1999-1 as the agency's most definitive guideline for determining the legality of yield spread premiums.*

## **Part II: The Trilateral Dilemma of Financial Regulation**

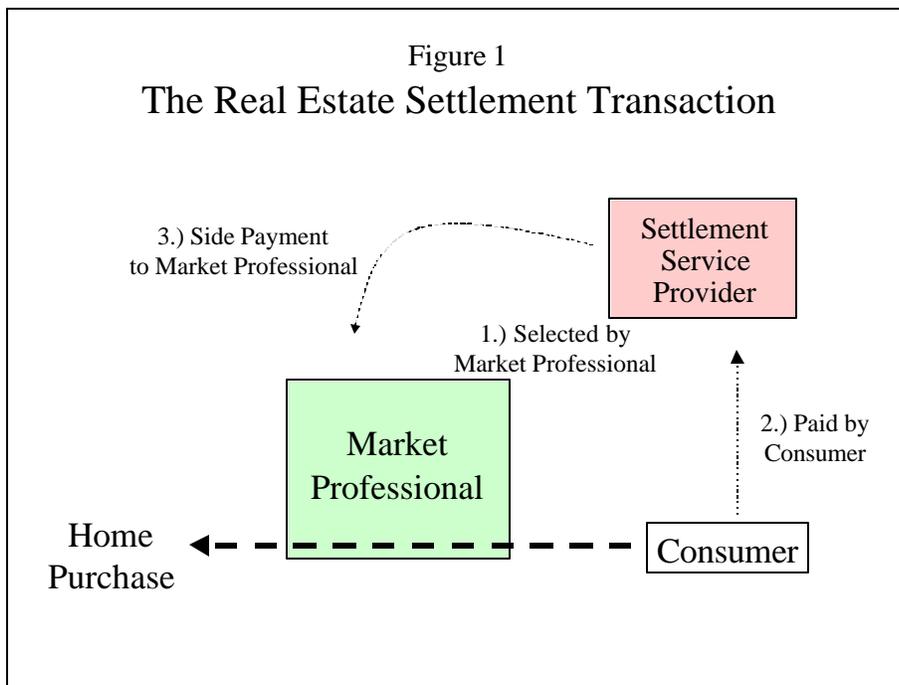
The problem that Congress confronted with the enactment of RESPA in 1974 is a common phenomenon in the financial services industry. In many different kinds of financial transactions, market professionals occupy positions that permit them to extract other side payments as a result of their capacity to steer the financial decisions of members of the general public. Regulatory problems of this sort typically involve three separate parties: a consumer, a market professional with authority to make or influence decisions made on the consumer's behalf, and a third party who will profit from those decisions and can also make side payments to the market professional in order to influence the professional's decision. In these situations, consumers are ill-equipped to prevent market professionals from exploiting their power to demand side payments in abusive and economically wasteful ways. Reflecting the three-cornered nature of these transactions and the quandary they pose for consumers, we call this kind of problem the trilateral dilemma of financial regulation.

We begin this part with a restatement of the problem of settlement costs as an illustration of a trilateral dilemma and then discuss the reasons why usual competitive forces cannot be expected to solve these problems. As this analysis makes clear, the considerations that led Congress to enact RESPA in the first place are quite similar to the reasons why real estate settlement presents a trilateral dilemma. In the second section, we review several other regulatory contexts in which similar problems arise and summarize how Congress and regulatory agencies have attempted to deal with trilateral dilemmas in other contexts. As we will explain, RESPA's combination of disclosure requirements and anti-kickback rules is characteristic of the kinds of government interventions used

to deal with the recurring problem of trilateral dilemmas in the financial services industry. We conclude this part by locating the payment of yield spread premiums within this framework.

### A General Description of the Problem of Real Estate Settlement Services

As documented in the legislative history of RESPA, real estate settlement transactions present a classic illustration of the trilateral dilemma. Consumers typically become involved in the settlement process when they purchase a new home, a major financial commitment and one that typically occurs only a limited number of times in any individual's lifetime. To effect these



transactions, consumers rely upon a variety of market professionals – attorneys, realtors, developers, etc. – to provide certain services and offer guidance with respect to other aspects of the transactions. Often, this guidance involves the selection of

other settlement service providers, including, for example, title insurance companies and attorneys. While the market professionals play a role in selecting among a range of possible settlement service providers, the consumer pays the cost of those services. And, again as documented in the legislative

history of RESPA, service providers in the early 1970's often received side payments (kickbacks and unearned referral fees) as a reward for selecting particular third-party service providers. Figure 1 illustrates these relationships, noting (1) the market professional's selection of a service provider; (2) the consumers's payment of the provider's fees; and (3) the third party's side payment to the referring market professional. The dilemma for the consumer is that market professionals face strong incentives to select the settlement service provider that makes the largest side payment as opposed to the one that offers the best and most cost-effective services for the consumer.

While the preceding paragraph and accompanying figure reflect the problem of real estate settlement services in RESPA's legislative history, one might wonder why ordinary market forces do not protect consumers in this context. For example, if settlement service providers are making side payments to market professionals won't market professionals then lower their own charges to consumers? And if some market professionals do not make these offsetting reductions, won't other market professionals come forward who are willing to make offsetting reductions in their charges and then won't consumers migrate to these lower cost providers?

From the legislative history of RESPA, it is clear that Congress did not believe that market forces were operating in this way in the real estate settlement industry. At multiple points in the congressional reports, testimony at hearings, and administrative documentation such as the 1972 HUD/VA Report, the point was made that kickbacks and unearned referral fees were not being offset by lower charges in other contexts, but rather were increasing the overall costs of home purchases for American consumers.<sup>74</sup> There are ample theoretical grounds to believe that this

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<sup>74</sup> See text accompanying note 6, 16, 23.

congressional judgment was sound.

First, for market mechanisms to work in this context, consumers must have some understanding of the services they are acquiring and the price those services should cost. As the congressional record demonstrates, however, consumers typically are not sophisticated about real estate settlement services nor are they likely to have good information about the appropriate price for particular services. In the words of Senator Proxmire, they are “babe[s] in the woods.”<sup>75</sup> Under these circumstances consumers have a limited ability to police the costs of settlement services or punish market professionals who encourage them to pay excessively high settlement costs.

Second, the legislative history of RESPA emphasized the position of trust and power that market professionals often assume in real estate settlement transactions. The congressional record suggests that consumers typically allow themselves to be guided by the advice of market professionals in selecting service providers. Indeed, it is precisely this power of the selection that permitted market professionals to obtain kickbacks and unearned referral fees in the first place. The existence of this relationship of trust and reliance further diminishes the likelihood that consumers will carefully monitor the cost of settlement service providers these trusted market professionals select.

Third, the multi-faceted nature of real estate settlement transactions further complicates the operation of market forces in this context. As the legislative history of RESPA documents, consumers in real estate transactions are purchasing a wide array of settlement services, each with

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<sup>75</sup> See *supra* note 31.

its own price and value. In addition, there is the real estate transaction itself, which will involve much more money and will therefore be much more significant for the consumer than any particular settlement service. There is ample evidence in economic literature that when faced with such complex, multi-faceted transactions, consumers will tend to limit their attention to one or two of the most salient factors, such as the home purchase itself and perhaps the selection of a single market professional upon whom to rely for advice and guidance.<sup>76</sup> Under these circumstances, it is not surprising that consumers do not carefully monitor prices of individual settlement services.

Finally, the “mysterious” nature of settlement services and kickbacks allows market professionals to discriminate in the price they charge different kinds of consumers. For customers who are sophisticated – for example those who know about the existence of side payments and the possibility of offsets in other professional fees – the market professionals can lower their prices. For other less sophisticated consumers, market professionals can simply pocket the side payment. Price discrimination of this sort disrupts ordinary market forces and reduces the likelihood that competitive pressures will work to the benefit of all consumers, particularly those who are less informed.

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<sup>76</sup> There is extensive academic literature on this subject. See, e.g., Jonathan Baron, *Thinking and Deciding* 295-97 (3<sup>rd</sup> ed. 2000) (discussing how decision making may be affected when multiple decisions are integrated); Robin Hogarth, *Judgement and Choice* 82-83 (2d ed. 1987) (discussing the limited ability of individuals to deal with complex decisions); Scott Plous, *The Psychology of Judgment and Decision Making* 94-95 (1993) (reviewing evidence that consumers often “satisfice” rather than optimize when faced with certain decisions).

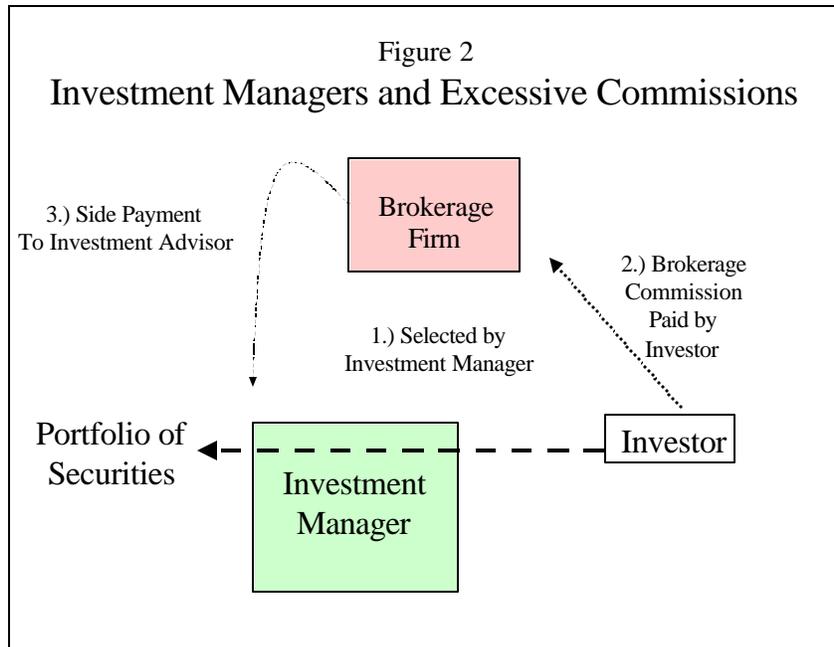
**B. Illustrations of the Trilateral Dilemma in Other Financial Contexts**

We now briefly review several other illustrations of the trilateral dilemma in other financial contexts. Each is structurally similar to the problem of real estate settlement transactions, and each offers another instance in which Congress and regulatory officials have chosen to intervene to protect consumers rather than relying on mere disclosure or ordinary mechanisms of market control.

**1. Investment Managers and Investors**

In the financial services industry, one of the best known examples of a trilateral dilemma involves the relationship between investment managers and the investing public. Investors often

rely on mutual fund companies and other firms to invest their savings in securities markets. In this capacity, investment managers typically make a number of decisions about the investor’s portfolio, including the decision of which brokerage firm to hire to do the actual buying and selling



of securities on stock exchanges and in other markets. These brokerage firms earn a commission on each purchase or sale of security and the cost of that commission is passed on to the investor.

In the late 1960's and early 1970's, investors discovered that investment managers were receiving substantial side payments from brokerage firms, particularly for transactions involving retail investors. A flood of lawsuits ensued, and a number of prominent investment firms were found liable for breaching their fiduciary duties to investors.<sup>77</sup>

As illustrated in Figure 2, side payments to investment managers in exchange for the selection of certain brokerage firms is a classic illustration of a trilateral dilemma. The investment manager's control over an investor's portfolio includes the authority to select brokerage firms (1). The costs of the brokerage firm's commissions is passed on to the investor (2). And the investment manager profits through the receipt of side payments from the brokerage firm (3). There are, in addition, reasons to believe that ordinary market forces will not easily correct the problem. To begin with, the mechanisms for making the side payments were, for many years, not well publicized and difficult for consumers to understand. Particularly the fact that larger, institutional investors were getting offsets for the arrangements was not known to most consumers. Furthermore, the complexity of the transaction diminished the ability of consumers to police the behavior of investment advisors. The investors' principal concern, after all, was for the performance of their underlying portfolio of securities, not the payment of relatively small commissions paid to brokerage firms. In addition, there was the relationship of trust and reliance between the investor and his or

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<sup>77</sup> This litigation and its aftermath is discussed in Howell E. Jackson & Edward L. Symons, Jr., *The Regulation of Financial Institutions* 755-65, 851-70 (1999). Also discussed in that book is a more recent permutation of this problem: payment for order flow from alternative trading markets to brokerage firms. See *id.* at 796-810. To date, federal regulators have dealt with this problem principally to the imposition of additional disclosure requirements, but more intrusive forms of regulation have also been proposed. See Allen Ferrell, *A Proposal for Solving the "Payment for Order Flow" Problem*, 74 *S. Cal. L. Rev.* 1027 (2001).

her investment manager, heightened by the fiduciary obligations imposed on the investment manager.

Congress addressed this problem, which has come to be known as “soft dollar” arrangements, in 1975. In addition to taking steps to encourage market forces to lower the level of all brokerage commissions, Congress enacted section 28(e) of the Securities Exchange Act of 1934, a new legal regime limiting the circumstances under which an investment manager could receive side payments from a brokerage firm charging a commission higher than otherwise available commissions.<sup>78</sup> In essence, section 28(e) sanctions side payments to investment managers only if they are made in the form of research services which are used to benefit the manager’s investment accounts. Even then, the investment manager is required to make certain periodic disclosures about these side payments, and over the years the Securities and Exchange Commission has expanded the scope and detail of these disclosures.<sup>79</sup> In practice, the effect of section 28(e) has been to prevent investment advisors from obtaining other kinds of side payments from brokerage firms.

## 2. Corporate Sponsors of 401(k) Plans

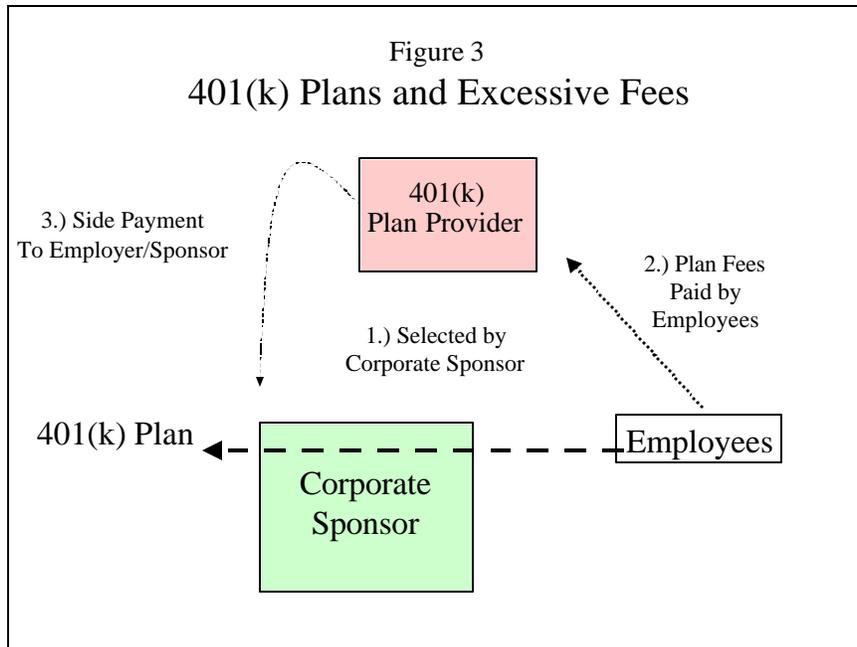
Another illustration of a trilateral dilemma arises in the context of 401(k) retirement savings plans that corporations are increasingly offering their employees instead of more traditional

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<sup>78</sup> 15 U.S.C.A. § 78bb(e) (West 2001).

<sup>79</sup> See Inspection Report on the Soft Dollar Practices of Broker-Dealers, Investment Advisers and Mutual Funds (Sept. 22, 1998) (report of the SEC Office of Compliance, Inspections and Examinations) (available at <<http://www.sec.gov/news/studies/softdolar.htm>>). See also Thomas P. Lemke & Gerald T. Lins, *Soft Dollars and Other Brokerage Arrangements* 61 (1999).

forms of pension plans. Although 401(k) plans are designed to encourage retirement savings for workers, only their employers can establish or sponsor these plans. And, when a corporation sponsors a 401(k) plan it must choose from among a host of companies that provide the services



necessary to run a 401(k) plan, including various administrative and bookkeeping functions as well as the management and investment of the employee's retirement savings. Typically, these 401(k) service providers are compensated through annual

fees charged to participating employees or deducted from their account balances. In recent years, the financial press and regulatory authorities have focused on the fact that 401(k) service providers are making side payments to corporate sponsors of 401(k) plans by assuming various administrative functions that the corporate sponsor would otherwise have to bear itself.<sup>80</sup> The 401(k) plan provider

<sup>80</sup> See Study of 401(k) Plan Fees and Expenses (Apr. 13, 1998) (study of the Department of Labor, Pension and Welfare Benefits Admin.) [hereinafter 1998 Study of 401(k) Fees] (available at <<http://www.dol.gov/dol/pwba/public/pubs/401kRept.pdf>>); Don't Minimize Differences In 401(K) Expenses, Sun-Sentinel Ft. Lauderdale, Nov. 17, 1997. See also Yolanda Sayles, ERISA Section 404(C) Plan Fees and Expense: Is There An Affirmative Fiduciary Duty to Disclose?, 25 Wm. Mitchell L. Rev. 1461, 1470 (1999).

then recovers the cost of these payments by charging the employees higher fees on their 401(k) plans.

Again, this situation has the hallmarks of a trilateral dilemma. (See Figure 3.) The corporate sponsor selects the 401(k) plan provider (1); the cost of the provider is borne by the employees through annual 401(k) plan fees (2); and the plan provider makes side payments to the corporate sponsor in the form of additional administrative services (3). The kinds of market imperfections outlined in previous examples are also present here. Many employees will not be sophisticated about 401(k) fees and cannot be expected to police costs in a meaningful way. In addition, the transactional setting is complex and multi-faceted. Not only is the employee's primary financial concern with the overall performance of his or her retirement savings, but there is the added complexity of the employment relationship surrounding the transactions. How realistic is it to expect employees to change jobs because of higher-than-average fees on an employer's 401(k) plan or even to check the nature of retirement benefits at this level of detail before accepting a job in the first place?

As a result of these problems, the Department of Labor recently undertook a number of actions to respond to perceived abuses in the area. In addition to publishing a series of substantial studies of the subject, the Department has produced a model disclosure form that employers can now use to explain 401(k) fees to employees.<sup>81</sup> The Department clarified its position that the federal statute governing retirement savings – the Employee Retirement Income Securities Act of 1974 –

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<sup>81</sup> Charles Lerner, Department Of Labor Enforcement Developments, SF53 ALI-ABA 245, 251 (2001).

establishes substantive duties on corporate sponsors to act in the best interest of participating employees and to search for 401(k) plans that minimize costs for employees.<sup>82</sup> Corporate sponsors who breach these duties are subject to a variety of penalties, including government enforcement actions and private litigation. In sum, the governmental response to this trilateral dilemma was a combination of disclosure and substantive prohibitions.

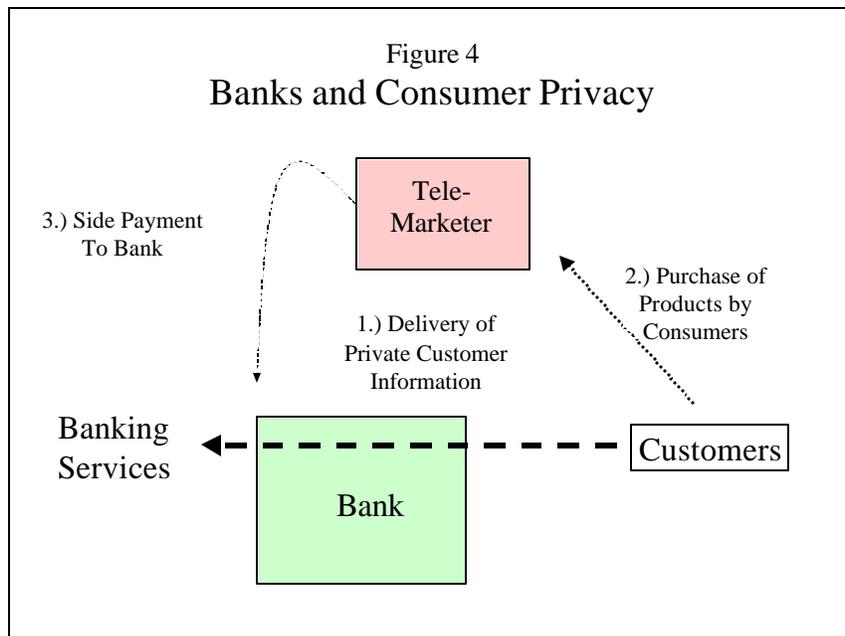
### **3. Financial Institutions and Private Consumer Information**

A final and quite recent example of a trilateral dilemma concerns misuse of private consumer information on the part of financial institutions. Over the past few years, there have been an increasing number of reports of financial institutions selling private consumer financial information to third party vendors – often telemarketing firms. This information can include information about the consumer’s finances and spending patterns, credit card information, and even (in the case of insurance companies) information about a consumer’s health and medical conditions. The third parties then use this information to market products to the consumers, and recover the cost of purchasing the private information through the sale of products and services.

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<sup>82</sup> See 1998 Study of 401(k) Fees, *supra* note 79, at 39-40.

These practices present an extreme form of the trilateral dilemma, illustrated in Figure 4. A bank (or other financial institution) obtains a variety of private information about consumers in the course of ordinary banking relationships. The bank can then decide which telemarketers or other third parties to whom to provide this information (1), and then that firm uses the information to sell products and services to the consumer (2). The third-party telemarketer compensates the bank, presumably from profits derived as a the result of its marketing efforts to bank customers (3). As with other instances of the trilateral dilemma discussed above, there are a host of reasons to suspect that these practices do not serve the best interest of consumers. To begin with, banks seldom disclosed that they were selling information in this manner nor did telemarketers typically disclose from where they had obtained a consumer's name or other contact information. In addition, even



if a consumer somehow discovered that its bank was disclosing information in this way, it might be difficult or costly for the customer to change banks just because of this practice.

Because market forces did not seem likely to protect consumer

interests in this area, Congress in 1999 passed a new law regulating how financial institutions deal

with confidential consumer information.<sup>83</sup> Essentially, the legislative response has two components. First, financial institutions are now required to make periodic disclosures to consumers about their privacy policies and, in particular, whether they make private consumer information available to third parties. (These statements are being distributed for the first time this year.) Second, Congress gave a consumer the unconditional right to “opt out” of any institution’s plan to share certain private information about that consumer with third parties. If a consumer exercises this opt-out right, the financial institution is not allowed to profit from selling that consumer’s private information to other third parties. Again this substantive right is granted to consumers in addition to the right to obtain periodic disclosures about the privacy policies of banks and other financial institutions.

### **C. Locating the Payment of Yield Spread Premiums within this Framework**

Against this background, we turn now to the practice of paying yield spread premiums at issue in this litigation. We first explain how the basic structure of the practice satisfies the formal requirements of a trilateral dilemma outlined above. We then consider whether it is plausible that the institutional context in which yield spread premiums are paid reflects the sort of market imperfections that originally motivated Congress to enact RESPA in 1974 and that are generally associated with trilateral dilemmas in other area of the financial services industry.

#### **1. Formal Requirements of a Trilateral Dilemma**

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<sup>83</sup> See Gramm-Leach-Bliley Financial Modernization Act of 1999, Title V, Pub. L. No. 106-102, 113 Stat. 1338 (1999). See also Priscilla A. Walter, Privacy Provisions of Gramm-Leach-Bliley: No Small Compliance Task, ABA Bank Compliance, May/June 2000, at 7.

In many respects, the phenomenon is quite similar to the kinds of real estate settlement practices that prompted Congress to enact RESPA in 1974. A consumer, who is in the process of purchasing or refinancing a home or other property, comes to a mortgage broker for assistance in obtaining a mortgage. The mortgage broker provides an array of services to the consumer, including helping the consumer complete a variety of application forms, hiring other providers of settlement services (such as appraisers and title insurance companies), and working through various other issues that may arise in the course of the transaction.<sup>84</sup> One of the mortgage broker's responsibilities is to recommend a lending institution to finance the consumer's mortgage.<sup>85</sup> Typically, mortgage brokers have correspondent relationships with a larger number of lending institutions. As a large number of factors are relevant in determining which lending institution is selected for any particular consumer, the mortgage broker has considerable latitude in selecting a lending institution for a particular consumer. Individual consumers, therefore, are heavily dependent upon mortgage brokers to select lending institutions in an appropriate manner.

Lending institutions on the other hand have strong incentives to originate as many mortgages as possible and therefore have incentives to compete to get as many referrals from

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<sup>84</sup> The Department of Housing and Urban Development has identified fourteen different kinds of services that might be provided in connection with a loan origination. See RESPA Statement of Policy 1999-1 Regarding Lender Payments to Mortgage Brokers, 64 Fed. Reg. 10,080, 10,085 (Mar. 1, 1999). See also Deposition of Ronald Altman 12 (July 8, 1998) (explaining that a borrower's "situation and his goals" determine selection of lending institution).

<sup>85</sup> Industry surveys have estimated that the average mortgage broker has correspondent relations with 20 lending institutions. See Mortgage Brokers 1998 at 9 (May 1999) (report prepared by Wholesale Access) [hereinafter Wholesale Access Report].

mortgage brokers as possible. Profits of lending institutions derive from two basic sources: Profits from the resale of mortgages into the secondary mortgage market and ancillary benefits from originating loans.

- *Mark-Up on Resale into the Secondary Market:* Nowadays, lending institutions typically do not retain mortgages on their balance sheet. Instead, shortly after a mortgage is originated, the lending institution resells the mortgage on the secondary mortgage market as part of a mortgage pool. Lending institutions typically offer to finance mortgages at a rate that will allow them to make a standard amount of profit when the mortgage is sold in the secondary market.<sup>86</sup> So the more mortgages a lending institution originates, the greater its profits.
- *Ancillary Benefits:* In addition to profiting from the resale of mortgages into the secondary market, lending institutions derive certain other benefits from originating new mortgages.<sup>87</sup> The most important of these are “mortgage servicing rights” – that is the right to provide a variety of administrative services over the repayment period of the mortgage.<sup>88</sup> This right is valuable because mortgage service providers are paid

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<sup>86</sup> The pricing models of defendant lending institutions are discussed in Deposition of Phillip Miller 21-23, 27, 44 & pricing sheet attachment (May 24, 2001); Deposition of Steven Kapp 13 (May 19, 1998); Deposition of David Pritchard at 44, 47 ( Mar. 11, 1998) . For purposes of our analysis in this report, we assume the accuracy of the claim that the re-sale profit of lending institutions do not vary with respect to the interest rate or yield spread premium associated with the individual mortgages.

<sup>87</sup> These additional benefits and their impact on the calculation of yield spread premiums are discussed in Deposition of Phillip Miller 23 (May 24, 2001); Deposition of Steven Kapp 13, 26 (May 19, 1998); Deposition of David Pritchard at 51, 109 ( Mar. 11, 1998).

<sup>88</sup> The right to hold escrow balances (advanced payments for insurance and taxes that many borrowers make in connection with their monthly mortgage payments) also can be valuable. The right to retain escrow balances makes loan origination even more profitable for lending institutions, and also increases with the size of particular mortgages and the period of time those mortgages remain outstanding. Telephone Conversation with Charles Guy (June

an annual fee for their services, typically 3/8th of one percent of the outstanding balance on a mortgage. The more mortgages a lending institution originates, the more mortgage servicing rights it obtains. In addition, the larger the size of any particular mortgage and the longer the mortgage remains outstanding, the greater the value of mortgage servicing rights.<sup>89</sup>

Together these two sources of profit create strong incentives for lending institutions to want mortgage brokers to select them as loan originators for as many potential borrowers as possible.

Yield spread premiums offer a mechanism through which a lending institution might make side payments to mortgage brokers in order to influence the brokers' decision regarding the selection of a lending institution on the part of various consumers. And, indeed, if one considers the way in which the defendant lending institutions in this litigation have calculated the amount of yield spread premiums they pay mortgage brokers, the payments seem well-designed both to maximize the number of mortgages that mortgage brokers will place with defendant lending institutions and to create extra incentives for mortgage brokers to place particularly profitable mortgages with defendant lending institutions. (Box A, see pages 4-5 above, reviews how the yield spread premium was calculated in one illustrative loan from the empirical analysis presented elsewhere in this report. The base amount of the yield spread premium creates an incentive for mortgage brokers to place loans with defendant lending institutions when borrowers are not aware of prevailing interest rates

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2001) (industry expert retained by plaintiffs' counsel).

<sup>89</sup> Because the cost of mortgage servicing is largely fixed – that is, the cost does not vary with the size of a mortgage – servicing larger mortgages is more profitable than servicing smaller mortgages. The value of mortgage servicing rights also increases, the longer a mortgage remains outstanding because the mortgage service provider receives its annual fees for a longer time.

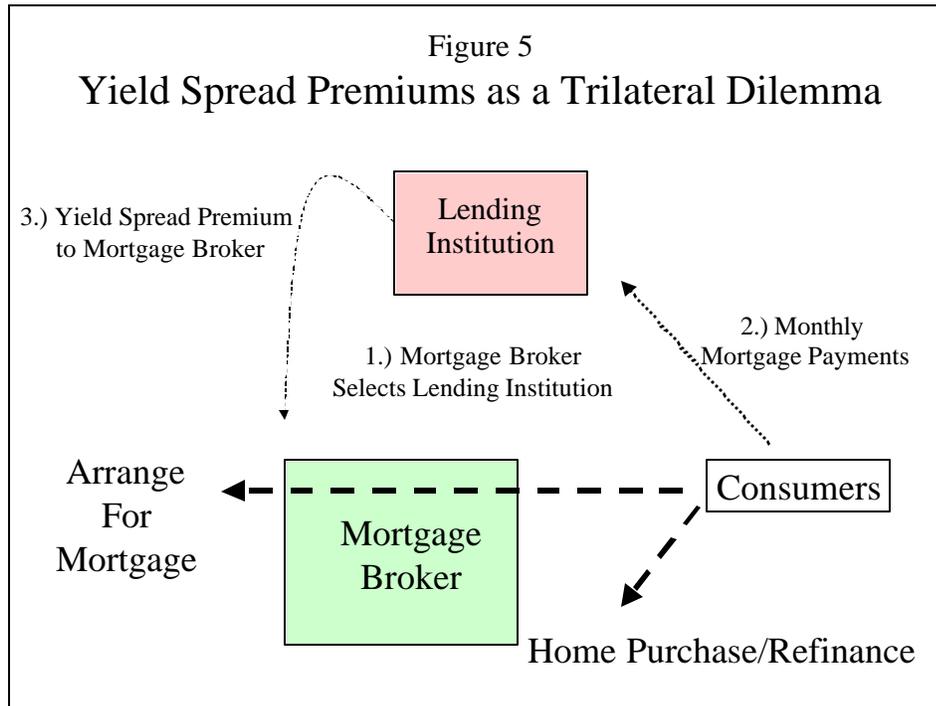
for par loans; the net adjustments increase these incentives for, among other things, larger loans that generate the ancillary benefit of greater profitability for defendant lending institutions on mortgage servicing.)

From the perspective of mortgage brokers, yield spread premiums offer a potentially lucrative mechanism for enhancing compensation. To the extent that mortgage brokers can retain these payments (and not make offsetting reductions in other forms of compensation or incur additional expenses for transactions involving yield spread premiums), the payments will increase mortgage broker compensation and create potentially substantial incentives to steer consumers towards lending institutions that pay higher yield spread premiums. Moreover, to the extent that the practice of paying yield spread premiums becomes widespread, lending institutions may have little choice but to offer yield spread premiums in order to maintain an acceptable volume of loan originations.<sup>90</sup>

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<sup>90</sup> The legislative history of RESPA offers considerable evidence that in the early 1970's many settlement service providers were similarly trapped into paying kickbacks and unearned referral fees in order to stay in business. See text accompanying note 30 ("making of such payments may heretofore have been necessary from a competitive standpoint in order to obtain or retain business").

Thus, as summarized in Figure 5, payment of yield spread premiums satisfies the formal requirements of a trilateral dilemma. Mortgage brokers, in practice, select the lending



institution to originate the consumer's mortgage (1). The consumer ends up paying the monthly mortgage payments, which constitute both the asset that the lending institution resells into the secondary market

and also the source of the ancillary benefits the lending institution derives from the transactions (2).

Finally, the yield spread premiums constitute a side payment that can potentially increase the mortgage broker's overall compensation and thereby influence its selection of a lending institution

(3).

## 2. Market Imperfections in the Payment of Yield Spread Premiums

As is always the case in considering contexts with the potential for trilateral dilemmas, there remains the possibility that such practices do not seriously harm consumers because competitive markets force the value of side payments to be passed along to consumers either through the

reduction of other expenses (like other compensation paid to mortgage brokers) or through the provision of additional services.<sup>91</sup> Within the financial services industry, however, market forces often do not function smoothly, and so Congress and regulatory authorities regularly intervene to regulate trilateral dilemmas and prohibit certain sorts of side payments. As explained below, a number of factors lead me to conclude that the institutional context in which yield spread premiums are paid reflects the same sort of market imperfections typically associated with trilateral dilemmas that require governmental intervention.

#### **a) Barriers to Consumers' Monitoring of Yield Spread Premiums**

The manner in which yield spread premiums are calculated and paid creates a number of barriers that restrict the ability of consumers to monitor yield spread premiums and ensure that they receive the value of those payments. To begin with, there is considerable question whether consumers understand what yield spread premiums are or that the costs of these premiums are financed by consumers through their monthly mortgage payments. For example, if one reviews the HUD booklet on settlement costs, there is no direct discussion of yield spread premiums or how these premiums are financed. The only tangentially relevant disclosure is a statement that “[y]our mortgage broker may be paid by the lender, you as the borrower, or both.”<sup>92</sup> There follows this

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<sup>91</sup> In making this statement, we do not mean to suggest that section 8 of RESPA exempts kickbacks and unearned referral fees when market conditions force those payments to be used for the benefit of consumers. The text of the provision does not include such an exemption, and the legislative history of the Act strongly suggests that Congress intended to establish a categorical prohibition.

<sup>92</sup> See *Buying Your Home: Settlement Costs and Helpful Information 8* (Jun 1997) (prepared by the U.S. Department of Housing and Urban Development). This document is

additional advice: “You may wish to ask about the fees that the mortgage broker will receive for its services.”<sup>93</sup> Elsewhere the booklet notes the section of the HUD-1 form where mortgage broker compensation, including yield spread premiums, would typically (although not invariably) be located.<sup>94</sup> Even if a consumer were to read and comprehend these statements, it is not clear what that consumer would think when he or she reviewed a HUD-1 statement with the words such as “Deferred Premium to Heartland Mortgage paid by Standard Federal (POC\$2137.00) 2%” on line 816 of an addendum to the consumer’s HUD-1 Form.<sup>95</sup> To begin with, the language suggests that the payment is being made by the lender and not the borrower, and the implication is reinforced by the fact that the amount is not added into the line denominated “Total Settlement Charges [Paid from Borrower’s Funds at Settlement]” at the bottom of the second page of the HUD-1 form. Critically absent is disclosure of the fact that the borrower him or herself finances the cost of yield spread premiums through higher monthly mortgage payments. Indeed, were a borrower to consult standard reference books on how to purchase a home, it is unlikely that he or she would be enlightened as to the significance of yield spread premiums.<sup>96</sup> So while defendants’ experts concede (as they must)

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appended as Exhibit D to the June 15, 2001, report of defendants’ expert Bruce A. Robb as an example of the kinds of disclosures typically made to consumers in this context.

<sup>93</sup> Id.

<sup>94</sup> Id. at 22.

<sup>95</sup> This is the actual language that is on the HUD 1 statement associated with the illustrative transaction described in Box A. See supra pp 4-5. A copy of the HUD-1 statement is attached as Appendix A.

<sup>96</sup> See, e.g., W. Frazier Bell, *How to Get the Best Home Loan* (2d ed. 2000); Ilyce R. Glink, *100 Questions Every First-Time Home Buyer Should Ask* (2d ed. 2000); Robert Irwin, *Tips & Traps When Mortgage Hunting* (2d ed. 1999). As an illustration of the kinds of

that consumers bear the economic costs of yield spread premiums,<sup>97</sup> the vast majority of consumers will not be aware of this relationship even if they studiously review the documentation that typically accompanies a mortgage transaction or popular guides on purchasing and financing a home.

Moreover, even if consumers were aware of the relationship between yield spread premiums and a borrower's financing costs, evaluating the trade-off between paying higher interest rates to finance yield spread premiums and paying higher closing costs is not a simple matter. For example, on a 30-year fixed rate mortgage for \$106,850, what is the difference in the cost to a consumer of paying a 7.125 percent interest rate as opposed to a 6.5 percent rate? This is precisely the sort of calculation necessary to evaluate a yield spread premium.<sup>98</sup> From a technical perspective, valuing

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information a savvy home buyer might obtain about closing costs in these guides (and the absence of any discussion of yield spread premiums, see chapter 10 of the Bell book, which is reproduced as Appendix B. While the legal academic literature is beginning to confront the issue of yield spread premiums, see, e.g., Chris Byrd, *The Rise and Fall of Consumer Protection Under RESPA*, 68 UMKC L. Rev. 329 (1999); Eloisa C. Rodriguez, *RESPA – Questioning its Effectiveness*, 24 Hamline L. Rev. 68 (2000); Bruce A. Wahl, *Yield Spread Premium Class Action under RESPA: Confusion Predominates*, 19 Rev. Litig. 97 (2000), and government regulators are starting to pay attention to the topic, see, e.g., HUD Statement of Policy 1999-1, *supra* note 84, the practice has not been widely publicized. Another reflection of the relatively low level awareness of the practice of yield spread premiums is the fact that the 1997 edition of the National Consumer Law Center's manual on Unfair and Deceptive Acts and Practices did not include any discussion of yield spread premiums. Only in the more recent Cumulative Supplement to the manual did a warning regarding yield spread premiums appear. See National Consumer Credit Center, *Unfair and Deceptive Acts and Practices* ¶ 5.1.10 (1997 & 2000 Cumulative Supp.).

<sup>97</sup> See, e.g., Report of Professor Edwin S. Mills 9 (June 2001) (“all mortgage broker compensation is ultimately paid by borrowers”).

<sup>98</sup> This is the implicit choice facing the borrower involved in the transaction described in Box A. As structured, the loan (a 30-year fixed conventional loan) carried an interest rate of 7.125, and the lending institution priced the loan at 102.0 and generated a yield spread premium of \$2137 (or two percent of the loan amount of \$106,850). With a lower

this difference is complex. To begin with, the consumer must determine monthly mortgage costs for both alternatives. In addition, as the comparison entails determining the present value of future cash payments, the consumer must select an appropriate discount rate and also estimate how long the loan is likely to remain outstanding in order to determine the cost of the difference to the consumer. Having undertaken this valuation, the consumer must then compare the benefits to be derived from paying the higher mortgage payments associated with a yield spread premium, with either the reduction of other payments to the mortgage broker or other benefits. Inter-temporal comparisons of this sort are notoriously difficult for consumers to evaluate effectively.<sup>99</sup>

As evidence that consumers are not now fully and adequately informed about costs in mortgage transactions and the relationship between interest rates and settlement charges, one need only look to the recent report of the Federal Reserve Board and Department of Housing and Urban Development.<sup>100</sup> One of the principal issues that this report addresses is the confusion that consumers face when they have to compare trade-offs between closing costs (such as the ones at issue in this litigation) and interest rates. The report concludes that the current disclosure rules, under which consumers must evaluate these two expenses separately, are inherently confusing. The

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interest rate of approximately 6.5 percent, the loan would have become a par loan (priced at 100.00) with no yield spread premium.

<sup>99</sup> See Richard H. Thaler, *The Winner's Curse* 92-106 (1992) (discussing problems of intertemporal choice).

<sup>100</sup> See Joint Study on The Truth in Lending Act and the Real Estate Settlement Procedures Act by the Board of Governors of the Federal Reserve System and the Department of Housing and Urban Development (available at <<http://www.federalreserve.gov/boarddocs/RptCongress/tila.pdf>>.)

report then recommended that Congress adopt a new disclosure regime in which settlement charges would be factored into a single adjusted interest rate.<sup>101</sup> If adopted, these reforms would extend to real estate transactions of the sort discussed in this report. That a joint report by the staffs of the Federal Reserve and HUD determined that disclosure in this area is in need of substantial reforms supports our assessment that consumers have serious difficulty understanding the relative significance of interest rates and other costs associated with loan transactions of the sort at issue here.

#### **b) Reliance on Mortgage Brokers in Selection of Lending Institutions**

Mortgage brokers also quite clearly have a major role in selecting among lending institutions on behalf of individual consumers.<sup>102</sup> The range of possible financing options is quite large and brokers have a wide range of discretion in selecting among different lending institutions as well as different programs and pricing options offered by particular lenders.<sup>103</sup> The discretionary power of

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<sup>101</sup> See *id.* at 8-16.

<sup>102</sup> In an affidavit filed in this litigation, Stephen C. Kapp, vice president of Standard Federal Bank, summarized the role of the mortgage broker in the following terms:

Among the most important services a mortgage broker performs for a borrower is to select an appropriate wholesale lender for the mortgage broker's customer, taking into account such factors as the kinds of loan products a wholesale lender offers, the underwriting requirements of particular lenders and their underwriting flexibility, the lender's ability to make underwriting decisions quickly, and other aspects of the wholesale lender's program.

Affidavit of Steven C. Kapp of January 14, 1999, at ¶ 23.

<sup>103</sup> Consider the description of the process from the perspective of defendant Standard Federal:

Standard Federal's wholesale price sheets include many loan products and combinations of interest rates, yield spread premiums and discount points that a

mortgage brokers is even more pronounced in this area because much of the information that consumers would need to compare different borrowing possibilities are not typically available to the consumer. For example, one important piece of information that consumers need to evaluate the desirability of obtaining a loan with a large yield spread premium is information about the interest rate that the borrower would pay on a comparable “par loan” for which no yield spread premium would be paid. However, consumers are typically not permitted to see the rate sheet that includes the range of pricing options, and it is our understanding that this information is rarely, if ever, disclosed orally.<sup>104</sup> In the absence of good information about the significance of yield spread premiums or the options available to them, consumers are quite likely to defer to the mortgage broker’s selection of lending institutions.

### **c) Complex and Multi-Faceted Nature of the Process**

The process of obtaining a mortgage has the complexity and multi-faceted characteristics that are associated with the trilateral dilemma in other contexts. Whether the consumer’s mortgage loan will be approved and whether the underlying home purchase or refinancing will go through as planned are all likely to have greater salience to the consumer than the amount of compensation the

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mortgage broker may select for his/her customer. The flexibility provided by these numerous options allows brokers to determine the appropriate retail price in light of the borrower’s needs and the broker’s revenue requirements.

Id. at ¶ 30.

<sup>104</sup> For example, at the bottom of the rate sheet discussed in Box A is the warning “Not for distribution to consumers.” See *supra* pp 4-5.

mortgage broker earns on the transaction.<sup>105</sup> In addition, as a practical matter, there may be considerable time pressures associated with these transactions. Once a consumer has begun to work with a mortgage broker on a mortgage application and some degree of personal trust has developed, it is plausible that the consumer will not inquire too strenuously when the broker proposes a particular lending institution that the broker represents to be appropriate for the transaction and the consumer's financing requirements.

#### **d) Possibility of Price Discrimination Among Consumers**

Finally, to the extent that some borrowers do carefully monitor the selection of lending institutions, understand the significance of yield spread premiums, and insist on receiving appropriate compensation for the cost of those premiums, mortgage brokers have a mechanism for satisfying those customers. The broker can "credit" the customer for all or a portion of the yield spread premium. As is presented in the next section of this report, mortgage brokers do occasionally grant such credits, but only for a small percentage of loans on which yield spread premiums are collected. From a theoretical perspective, however, the credits are important because they provide a vehicle whereby mortgage brokers can satisfy the demands of a small number of "sophisticated" consumers without disrupting the standard practice of obtaining yield spread premiums. Like other forms of price discrimination, granting ad hoc credits allows mortgage brokers to set yield spread premiums at the highest level that each consumer will accept. Were mortgage brokers to set yield spread premiums in this way, it would deny consumers the protections afforded in markets where all consumers pay the same "market" price.

#### **e) Relevance of A Competitive Secondary Mortgage Market**

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<sup>105</sup> See *supra* note 76 and accompanying text.

Finally, we should add a few words on the relevance of a competitive market for secondary mortgages. A number of defendants' experts have addressed the size and depth of the secondary mortgage market and the dramatic impact that this market has had on the cost of residential mortgage loans in this country.<sup>106</sup> We do not understand these opinions to be in conflict with the analysis presented above. The trilateral dilemma facing consumers in this context has nothing to do with the efficiency of the secondary mortgage market. We have assumed for purposes of our analysis that market forces determine the price at which lending institutions can sell their mortgage pools and that lending institutions set their interest rates on particular loan programs so that they earn a standard "mark-up" on each transaction.<sup>107</sup> That these prices are set competitively and efficiently does not influence our analysis. The relationship that We are addressing in this report is the one between the mortgage broker and individual consumers. The question is whether this relationship has characteristics that might make it possible and advantageous for mortgage brokers to steer certain consumers to financing arrangements that increase their overall costs in ways that are inefficient and unfair. Our view, as explained in this part, is that the relationship between mortgage brokers and consumers seems to have structural characteristics that make such abuses possible. The relationship, in other words, has the characteristics of a trilateral dilemma, requiring governmental intervention.

As further evidence that trilateral dilemmas can exist on the periphery of efficient markets, consider the example of investment managers and brokerage commissions.<sup>108</sup> In that case, the underlying transactions involved the sale and purchase of common stock and other securities. Many

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<sup>106</sup> See, e.g., Report of Ann B. Schnare, Ph.D (June 15, 2001).

<sup>107</sup> See *supra* note 85 and accompanying text.

<sup>108</sup> See *supra* Part II.B.

of these transactions occurred on the New York Stock Exchange, which is the archetypical efficient market. Still it was possible for investment managers to exploit consumers by hiring brokerage firms that charged excessively high commissions (and then make side payments to investment managers). If the efficiency of the New York Stock Exchange somehow “solved” this problem, then Congress and the SEC would never have had to concern themselves with soft dollar arrangements. Unfortunately, efficiency in one market does not protect consumers in related transactions.

### **Part III An Empirical Assessment of Yield Spread Premiums**

In this final part, we report the results of an empirical investigation of the payment of yield spread premiums that Professor Jackson undertook in his capacity as an expert witness in the *Glover v. Standard Federal Bank* litigation. The goal of this investigation was to explore the following issues:

First, what is the magnitude of yield spread premiums for loans that defendant lending institutions funded during the class period both in absolute amounts and in comparison to other principal sources of mortgage broker compensation?

Second, when mortgage brokers received yield spread premiums in connection with loans funded by defendant lending institutions during the class period, was the cost of these yield spread premiums offset by a comparable reduction in other borrower costs?

Third, what evidence is there to suggest that yield spread premiums are associated with additional services being provided to borrowers in connection with loans that defendant lending institutions funded during the class period?

This part begins with a discussion of the methodology underlying this investigation, including a review of the data we have examined and a discussion of procedures followed in inputting data. We then consider each of the three issues presented above, presenting and assessing the implications of our findings as well as relating those findings to the theoretical discussions of yield spread premiums in Part II.C. We conclude with a discussion of the relationship between this empirical assessment and the considerations that motivated Congress in 1974 to prohibit kickbacks and unearned referral fees in real estate settlement transactions.

## A. Overview of Methodology

### 1) Groups of Loan Available for Analysis

For the purposes of this analysis, we had available to us HUD-1 statements for three different groups of loans.

1. *The Heartland Loans*: This group consists of 111 loans obtained by members of the plaintiff class and other borrowers and originated during the class period through Heartland Mortgage Corporation. The HUD-1 statements for the Heartland loans were produced by defendants in response to discovery requests for all members of the plaintiff class with mortgages that were originated through Heartland Mortgage Corporation on which yield spread premiums were paid. As produced, however, the group also included a number of loans on which yield spread premiums were not paid, and thus apparently consists of all loans funded by defendant lending institutions and originated through Heartland Mortgage Corporation during the class period.

2. *The Plaintiffs' Sample*. This sample of approximately 800 loans was selected under the supervision of the court on behalf of the plaintiffs and with the agreement of the parties. Under these negotiated procedures, eight dates during the class period were selected across the class period. For each date, the defendants were required to produce HUD-1 statements for 25 randomly selected loan files from each of four separate categories:

2a. *Above Par Loans*: This subsample was designed to include loans which defendant lending institutions originated through mortgage brokers and for which defendant lending institutions paid more than the loan amount (i.e., a total price of more than 100.0). The premium on these loans (i.e., the amount by which the total price exceeds par) would typically be paid to the mortgage broker in the form of a yield spread premium.

2b. *Par Loans*: This subsample was designed to include loans which defendant lending institutions originated through mortgage brokers and for which

defendant lending institutions paid exactly a par price (i.e., a price of 100.0). Typically there would be no explicit yield spread premium paid on these loans.

*2c. Below Par Loans:* This subsample was designed to include loans which defendant lending institutions originated through mortgage brokers and for which defendant lending institutions paid less than the loan amount (i.e., a total price of less than 100.0). Typically, no explicit yield spread premium would be paid on below par loans, and the borrower would typically be required to pay “discount points” to the lender in order to cover the difference between the amount of the loan and the total price.

*2d. Retail Loans:* This subsample was designed to include loans that the defendant lending institutions made directly to retail customers and for which a mortgage broker did not participate. No yield spread premiums are paid to mortgage brokers on retail loans.

On certain dates selected for producing the Plaintiffs’ Sample, defendant lending institutions did not produce enough par loans or below par loans to generate a sample of 25 loans, in which case loans were selected from another date within a short period of time.

*3. Defendants’ Sample.* Another sample of approximately 2,100 loans was selected under the supervision of the court on behalf of the defendants. For this sample, counsel for defendants requested that the court select another series of dates from which to draw a sample of all loans that defendant lending institutions made on those dates. As a result of these sampling procedures, the Defendants’ Sample includes a combination of above par loans, par loans, and below par loans. On many of these loans, yield spread premiums were paid to mortgage brokers. There were no retail loans in the Defendants’ Sample.

## **2) Data Entry Procedures**

As an initial stage of the investigation, I arranged for the data from the more than 3,000 loans files described above to be encoded digitally into a series of databases. As each file has several hundred possible fields, this was a substantial undertaking. I established the following

procedures. First, under my supervision, a research assistant with substantial experience in data analysis developed a template through which to enter each loan file. My research assistant and I used this template to enter the files for the Heartland Loans. Then, we prepared a detailed set of instructions for data entry, as well as additional templates for both the Plaintiffs' Sample and the Defendants' Sample. These templates and instructions were distributed to accountants and in some cases legal assistants associated with plaintiffs' lawyers in these cases. The files for the Plaintiffs' Sample and Defendants' Sample were then entered under my supervision.

To ensure the accuracy of the data entry process, a number of "tests" were written into our input templates. For example, the HUD-1 statements include figures representing total costs paid by borrowers. One of our tests checked to make sure that the borrower costs inputted for each file added to the figure reflected on that HUD-1 statement for total borrower costs. In addition, once data entry was completed for each sample, a research assistant reviewed all files to confirm that the values critical to my analysis were entered correctly. This review process was completed in the summer of 2001 for the loans in the Plaintiffs' Sample and in the fall of 2001 for loans in the Defendants' Sample.<sup>109</sup>

In addition to the data entered from the HUD-1 forms produced in discovery, I have received a substantial amount of data from defendants. This additional data has come in both electronic and paper form. Under my supervision, my research assistants have entered much of this supplemental data into a combined database. The database covers the Heartland loans as

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<sup>109</sup> For the Defendants' Sample, my research assistants spent on average more than ten minutes checking each of the approximately 2,100 HUD-1 forms from which this portion of our database was derived. In addition, my most experienced research assistant reviewed all of the files, ran a number of diagnostic checks, and when questions arose re-examined the files in question. In a further effort to validate our data entry procedures, I have, where possible, compared our data with analyses prepared by defendants or defendants' experts in connection with this litigation. With a high degree of reliability, I have been able to replicate the defendants' results. Where discrepancies have arisen, I have checked the underlying documentation and satisfied myself that the difference was the result of a data entry error or misinterpretation on the part of defendants or defendants' experts. However, these discrepancies have arisen in only a small number of cases.

well as the loans in both the Plaintiffs' Sample and the Defendants' Sample – a total of approximately 3,050 loans. For each loan, this combined database includes as many as several hundred fields of data. All of the statistical analyses presented in this report are based on data in the combined sample. A copy of that combined sample, in electronic form, is attached to this report as Electronic Exhibit A.

### **3) Files Available for Analysis**

As a result of the data entry process described above, I had potentially available for analysis approximately 3,050 loan files, divided into the groups indicated in Table 1. For a variety of technical reasons, not all of these loans could be used in this report. A certain number of loans (65 loans or approximately two percent of the total sample) could not be entered, principally because the files were either illegible or incomplete. Thus the number of files that my assistants and I actually entered was 2,985. A further reduction in loans available for analysis relates to inability to match all of the loans in our sample to the defendants data. As is explained in more detail below, various aspects of our analysis required use of both data we compiled from HUD-1 forms and information supplied to us by defendants and their experts. While the matching process worked in most cases, we were unable to match some 38 loans, and therefore the actual number of loans available for our analysis was 2,947 loans. Table 1 provides further details on the composition of the loans available for analysis as well as the impact of the various reductions on each group of loans.

We performed one additional adjustment on loans in the Plaintiffs' Sample. As described above, the Plaintiffs' sample was designed to include several subsamples of above par, par, and below par loans, classifications based on the price of particular loans. When we received defendants' data on loan prices, we discovered a number of discrepancies between that information and the classification of loans for purposes of creating the subsamples of the Plaintiffs' Sample. For example, for some loans initially included in the Above Par Sample – which were supposed to have prices above 100.0 – defendants reported actual prices of 100 or

less. On the assumption that defendants' pricing data was more accurate measure of loan type, we reclassified a number of loans in the Plaintiffs' sample. This reclassification, which is reported in the final column of Table 1, caused minor changes in the number of loans included in

Table 1  
Loans Available for Analysis

		Original Number	Available for Analysis	Matched with Defendants Data	Reclassified Based on Price
<b>Heartland Loans</b>		<b>111</b>	<b>111</b>	<b>108</b>	<b>108</b>
<b>Plaintiffs' Sample</b>		<b>802</b>	<b>764</b>	<b>747</b>	<b>747</b>
	Above Par	202	202	202	190
	Par	200	191	191	186
	Below Par	200	183	182	199
	Retail	200	188	172	172
<b>Defendants' Sample</b>		<b>2137</b>	<b>2110</b>	<b>2092</b>	<b>2092</b>
<b>Total Loans</b>		<b>3050</b>	<b>2985</b>	<b>2947</b>	<b>2947</b>

the various subsamples.<sup>110</sup>

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<sup>110</sup> As explained in the text, this adjustment is based on our assessment of the relative reliability of data provided us by defendants. We have rerun our critical findings, presented below, to confirm that our conclusions would not be materially affected had we used the initial classifications of the Plaintiffs' Sample rather than the reclassification described in the text.

## **B. Presentation of Results**

- 1. What are the incidence and magnitude of yield spread premiums for loans that defendant lending institutions funded during the class period both in absolute amounts and in comparison to other principal sources of mortgage broker compensation?**

### **a) Incidence of Yield Spread Premiums**

We began by considering the frequency with which mortgage brokers received yield spread premiums on the loans we were analyzing. To address this issue, we examined the three groups of loans in which yield spread premiums might be present: the Heartland Loans, the Above Par Sample, and the Defendants' Sample.<sup>111</sup> Within these groups of loans, we had two mechanisms for determining the incidence of yield spread premiums. First, we inspected the HUD-1 forms associated with each loan to determine whether a yield spread premium was disclosed on the form. Second, we used the defendants' electronic database to determine whether yield spread premiums were present for loans in the group. Table 2 reports the results of both methods of investigation.

Overall, the incidence of yield spread premiums reported in Table 2 is quite high – over 80 percent by all measures. For certain groups, this high incidence of yield spread premiums is an artifact of the manner in which the groups were constructed. For example, one would expect yield spread premiums to be paid on all loans in the Above Par Sample, as this sample was limited to loans with prices above 100.0. The rate of yield spread premiums in other groups, however, represents a reasonable estimate of the incidence of yield spread premiums in the overall population of loans originated by defendant lending institutions through mortgage brokers

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<sup>111</sup> As explained above, yield spread premiums are not associated with retail loans, and the two remaining subsamples were limited to loans with a price of 100.0 or less, on which yield spread premiums were not expressly charged.

during the class period. Given its size and the manner in which it was constructed, I believe the incidence of yield spread premiums in the Defendants' Sample reported in Table 2 – between 85 and 90 percent – represents a good estimate of the incidence of yield spread premiums in the overall population. In other words, on six out of seven loans that defendant lending institutions made through mortgage brokers during the class period, a yield spread premium was paid to the mortgage broker.

Table 2  
Incidence of Yield Spread Premiums

	<i>Loans In Group</i>	<i>YSPs Found on HUD-1s</i>	<i>Percent of Total Loans</i>	<i>YSPs Reported in Defendants' Data</i>	<i>Percent of Total Loans</i>
Heartland Loans	108	98	90.74%	99	91.67%
Above Par Subsample	190	182	95.79%	190	100.00%
Defendants Sample	<u>2092</u>	<u>1728</u>	<u>82.60%</u>	<u>1806</u>	<u>86.33%</u>
<b>Total</b>	<b>2390</b>	<b>2008</b>	<b>84.02%</b>	<b>2095</b>	<b>n.a.</b>

The difference in Table 2's estimates of yield spread premiums is noteworthy. Our estimates of yield spread premiums based on examination of the paper HUD-1 forms disclosed to borrowers were invariably lower than estimates based on defendants' electronic records. The source of this difference is not clear. One possibility is that settlement agents failed to include the mandated disclosure of yield spread premiums in these cases. Another possibility is that the yield spread premiums were disclosed on these forms and my research assistants were not able to find them.<sup>112</sup> Finally, it is possible that defendants' electronic records were in error and yield spread premiums were not present in these cases. For purposes of our analysis, we have proceeded under the assumption that the defendants' electronic data represents the best estimate of yield spread premiums actually paid and we have therefore incorporated that estimate into subsequent analysis.<sup>113</sup>

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<sup>112</sup> As discussed elsewhere in this report, disclosure of yield spread premiums in HUD-1 forms is often cryptic and confusing. Our difficulty in identifying yield spread premiums reinforces this point. In the first stage of our data entry procedures, our entry teams found yield spread premiums in only 69 percent of the loan files examined, even though these teams consisted of trained para-legals and accountants who were expressly and repeatedly instructed to look carefully for these payments and given detailed instructions as to where on the HUD-1 forms the information was likely to be found. In the next stage, with a second team of assistants, consisting of Harvard Law School students working under my direction, we achieved the 82.6 percent incidence reported in Table 2, but only after prompting the researchers to renew their efforts in cases in which defendants' electronic data suggested that a yield spread premium was present. (These students spent, on average, more than ten minutes reviewing each of the 2100 HUD-1 forms in the Defendants' Sample.) In the end, there were still 78 loans in the Defendants' Sample in which we could not find a yield spread premium even though the defendants' electronic records indicated one had been paid. As indicated in the text, there remains a possibility that yield spread premiums were disclosed in some of these cases, however, I think it is more likely that they were not disclosed on the relevant forms.

<sup>113</sup> Defendants' experts have also apparently proceeded on this assumption. See Deposition of Susan E. Woodward at 10 et seq. (July 31, 2001). An alternative approach would be to limit our analysis to loans in which identical estimates of yield spread premiums were reported under both methods. As explained below, we retested our principal findings using this alternative approach and found comparable results.

**b) The Magnitude of Yield Spread Premiums.**

In terms of both absolute dollar amounts and as a percentage of loan amounts, yield spread premiums constitute both a substantial cost for consumers and a substantial source of compensation for mortgage brokers. Table 3 presents summary statistics on the average level of yield spread premiums for the three groups of loans where yield spread premiums were charged.

Table 3  
Magnitude of Yield Spread Premiums  
For Loans Where YSPs Were Paid

Group	Average (percent of loan amount)	Average (dollars)	Total (dollars)
Heartland Loans (99)	1.16 %	\$ 1,442	\$ 142,743
Above Par Sample (190)	1.54%	\$ 1,878	\$ 356,731
Defendants' Sample (with ysp) (1806)	1.54 %	\$ 1,848	\$ 3,337,585

As this table indicates, the average amount of yield spread premiums was in excess of \$1,800 for both the Above Par Sample and those loans from the Defendants' Sample. Measured in terms of the average percentage of loan amounts, yield spread premiums for these two samples were both 1.54

percent. In the case of the Heartland Loans, yield spread premiums were somewhat smaller by both measures (\$1,442 or 1.16 percent of loan amount) but still quite large. The final column of Table 3 reports the total amount of mortgage broker compensation that yield spread premiums generated for the three groups of loans. For example, on the 190 loans in the Above Par Sample, yield spread premiums generated \$356,731 of revenue for mortgage brokers. For the 1,806 loans with yield spread premiums in the Defendants' Sample, these fees generated more than \$3.3 million of income for mortgage brokers. These numbers indicate that yield spread premiums constitute a substantial expense for borrowers and a major source of revenue for mortgage

brokers, both in absolute terms and as a percentage of loan amount.

In certain respects, the foregoing analysis may actually understate the overall importance of yield spread premiums. In the course of our analysis, we discovered that borrowers were paying mortgage brokers substantial amounts of loan discount fees on many transactions. Loan discount fees have been traditionally associated with below par loans; borrowers use these fees to “pay down” the interest rate on these loans. Our analysis revealed that these fees were also being paid on loans in the Above Par Sample, the Par Sample, and the Defendants’ Sample as well as on certain of the Heartland Loans. Table 4 reports the number of loans with loan discounts in each group, the percentage of loans with discounts in each group, the average amount of loan discounts when such discounts were paid, and the total dollar amount of discounts at issue.<sup>114</sup>

There is some question how to interpret these loan discounts. On the HUD-1 forms, they appear as a separate cost for borrowers and thus a separate source of mortgage broker compensation. However, a strong argument could be made that these loan discount fees are

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<sup>114</sup> Like yield spread premiums, loan discounts are not consistently and clearly reported on HUD-1 Forms. Sometimes loan discount fees are reported on HUD-1 forms, but it is not clearly indicated to whom they are paid. Other times, no loan discount fees are reported on the HUD-1 forms, but defendants’ electronic records indicate that the loans in question have below par prices and that loan discount fees should have been paid to defendant lending institutions. This problem was particularly acute for below par loans. Of the 199 loans in the Plaintiffs’ Below Par Sample, our efforts to calculate the loan discount fee paid to the defendant lending institutions based on a review of the HUD-1 forms matched the corresponding entry in defendants’ electronic records only 69 times or basically a third of the cases. In the face of these ambiguities, we adopted the following convention. We assumed that defendants’ electronic records were the most accurate measure of the true amount of loan discount fees paid to defendant lending institutions. When these discount fees were greater than the discount fees reported on the associated HUD-1 form, we inferred that the difference was paid to the mortgage broker as additional compensation. When the loan discount fee paid to the lender was more than the amount of loan discount fees reported on the associated HUD-1 form, we inferred that the difference was funded through a credit from the mortgage broker.

indirectly attributable to yield spread premiums. After all, borrowers pay loan discount fees in order to lower interest rates on their loans. Thus, when a borrower pays a loan discount fee on an above par loan or even a loan that ends up being a par loan, negotiations must have started with the interest rate on that loan being set at a level above the rate of a comparable par loan.<sup>115</sup> In the

**Table 4**  
**Loan Discount Fees as a Source of Additional Compensation for Mortgage Brokers**

	<b>Number</b>	<b>Percentage of Group</b>	<b>Average When Paid (dollars)</b>	<b>Total Amount (dollars)</b>
Heartland Loans (108)	16	14.8 %	\$ 744	\$ 11,909
Above Par Sample (190)	19	10.0 %	\$ 1,109	\$ 21,070
Par Sample (186)	51	27.4 %	\$ 1,335	\$ 68,096
Below Par Sample (199)	85	42.7 %	\$ 1,174	\$ 99,777
Defendants' Sample (2092)	306	14.6 %	\$ 1,228	\$ 375,919

absence of negotiation, that loan would have generated a higher yield spread premium than whatever premium is ultimately reported on the borrower's HUD-1 form. In essence, when a borrower buys down his or her interest rate under these circumstances, a portion of the pre-negotiation yield spread premium is simply converted into a loan discount fee. As such one could reasonably attribute the loan discount fees reported in Table 4 to the ability of mortgage brokers to recommend in the first instance above par loans with yield spread premiums. Under this line of reasoning, the magnitude of yield spread premiums would be even greater than the levels

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<sup>115</sup> When a borrower pays loan discount fees to a mortgage broker on what ultimately turns out to be a below par loan, negotiations over interest rates may also have started out at an above par rate.

reported above.

The ambiguous effect of loan discount fees paid to mortgage brokers is relevant to subsequent portions of our analysis when we attempt to compare mortgage broker compensations in loans in which yield spread premiums are paid to other loans untainted by yield spread premiums. To eliminate the possibly confounding effect of loan discount fees, we further segmented the Par Loans and Below Par Loans into subsamples of True Par Loans and True Below Par Loans. These subsamples included the 135 Par Loans and 114 Below Par Loans for which mortgage brokers did not receive any loan discount fees. As explained later, we used these subsamples, and particularly the subsample of True Par Loans, as our primary benchmarks against which we compared samples of loans in which yield spread premiums were paid.<sup>116</sup> In some of our analyses of the Defendants' Sample, we also made adjustments for discount fees paid to mortgage brokers.

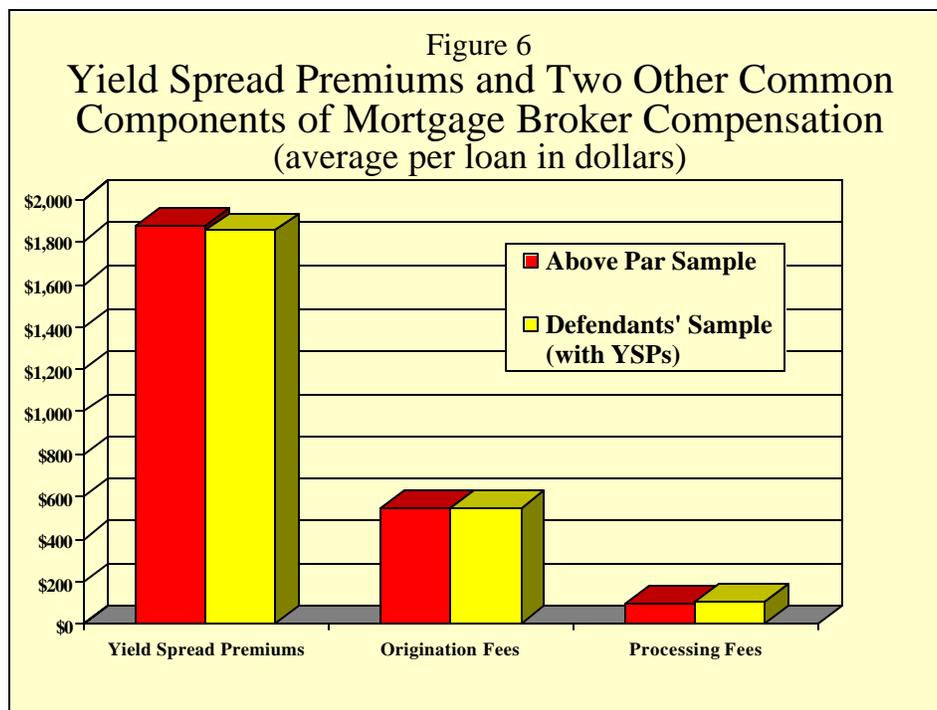
### **c) Amounts as Compared with Other Common Components of Mortgage Broker Compensation**

Another way to assess the magnitude of yield spread premiums is to compare these payments to other fees that borrowers pay mortgage brokers. Figures 6 and 7 compare the

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<sup>116</sup> As with many other aspects of our analysis, we reran our principal tests using our original Par Loan and Below Par Loan samples. While the size of the effects noted in the text differ somewhat for these alternative tests, our conclusions and their statistical significance were unaffected. Illustrations of these differences are reported in the margins below.

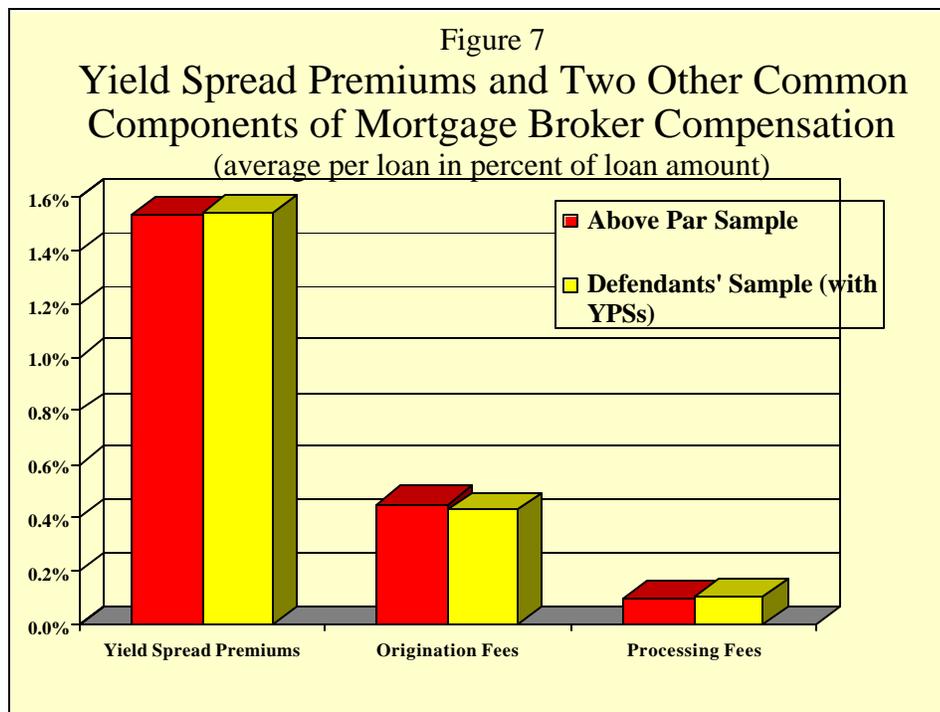
average level of yield spread premiums to the average levels of two other fees commonly paid to mortgage brokers in these transactions: loan origination fees and processing fees. The figures report averages from two different groups of loans: those in the Above Par Sample, and those in the Defendants' Sample. Figure 6 illustrates these averages in dollar amounts. As this table indicates, for both the Above Par Sample and the Defendants' Sample, average yield spread premiums are much bigger than origination fees or processing fees. For example, in the case of the Above Par Loans, average yield spread premiums were \$1,877, whereas average origination fees were \$541 and average processing fees were \$100. For loans with yield spread premiums in



the Defendants' Sample, average yield spread premiums were \$1,848, where average origination fees were \$456 and average processing fees were \$105.<sup>117</sup>

<sup>117</sup> Average yield spread premiums also exceeded other averages in the case of the Heartland Loans, but the differential is not as great. For the most part, our analysis in the text focuses on data regarding the Plaintiffs' Sample and the Defendants' Sample, as these are the loans that are representative of the overall practices of defendant lending institutions. The Heartland loans are not – and were not

An alternative way of presenting this data is to consider fees as a percentage of loan amounts. As some fees, such as origination fees, are commonly determined as a percentage of loan amount, this alternative presentation controls for the size of individual loans and reduces the possibility that loan size might be confounding our analysis. Figure 7 illustrates average borrower fees as a percentage of loan amounts for both the Above Par Sample and the Defendants' Sample with yield spread premiums. Viewed in this way, yield spread premiums again constitute the largest component of mortgage broker compensation. Taken together, Figures 6 and 7 leave little doubt that yield spread premiums constitute the principal source of mortgage broker compensation in loans where yield spread premiums are charged.



**d) Distribution of Yield Spread Premiums Compared to Other Costs**

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selected to be – a representative sample.

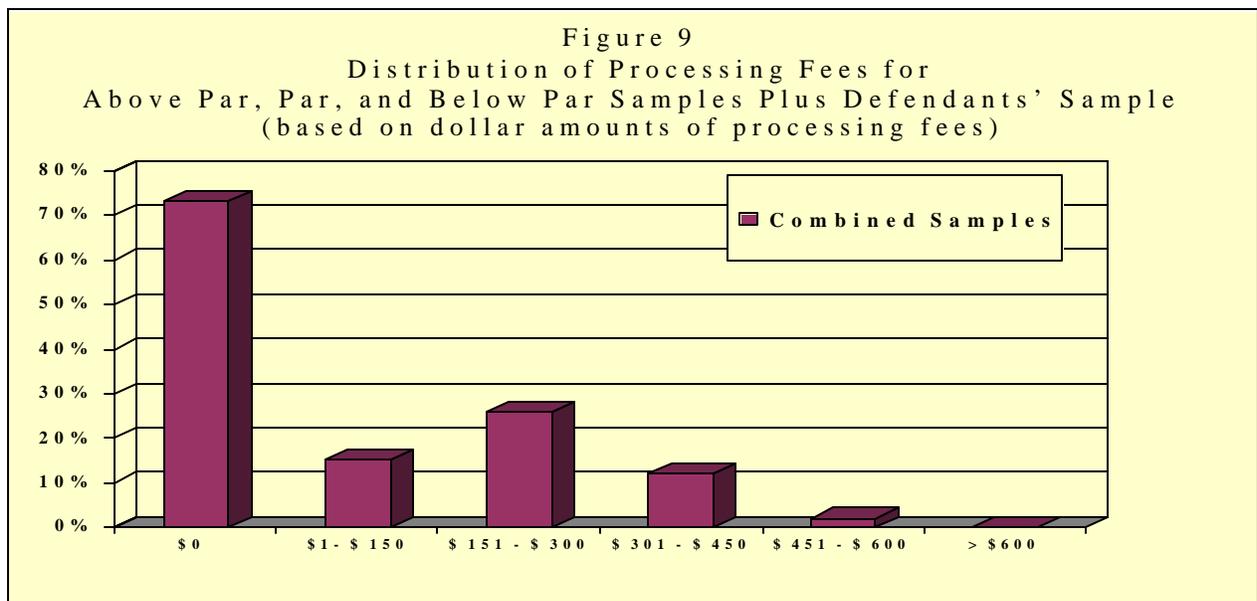
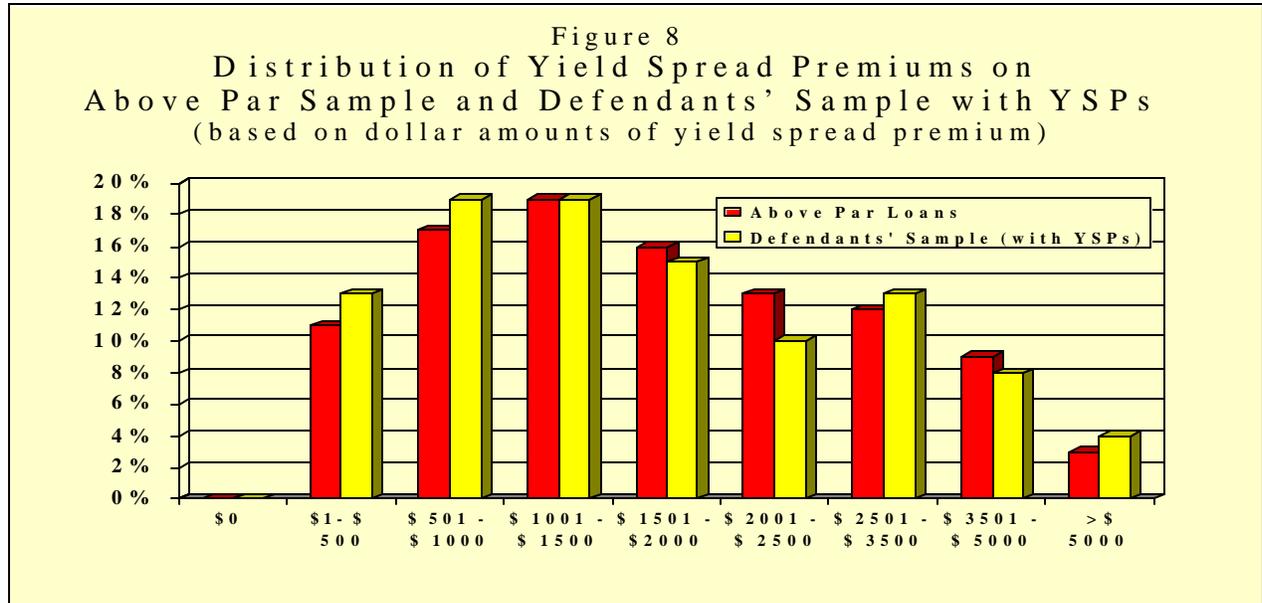
We also examined variations in the amount of yield spread premiums that borrowers paid on various loans in our sample. Figures 8 and 10 present these distributions, first for the absolute amount of yield spread premiums, and then for yield spread premiums as a percentage of loan amounts. What these figures reveal is that there is substantial and unusual variation in the amount of yield spread premiums paid on particular loans. This is true of all the groups of loans in which yield spread premiums are paid.<sup>118</sup> Looking, for example, at the bar graphs (in dark red on Figure 8) representing yield spread premiums paid in the Above Par Sample, while seventeen percent of borrowers paid yield spread premiums of between \$501 and \$1,000, and another nineteen percent paid yield spread premiums in the \$1,001 to \$1,500 range, sixteen percent of borrowers paid \$1,501 to \$2,000, and another thirteen percent paid premiums in the \$2,001 to \$2,500 range. Figure 10 indicates that this variation is not simply a result of the fact that yield spread premiums are calculated as a percentage of loan amount (which would tend to make yield spread premiums higher for loans with larger loans amounts). Reporting yield spread premiums as a percentage of loan amount for the same three groups of loans, Figure 10 indicates that this wide variation persists even when these payments are adjusted for loan size. As indicated in the yellow bars on Figures 8 and 10, yield spread premiums across the Defendants' Sample had a similarly wide dispersion.

To provide a better sense of how much variation there is in yield spread premiums, I have reproduced beneath Figures 8 and 10, comparable distributions for other sources of compensation for mortgage brokers. First, beneath figure 8 (which reports yield spread premium distribution expressed in absolute dollar amounts), I present the distribution for processing fees charged on all loans in the Plaintiffs' Sample funded through mortgage brokers and also all loans in the Defendants' Sample. The price of the processing fee is typically calculated in a dollar amount. As Figure 9 reveals, the distribution of processing fees is tightly bunched around two points on

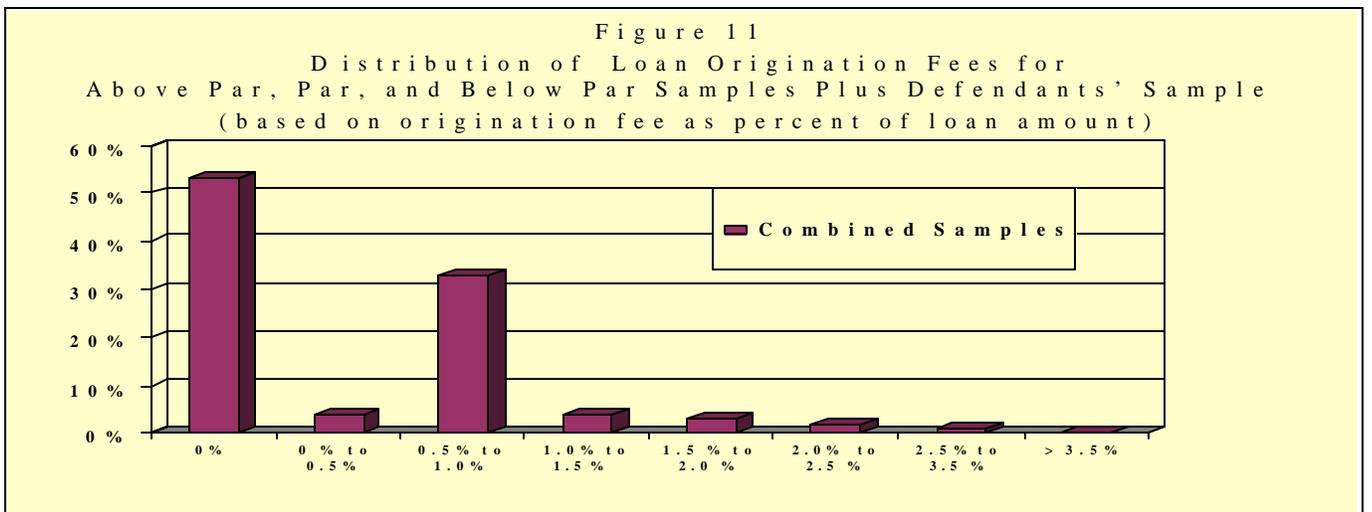
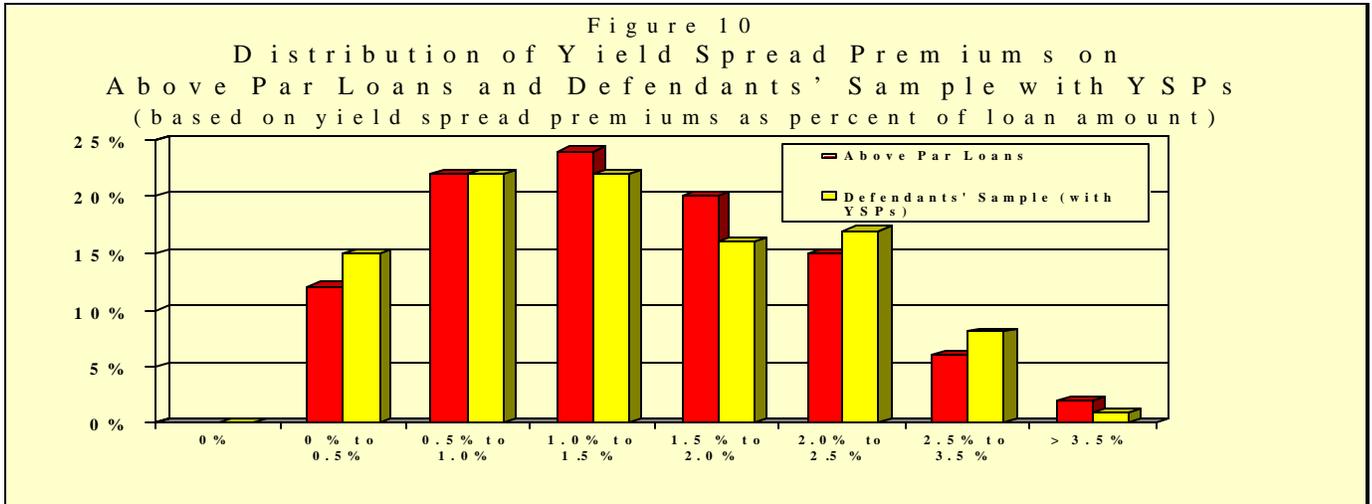
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<sup>118</sup> The text reports the distributions of the Above Par Sample and the Defendants' Sample with yield spread premiums – our two representative samples of loans with yield spread premiums. A similar distribution is present across the Heartland loans, which do not constitute a representative sample.

the distribution: zero when no fee is charged and between \$150 and \$300 otherwise. The absolute amounts of yield spread premiums shown in Figure 8 show no such bunching.



Figures 10 and 11 offer a comparable comparison involving origination fees, which are typically calculated as a percentage of loan amount. As Figure 11 indicates, loan origination fees, if they are imposed, are heavily concentrated in the range of 0.5 to 1.0 percent of loan amounts. As Figure 10 indicates, yield spread premiums exhibit no similar modal value.



### e) Interpretation of Analysis

The analysis presented above is important in several respects. To begin with, our data clearly establish that yield spread premiums represent a substantial expense for borrowers obtaining loans from defendant lending institutions in transactions involving mortgage brokers. This is true whether yield spread premiums are measured in absolute terms, as a percentage of loan amounts, or in comparison to other common components of mortgage broker compensation. The magnitude of yield spread premiums is enhanced by the fact that these charges appear to be imposed in nearly all loans that defendant lending institutions fund through mortgage brokers. Based on our analysis, our best estimate is that these payments are imposed in between 85 and 90 percent of such transactions.

In light of the magnitude of yield spread premiums as an expense for borrowers and as a source of revenue for mortgage brokers, it is remarkable that consumers are not provided better information about the existence and magnitude of these fees.<sup>119</sup> The absence of adequate consumer information about yield spread premiums and the financial importance of these payments, in my opinion, suggest the existence and operation of the sort of trilateral dilemma I described in Part II.C of this report. With this much money at stake, mortgage brokers face a strong financial incentive to steer consumers to lending institutions that pay yield spread premiums and, similarly, lending institutions face strong incentives to offer yield spread premiums in order to increase or even maintain their volume of loan originations and particularly loan originations with large ancillary payments.

The high level of variation in yield spread premiums is also a noteworthy finding. For

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<sup>119</sup> See *supra* note 61 and accompanying text. See also *supra* note 75 and accompanying text (discussing the difficulty our research team had in finding disclosures of yield spread premiums).

one thing, the high degree of variation in the payment of yield spread premiums hinders the ability of consumers to monitor these payments. While a consumer can figure out that origination fees are typically one percent of loan value and processing fees ordinarily are in the \$150 to \$300 range, the foregoing analysis suggests that no such rules of thumb are possible with respect to yield spread premiums, whether considered in absolute terms or as a percentage of loan amounts. Moreover, to the extent that my previous discussion has raised the possibility that mortgage brokers might be using yield spread premiums to discriminate among borrowers, the analysis presented here is consistent with that possibility. If mortgage brokers were using yield spread premiums to get the most compensation possible out of each customer, then you would expect to see the wide distribution of yield spread premiums reported in Figures 8 and 10 above. At a minimum, this data would seem to put the burden on defendants to explain why there is so much more variation in yield spread premiums than in other common sources of compensation for mortgage brokers, as presented in Figures 9 and 11. I consider possible explanations for this variation below.<sup>120</sup>

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<sup>120</sup> See *infra* pages 99-109.

**2. When mortgage brokers received yield spread premiums in connection with loans funded by defendant lending institutions during the class period, was the cost of these yield spread premiums offset by a comparable reduction in other forms of mortgage broker compensation or other borrower costs?**

In this subsection, we attempt to answer this question from a variety of perspectives. First we consider the relationship between total compensation paid to mortgage brokers in connection with groups of loans on which yield spread premiums are paid as compared with other groups of loans in which mortgage broker compensation is not affected by yield spread premiums. Next we perform a similar comparison of total borrower costs for groups of loans on which yield spread premiums are paid as compared with groups of loans in which mortgage broker compensation is not affected by yield spread premiums. Finally, we use regression analysis to estimate the extent to which the payment of yield spread premiums is offset by reductions in other forms of mortgage broker compensation in groups of loans in which yield spread premiums are paid.

**a) Mortgage Broker Compensation**

**i.) Definition of Total Mortgage Broker Compensation**

To examine the impact of yield spread premiums on overall mortgage broker compensation, we had first to establish a definition of mortgage broker compensation. Based on consultations with Charles Guy, an industry expert retained by the plaintiffs, and an independent review of relevant literature, I concluded that the following fees paid to mortgage brokers and

required to be reported on HUD-1 statements constitute an accurate measure of mortgage broker compensation:

	Yield Spread Premiums
+	Loan Origination Fees
+	Other Compensation <sup>121</sup>
-	Offsets for Settlement Costs Paid by Mortgage Broker
<hr/>	
	Total Mortgage Broker Compensation

For the most part, this formula is self-explanatory. However, two points of clarification are in order. The first concerns the deduction for settlement costs paid by mortgage brokers. On a relatively small number of HUD-1 statements, mortgage brokers are shown to have paid a portion of borrowers' costs, either through a credit on the first page of the statement or through the payment of expenses, sometimes outside of closing.<sup>122</sup> Because the payment of these fees

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<sup>121</sup> For these purposes, other compensation includes the following fees designated on HUD-1 statements as paid to the mortgage broker: underwriting, processing, funding, application fee, commitment fee, broker fee, closing fee, administration fee, document preparation, lender's inspection fee (or mortgage insurance inspection fee), assumption fee, and loan discount (when paid to mortgage broker). Not included in this list are certain itemized fees, such as appraisal fees and credit report fees, that are supposed to be passed-through to third parties. As explained below, these itemized fees are considered in our analysis of total borrower costs.

<sup>122</sup> For example, within the Plaintiffs' Sample, credits were reported in 15 instances with the Above Par Sample (7.9 percent of cases) with an average credit, when paid, of \$874. Among the Par Sample, credits were reported in 10 cases (5.4 percent of cases) with an average credit, when paid, of \$970. Within the Defendants' Sample, credits were present in 269 transactions (or 12.9 percent of the total sample). The average amount of credits was \$962. The incidence of credit was somewhat lower among loans in the Defendants' Sample without yield spread premiums (11.5 percent) than it was among loans in the Defendants' Sample with yield spread premiums (13.1 percent). In relationship to gross mortgage broker compensation, credits are quite small – less than three percent in the case of the Above

reduces a mortgage broker's revenues, these expenses were deducted from our calculation of mortgage broker compensation. The second point concerns our treatment of the payment of fees and other costs by the seller. On a relatively small number of HUD-1 statements, sellers are shown to have paid some or in rare cases many costs that are typically borne by borrowers. We have included these fees in our calculations on the grounds that these fees (if paid to mortgage brokers) increase mortgage broker compensation and are indirectly paid by the borrower in the form of a higher purchase price.

In a report prepared on behalf of defendants in this litigation, Bruce Robb has developed a similar definition of total mortgage broker compensation, and we have analyzed his results to understand his methodology, which is not explicitly revealed in his report. Based on our analysis, Mr. Robb's definition treats offsets and seller costs in the same manner as our definition does. The only difference between our two approaches appears to derive from the fact that his definition includes somewhat fewer fees in other compensation.<sup>123</sup> The two definitions of total mortgage broker compensation are thus quite similar. Although we rely primarily on our own definition of total mortgage broker compensation in the analysis presented below, we have conducted the same analysis using Mr. Robb's definition and none of the results is materially different. For various key results, we present our analysis using both definitions of total mortgage broker compensation.

## **ii.) Analysis of Groups of Loans with Yield Spread Premiums**

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Par Sample. Moreover, credits are not exclusively associated with loans with yield spread premiums.

<sup>123</sup> Mr. Robb's definition of other compensation appears to be limited to processing fee, flood certification fee, courier fee, and loan discount (when paid to mortgage broker).

To estimate total mortgage broker compensation, we began by examining the three groups of loans where yield spread premiums were routinely paid: the Heartland Loans, the Above Par Sample, and the Defendants' Sample (with yield spread premiums). Table 5 reports the average amount of total mortgage broker compensation in each group. The data presented in this table reveal a fair degree of uniformity. For all three of these groups, the average amount of total mortgage broker compensation falls within a fairly tight range, from \$2,548 in the Defendants' Sample to \$2,784 in Heartland Loans. It is also noteworthy that the average amounts of offsets in all three samples are quite small and especially small for the Above Par Sample and the Defendants' Sample with yield spread premiums.

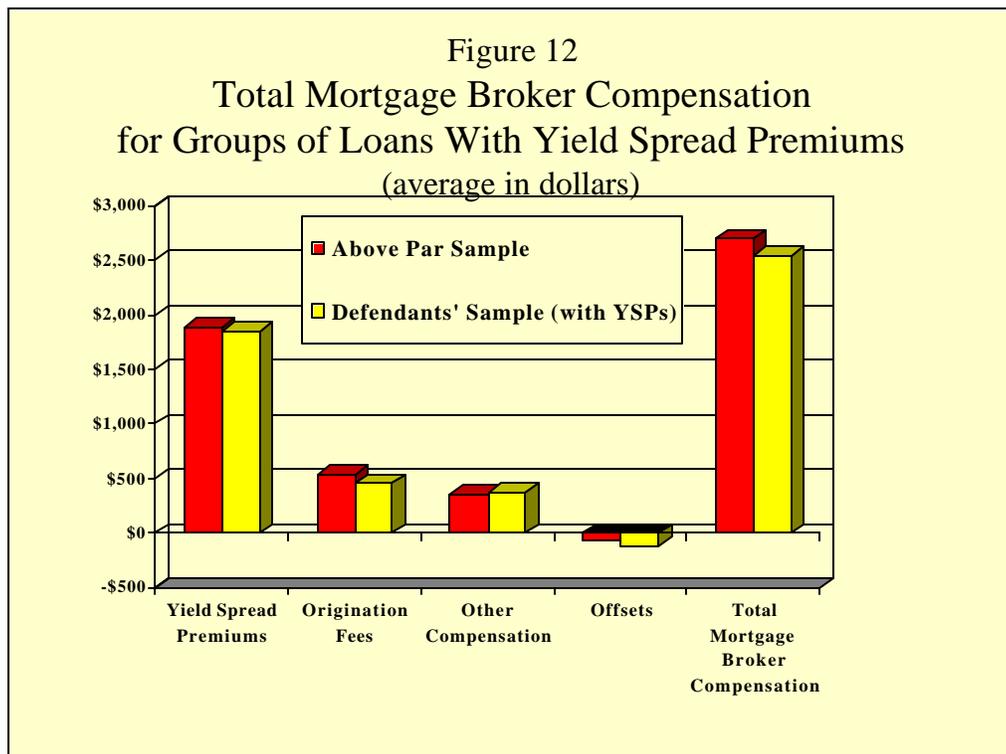
**Table 5**  
**Total Mortgage Broker Compensation for Groups of**  
**Loans with Yield Spread Premiums**  
 (average amounts in dollars)

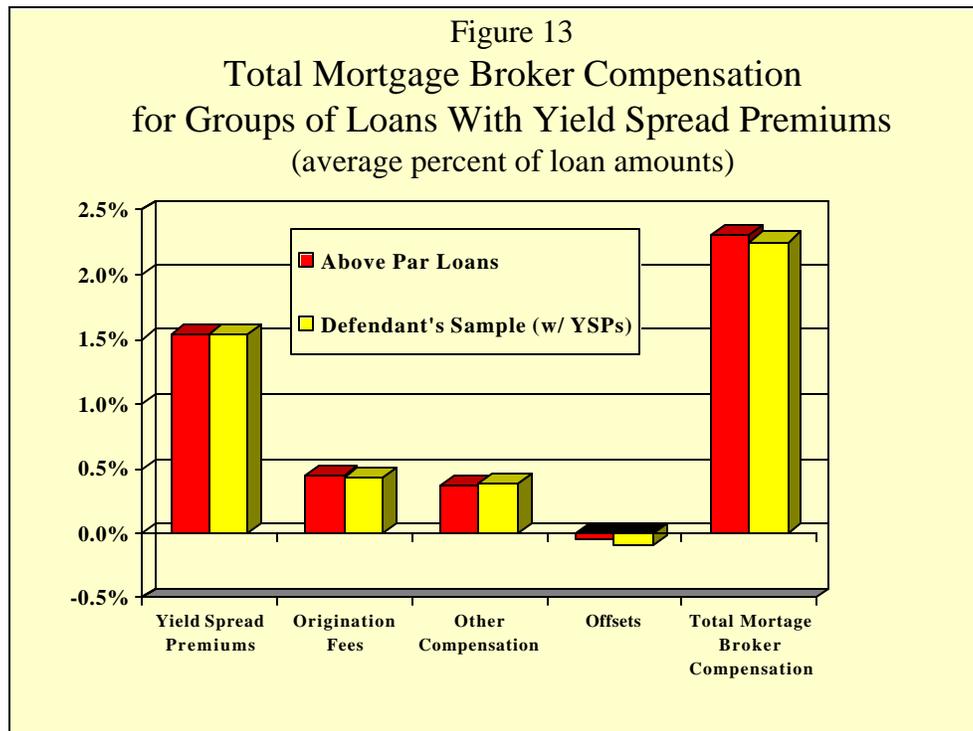
	<i>Yield Spread Premium</i>	<i>Origin. Fee</i>	<i>Other MB Comp.</i>	<i>Offsets</i>	<i>Total MB Comp.</i>
<b>Heartland Loans ( w/ ysp) (99)</b>	\$ 1,442	\$ 1,194	\$ 402	(\$ 186)	\$ 2,852
<b>Above Par Sample (190)</b>	\$ 1,878	\$ 541	\$346	(\$ 69)	\$ 2,696
<b>Defendants' Sample (w/ ysp) (1806)</b>	\$ 1,848	\$ 456	\$368	(\$124)	\$ 2,548

T w o  
 g r a p h i c  
 illustrations of  
 the same data  
 appear on the  
 next page.  
 Figure 12  
 presents the  
 components of  
 total mortgage  
 b r o k e r  
 compensation  
 i n d o l l a r  
 a m o u n t s

whereas Figure 13 presents the same components as a percentage of loan amount. These two figures nicely illustrate how similar the averages of total mortgage broker compensation (as well

as constituent components) are for the Above Par Sample and the Defendants' Sample with yield spread premiums. Although two samples were constructed in different ways, the similarity of results adds confidence that we have obtained a good estimate of total mortgage broker compensation in the underlying population – loans originated by defendant lending institutions through mortgage brokers.

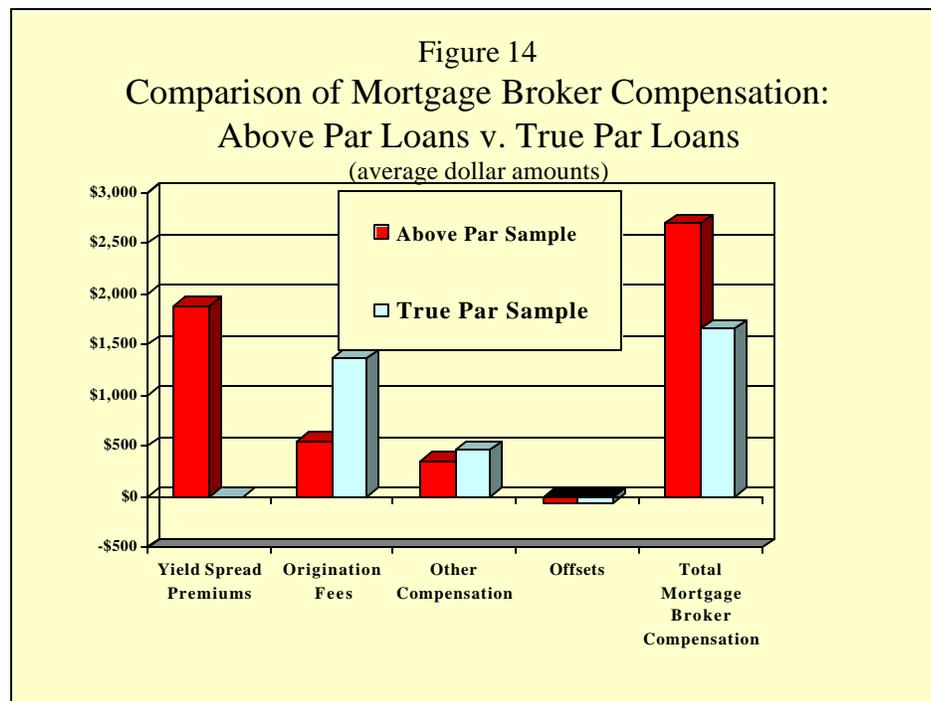




**iii.) Comparison of Mortgage Broker Compensation in other Comparable Groups of Loans**

The next stage of our analysis was to compare total mortgage broker compensation on loans in which yield spread premiums were not paid and for which we could get comparable estimates of total mortgage broker compensation. Here we focused our analysis on the subsets within the Plaintiffs’ Sample because all subsets were constructed in the same way and were therefore likely to be most comparable. Our goal therefore was to compare total mortgage broker compensation in the Above Par Sample (the subset of the Plaintiffs’ Sample with a high

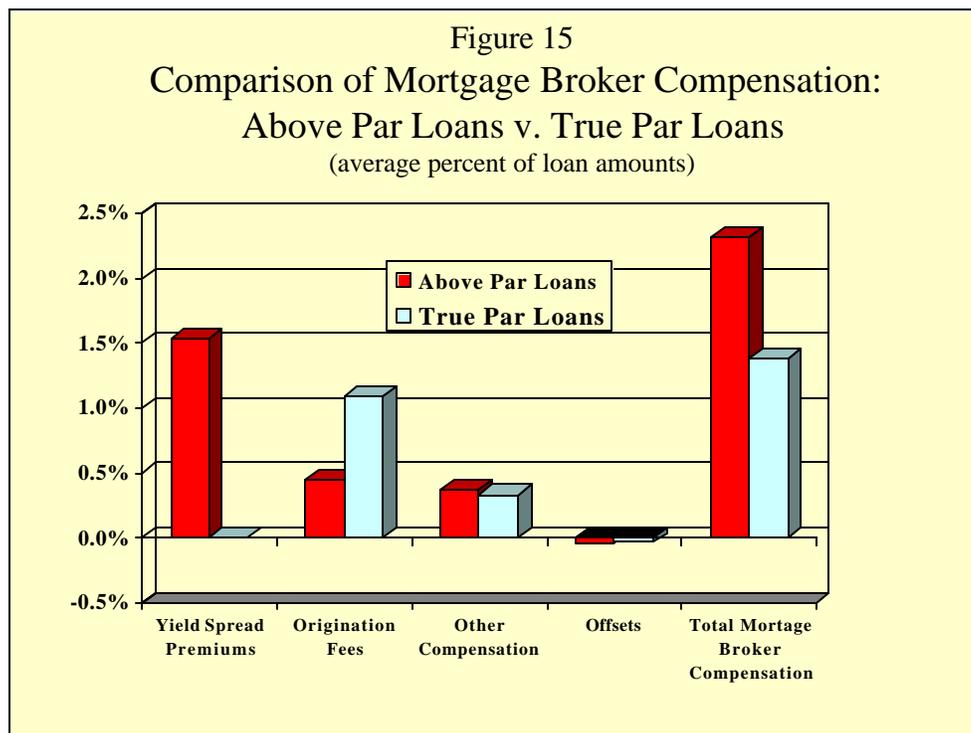
concentration of yield spread premiums) with a comparable subset of the Plaintiffs' Sample in which yield spread premiums did not influence total mortgage broker compensation. As explained above,<sup>124</sup> the subset of True Par Loans is, in our view, the most comparable subset for making these comparisons. However, for all of the analysis described below, we repeated our comparisons using a wide variety of comparisons and methodologies.



Our first comparison was between the dollar amount of mortgage broker compensation in the Above Par Sample and the dollar amount of mortgage broker comparison in the True Par Sample. As illustrated in the bar graphs of Figure 14, average total compensation paid to

<sup>124</sup> See *supra* page 60-62.

mortgage brokers in the Above Par Sample was \$1,046 dollars more than the average total mortgage broker compensation for the True Par Sample. Using standard statistical analyses, we confirmed that the difference in compensation was significant at greater than the 99 percent level.<sup>125</sup>



To control for potential differences in loan size, we also compared average levels of total mortgage broker compensation as a percentage of loan across groups. The results were similar to those obtained for dollar amounts of total mortgage brokerage compensation. As summarized in Figure 15, the average amount of total mortgage broker compensation for the Above Par

<sup>125</sup> Here and throughout the subsequent analysis, we used two separate measures of statistical significance: a two-sample “t” test of differences in means as well as a non-parametric test (Wilcoxon Signed Ranks). In all contexts and under both tests, the results reported were statistically significant at greater than the 99 percent level.

Sample was 2.312 percent of loan amount or 0.924 percent higher than total mortgage broker compensation for loans in the True Par Sample (1.388 percent of loan amount). This difference was statistically significant at greater than the 99 percent level.

In addition to the two basic comparisons of mortgage broker compensation summarized in Figures 15 and 16, we conducted numerous alternative formulations of the comparison, using both dollar amounts of compensation<sup>126</sup> and compensation as a percentage of loan amount.<sup>127</sup> A summary of the results is set forth in the margin. In each case, our analysis was consistent with the results reported above: total mortgage broker compensation was substantially higher for loans on which yield spread premiums were charged than was total mortgage broker compensation on other groups of comparable loans in our samples. Moreover in all cases these differences were statistically different at greater than the 99 percent level.

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<sup>126</sup> The following table summarizes our findings (using average dollar amounts) of the amounts by which total mortgage broker compensation on loans with yield spread premiums exceeded total brokerage compensation on groups of loans without yield spread premiums:

<i>Comparison</i>	<i>Average Excess</i>
Above Par v. Par	\$ 815
Above Par v. True Par (Robb Definition of Compensation)	\$1,122
Defendants' Sample (with YSP) v. True Par	\$ 899
Defendants' Sample (with Adjusted YSP) v. Defendants' Sample (w/out)	\$1,033
Above Par (based on YSP reported on HUD-1 Forms) v. True Par	\$ 1,097

Note: All differences statistically significant at the 99 percent level.

<sup>127</sup> The following table summarizes our findings (using average percentage of loan amount) of the amount by which total mortgage broker compensation on loans with yield spread premiums exceeded total brokerage compensation on groups of loans without yield spread premiums:

<i>Comparison</i>	<i>Average Excess (percent)</i>
Above Par v. Par	0.651 percent
Above Par v. True Par (Robb Definition of Compensation)	0.881 percent
Defendants' Sample v. True Par	0.868 percent
Defendants' Sample (with Adjusted YSP) v. Defendants' Sample (w/out)	1.055 percent
Above Par (YSP on HUD-1 Forms) v. True Par	0.941 percent

Note: All differences statistically significant at the 99 percent level.

In my view, the comparison between the Above Par Sample and the True Par Sample offers the most accurate comparison of total mortgage broker compensation in groups of loans in which yield spread premiums are paid and total compensation in comparable loans in which yield spread premiums do not play a role. In plain language, what this analysis suggests is that mortgage brokers earned on average \$1,046 more on loans where yield spread premiums were paid than on comparable loans in which yield spread premiums were not paid or, if one were to speak in terms of compensation as a percentage of loan amounts, extra compensation equal on average to 0.924 percent of loan amounts. This evidence is inconsistent with the proposition that the payment of yield spread premiums does not affect total mortgage broker compensation. Rather, the evidence unequivocally demonstrates that mortgage brokers earn substantially more on loans when yield spread premiums are paid.

#### **b) Measures of Total Borrower Costs**

An alternative way to consider the impact of yield spread premiums is to consider their impact on total borrower costs – that is, not only borrower costs associated with mortgage broker compensation but total borrower costs associated with the loan originations. To pursue this approach, we also analyzed our samples using this broader definition of costs. In particular, we analyzed:

- Total Mortgage Broker Compensation
  - + Itemized Mortgage Broker Expenses (typically passed-through to other parties)
  - + Fees Charged by the Lender
  - + Other Pass-Through Expenses Reflected on the HUD-1 (including itemized fees paid through Lender)
-

## Total Borrower Costs

In essence this formula reflected all borrower costs shown on HUD-1 forms, except for charges specifically related to the transaction (such as real estate commissions, pre-paid interest and taxes, etc.). In addition, this calculation does not include loan discount fees paid to the lender on below par loans to lower the loans' interest rates.

Table 6  
Total Borrower Costs and Components for  
Various Groups of Loans  
(average amounts in dollars)

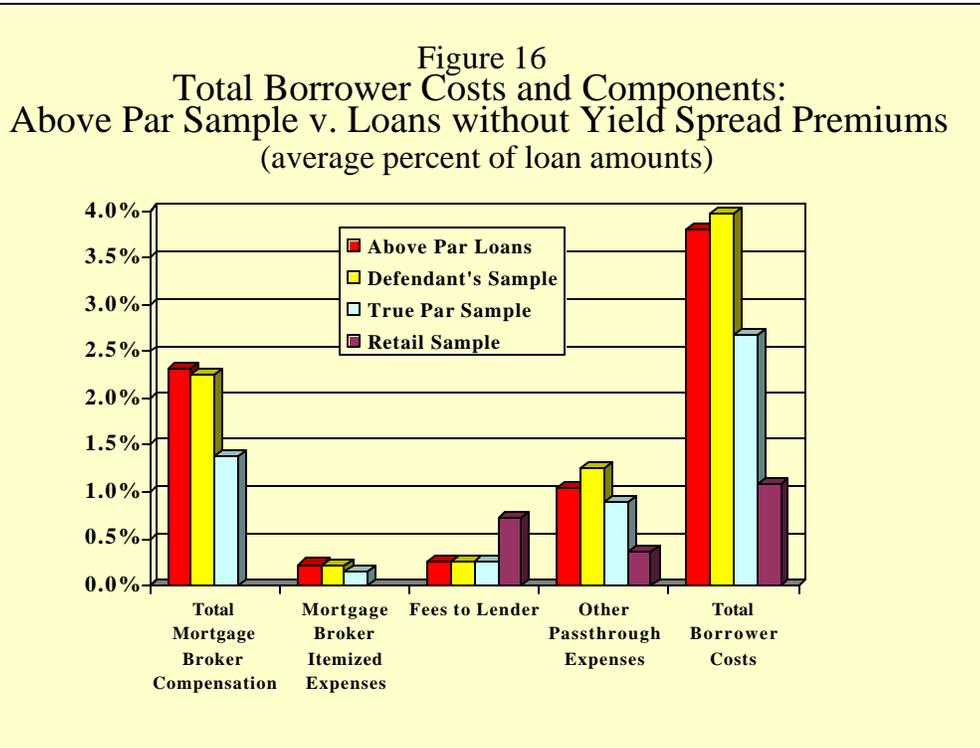
	<i>Total MB Comp.</i>	<i>MB Itemized Expenses</i>	<i>Fees to Lenders</i>	<i>Other Pass- through Charges</i>	<i>Total Borrower Costs</i>
<b>Above Par Sample (190)</b>	\$ 2,696	\$ 221	\$ 252	\$ 1,075	\$ 4,244
<b>Defendants' Sample (with YSPs) (1806)</b>	\$ 2,548	\$202	\$ 257	\$ 1,336	\$ 4,346
<b>True Par Sample (135)</b>	\$ 1,649	\$ 185	\$ 287	\$ 1,089	\$ 3,210
<b>Retail Sample (170)</b>	---	---	\$ 671	\$377	\$ 1,048

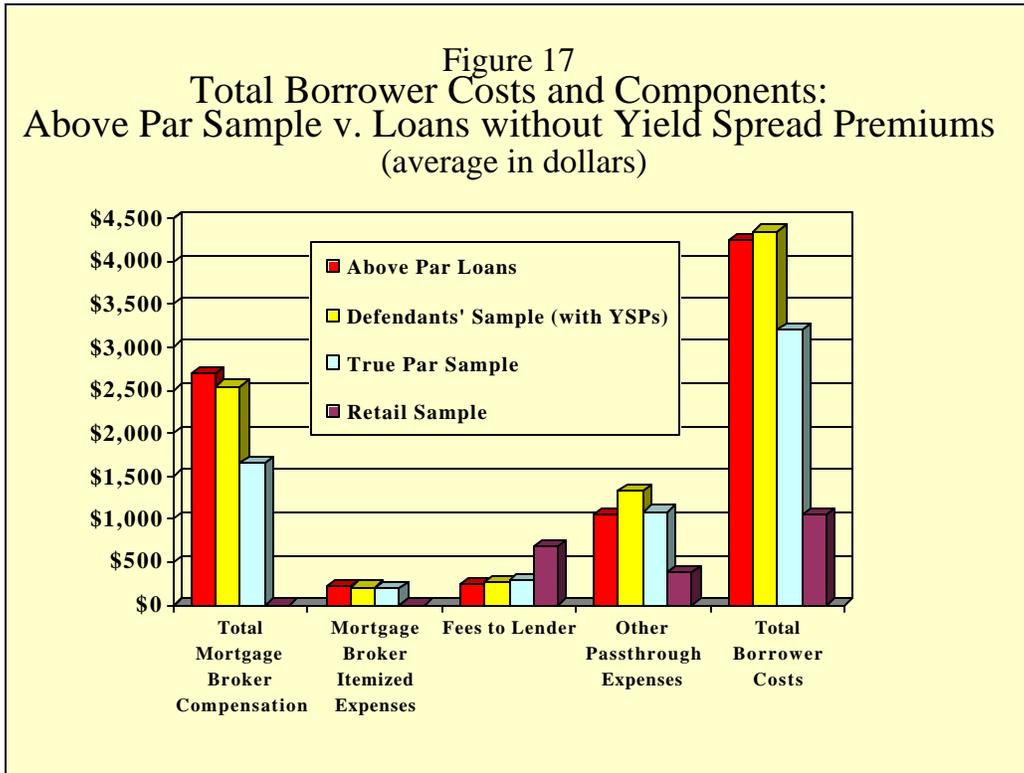
Using the foregoing definition, we calculated average total borrower costs for various groups of loans. A summary of

the results of this analysis is presented in Table 6. In all critical respects these results are consistent with our findings with respect to total mortgage broker compensation. In particular, the average amount of total borrower costs for groups of loans with yield spread premiums – in Table 6 represented by the Above Par Sample (dark red) and the Defendants' Sample with yield spread premiums (yellow) – were substantially higher than averages for loan groups without yield spread premiums. Focusing on what I believe to be the most appropriate comparison – the

Above Par Sample as compared with the True Par Sample – the difference in average Total Borrower Costs is \$1,034. This difference is statistically significant at greater than the 99 percent level. A similar difference (\$1,136) separates averages for the Defendants' Sample with yield spread premiums and the True Par Sample. These differences are illustrated graphically in Figure 16.

An alternative graphic presentation of Total Borrower Costs appears in Figure 17. This figure presents total borrower costs as a percent of loan amounts. Among other things, the figure shows that total borrower costs for loans unaffected by yield spread premiums – that is, the True Par Sample – were on average lower than total borrower costs for the Above Par Sample by 1.14 percent of loan amounts and lower than total borrower costs for the Defendants' Sample with yield spread premiums by 1.30 percent of loan amounts.





One noteworthy feature of this comparative analysis of total borrower costs, as presented in Figures 16 and 17 as well as in Table 6, is the extremely low costs reported for the Retail Sample. Our prior comparative analysis, which focused on mortgage broker compensation, did not include reference to the Retail Sample, because no mortgage broker compensation is paid on loans in the Retail Sample. The defendant lending institutions originated these loans directly. The foregoing analysis suggests that average borrower costs associated with the Retail Sample were substantially lower than the other groups of loans analyzed, all of which were originated through the offices of mortgage brokers. The differences are pronounced. For example, as reported in Table 6, average total borrower costs for the Retail Sample were only \$1,048, that is less than a quarter of the comparable cost for loans in the Above Par Sample (\$4,244) or the Defendants' Sample with Yield Spread Premiums (\$4,346). This difference is striking and warrants additional investigation.

When we first discovered the size of this difference, I hypothesized that the defendant lending institutions might be charging much higher interest rates for retail borrowers. Such a difference might explain the dramatically lower direct borrower costs in the Retail Sample. In effect, the defendant lending institutions would be earning an implicit yield spread premium on these loans. To test this hypothesis, we examined the interest rate actually paid on retail loans

**Table 7**  
**Price and Other Observable Characteristics of Retail Loans and Other Groups**

<i>Group</i>	<i>Loan Size (average)</i>	<i>Government Loans (percent)</i>	<i>Interest Rate (average)</i>
Loans with Yield Spread Premiums:			
Heartland (99)	\$ 131,801	4.0 %	<b>7.55 %</b>
Above Par (190)	\$ 129,602	13.2 %	<b>7.62 %</b>
Defendants' Sample (1806)	\$127,142	11.4%	<b>7.48 %</b>
Retail Sample (170)	\$130,541	2.4 %	<b>7.38 %</b>

ns is presented in Table 7. Even though retail loans seem comparable to other groups in terms of average of loans, the interest rates charged on retail loans were actually lower than those charged on loans with yield spread premiums. For example, the average interest rate on the Retail Loans was 7.38 percent, which is lower than the average for all other groups of loans on which yield spread premiums were charged. Perhaps the best comparison is with the Above Par Loans – which had an average interest rate of 7.62 percent – because this sample was constructed in the

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same manner as the Retail Sample. Thus, contrary to our original hypothesis, this evidence suggests that borrowers in the Retail Sample were on average paying lower interest rates than were borrowers with loans in other groups. Accordingly, while additional investigation of this issue is needed,<sup>128</sup> our analysis suggests that loans in the Retail Sample have much lower costs than groups of loans associated with high incidence of yield spread premiums. There is, moreover, no obvious way in which defendant lending institutions are imposing additional charges on borrowers from the Retail Sample.

In sum, our analysis of borrower costs is inconsistent with the proposition that borrowers do not pay higher costs on loans with yield spread premiums. Indeed, our evidence strongly suggests that total borrower costs on loans with yield spread premiums are on average much higher. A good estimate of the extra amount that borrowers pay on loans with yield spread premiums is on average more than 1.0 percent of loan amounts or, in dollar terms, more than \$1,100.

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<sup>128</sup> Our comparison of the observable characteristics of the Retail Sample and other groups of loans, presented above, is fairly crude and intended as only a quick check of whether the dramatically lower settlement costs associated with the Retail Sample could be explained by higher interest rates. Our analysis suggests that this is not a plausible explanation. As discussed in more detail below, see *infra* pp. 132-34, one of defendants' expert witnesses attempted to use more sophisticated statistical methods to show that the interest rates on retail loans were actually much higher than those charged on other loans, once one controlled for a number of different factors. As we explain below, this analysis was marred by several elementary errors in statistical analysis. See *id.*

### c) Regression Analysis

In some filings in this litigation, defendants have claimed that yield spread premiums are fully offset through the reduction of other charges imposed on borrowers. Defendants' theory of "full financial offset" implies that for every dollar paid in yield spread premiums, borrowers are given a dollar offset or reduction of more traditional up-front cash payments to the mortgage broker. Such a pricing policy is said to be economically neutral because borrowers pay the same amount for obtaining a mortgage, whether they pay yield spread premiums or more traditional up-front costs. Similarly, mortgage brokers would be indifferent to yield spread premiums because they obtain the same revenue however borrowers choose to make their payments.<sup>129</sup>

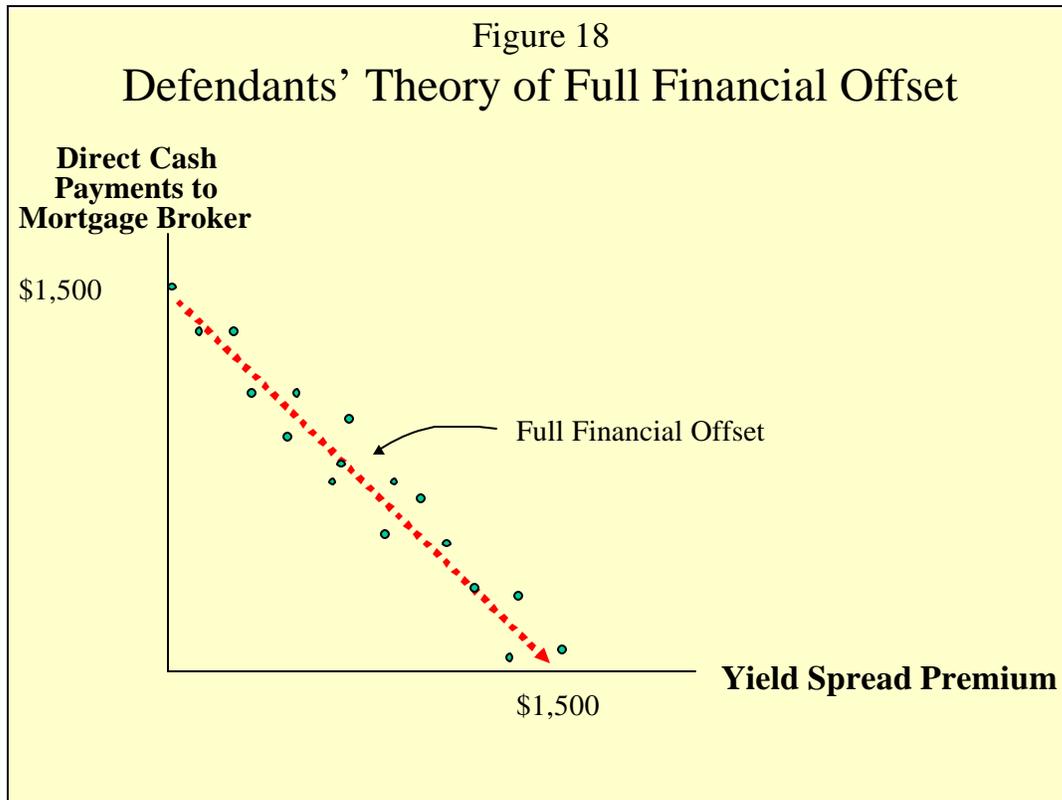
The foregoing analysis largely rebuts that claim. Within the Plaintiffs' Sample, loans with yield spread premiums – that is, the Above Par Sample – generated much higher revenue for mortgage brokers and much higher total settlement costs for borrowers than did comparable loans without yield spread premiums. These substantial differentials indicate that yield spread premiums were not offset by a reduction in other charges. In an effort to corroborate these findings, we undertook another form of analysis on the Defendants' Sample. This alternative analysis is known as regression analysis and is a method that economists typically use to explore the relationship between different characteristics within a particular group. Here we are using the technique to explore the relationship between yield spread premiums and other mortgage broker compensation in loans originated by defendant lending institutions.

Before turning to our regression results, it is important to understand their relationship to defendant's theory of full financial offset. As explained above, defendants claim that there is a

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<sup>129</sup> See, e.g., Defendant Standard Federal Bank's Memorandum of Law in Opposition to Plaintiffs' Motion for Summary Judgment 8-9 (filed Sept. 10, 2001); Defendant Standard Federal Bank's Memorandum of Law Supporting Motion for Class-wide Summary Judgment or Alternatively for Class Decertification 9-10 (filed Aug. 13, 2001) (yield spread premiums "redistribute the up-front costs between the borrower and the lender"). See also HUD RESPA Statement of Policy 2001-1 (Oct. 15, 2001) (characterizing yield spread premiums as a "third option" for covering settlement costs).

dollar for dollar trade-off between yield spread premiums and direct cash payments to mortgage brokers. Figure 18 provides a graphic illustration of this theory. The vertical axis of the graph represents direct cash payments to mortgage brokers and the horizontal axis payments made through yield spread premiums. Any combination of direct cash payments and yield spread premiums can be plotted on this graph. The dashed line represents an economically neutral combination of fee arrangements that would provide total mortgage broker compensation of \$1,500. At one extreme, the entire fee could be paid in up-front cash payments. Or the full amount could be paid as yield spread premiums. Or, half the fee could be paid in up-front charges and half as yield spread premiums. According to defendants, the line shown in Figure 18 reflects the manner in which defendant lending institutions and mortgage brokers in this case actually employ yield spread premiums – i.e., for every additional dollar paid through yield spread premiums, there is an offsetting reduction in charges paid through up front cash payments. Thus, if one were to plot, for each of defendants' loans, the amounts of direct cash compensation paid to mortgage brokers on each loan and the amount of yield spread premiums for that loan, the points should fall along the economically neutral line shown in Figure 18.



Regression analysis provides a scientific mechanism for testing claims of this sort. What we do with regression analysis is, in essence, to plot the actual yield spread premiums and direct cash payments for the 2,092 loans in the Defendants' Sample. We then draw a line that best reflects the relationship between these two kinds of costs and see how closely this line matches the one that defendants advance under their theory of full financial offset. With regression analysis, we can determine with a high degree of precision whether the data fit the defendants' theory of full financial offset. As explained in considerable detail below, our analysis of the Defendants' Sample unambiguously and resoundingly rebuts defendants' claim of full financial offset.

### **i.) Simple Regressions**

We begin with two simple linear regressions measuring the relationship between yield spread premiums and direct cash payments to mortgage brokers.<sup>130</sup> Figure 19 provides a graphic presentation of this data as well as a dotted line, presenting the regression software's best guess of a straight line representing the relationship between yield spread premiums and direct cash payments to mortgage brokers in the Defendants' Sample. This graph is noteworthy in several respects. First, as illustrated in Figure 19, the data clearly do not match the line associated with defendants' theory of full financial offset.<sup>131</sup> There is no strong and obvious relationship between the two variables, and the line that best describes the relationship is much flatter than the line associated with full financial offset. In other words, the graph strongly suggests that for every dollar added in yield spread premiums there is not an offsetting dollar reduction in direct cash payments to mortgage brokers. This analysis suggests that we can reject defendants' theory of full financial offset with greater than 99 percent confidence.

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<sup>130</sup> For these purposes, direct cash payments to mortgage brokers is defined to be Total Mortgage Broker Compensation, described above, minus yield spread premiums, and thus accounts for all credits paid by mortgage brokers at closing. Our regression analysis was performed on SYSTAT 10.0 software using data included in our electronic database.

<sup>131</sup> The data presented in Figure 19 is limited to the ranges indicated; the regression line, however, reflects all 2,092 loans in the Defendants' Sample.

[Insert Figure 19 Here]

Regressions provide a more precise way of presenting the same information. In the following box marked Simple Regression A, we present the regression output for the data shown in Figure 19. In essence, the regression constitutes the formula (in blue) of the line shown in Figure 19. The first number in the equation (1261.81) is known as the constant and represents the best guess of the amount of direct cash payments when there is no yield spread premium: \$1,261.81. The next term in the equation is the coefficient for the yield spread premium variable. The most natural interpretation of this coefficient (-0.263) is the amount by which direct cash payments to mortgage brokers goes down for every dollar of increase in yield spread premiums. Thus, the regression suggests that on average direct cash payments to mortgage brokers go down by only 26 cents for every dollar that yield spread premiums go up. By contrast, defendants' theory of full financial offset implies that direct costs should go down by a full dollar for every dollar of increase in yield spread premiums.

**Simple Regression A: Direct Cash Payments as a Function of Yield Spread Premiums**

(Dollar Amounts for Defendants' Sample; n = 2092)

$$1261.81 - 0.263 \times \text{Yield Spread Premium} = \text{Direct Cash Payments}$$

(39.68\*\*\*) (0.018\*\*\*)

Notes: Adjusted Multiple R Squared = 0.089

Standard errors shown in parentheses.

\*\*\* designates significance at the 99.9 percent level.

Several other aspects of the regression results reported above are relevant to our inquiry. First of all, the numbers and asterisks appearing in parentheses beneath the equation tell us how confident we should be that the relationship expressed in the equation is a close approximation of the actual tradeoff between yield spread premiums and direct cash payment in the overall population of loan transactions that defendant lending institutions originate d through mortgage

brokers during the class period. The triple asterisks indicate that we can be highly confident that these estimates are accurate and even more confident that the relationship is not the dollar for dollar trade-off upon which defendants' theory of full financial offset is based.<sup>132</sup> Also noteworthy is the relatively low Adjusted Multiple R Squared of 0.089 (reported in the first line of Notes to Regression A.) This statistic reports how much of the variation in direct cash payments is related to increases in yield spread premium, and here the percentage is only 9 percent. Ninety-one percent of the variation is attributable to other factors that this simple regression does not measure. This low level of explanation further rebuts defendants' theory of full financial offset, which implied that there was a strong and consistent negative relationship between yield spread premiums and direct cash payments to mortgage brokers. (For the defendants' theory to be confirmed, the coefficient would have to be negative one.)

As with prior analyses, we wanted to make sure that our regression results were not somehow affected by differences in loan amounts across loans in the Defendants' Sample. Accordingly, we conducted a similar simple regression, but this time using direct cash payments as percentages of loan amounts and yield spread premiums as percentages of loan amounts as our two variables. The results are presented below in the box marked Simple Regression B.

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<sup>132</sup> Technically speaking, to rebut defendants' theory of full financial offsets, one needs to reject the hypothesis that the coefficient for yield spread premiums is negative one.

**Simple Regression B: Direct Cash Payments as a Function of Yield Spread Premiums**

(Amounts as a Percentage of Loan Amounts for Defendants' Sample; n = 2092)

$$0.998 - 0.145 \times \text{Yield Spread Premium} = \text{Direct Cash Payments}$$

(0.039\*\*\*) (0.023\*\*\*)

Notes: Adjusted Multiple R Squared = 0.018

Standard errors shown in parentheses.

\*\*\* designates significance at the 99 percent level.

This alternative approach is even more at odds with the defendants' theory of full financial offset. To begin with, when one controls for loan size by expressing both direct cash payments and yield spread premiums as percentages of loan amounts, the relationship between the two variables further declines. The line reflecting the best guess of the relationship between direct cash payments and yield spread premiums is even flatter, suggesting that there is only a 0.145 percent average reduction in direct cash payments for every percentage point increase in yield spread premiums. Moreover, the predictive value of the regression – reported in the Adjusted Multiple R Squared – has declined to only 2 percent of overall variation.

In the course of our analysis, we also performed two more simple regressions using a different and arguably more accurate measure of yield spread premiums. As explained above, mortgage brokers sometimes convert yield spread premiums into direct payments by having the borrower buy down an above par interest rate through payments of loan discount fees to the mortgage brokers. In my view, this kind of discount fee – as opposed to the traditional form of discount fees paid to lenders – is really a disguised yield spread premium. Accordingly, we constructed a new variable (adjusted yield spread premiums), which includes yield spread premiums plus discount fees paid to mortgage brokers. We then ran two more regressions. In the first regression, we examined the relationship between adjusted yield spread premiums and

adjusted direct cash payments to mortgage brokers.<sup>133</sup> The results of this regression appear below as Simple Regression C. With this formulation – which is likely a better reflection of the true relationship between yield spread premiums and direct mortgage broker costs – the implicit offset declines to under 20 cents per dollar of yield spread premiums.

**Simple Regression C: Adjusted Direct Cash Payments as a Function of Adjusted Yield Spread Premiums**

(Dollar Amounts for Defendants' Sample; n = 2092)

$$1016.35 - 0.199 \times \text{Adjusted Yield Spread Premium} = \text{Adjusted Direct Cash Payments}$$

(36.02\*\*\*) (0.015\*\*\*)

Notes: Adjusted Multiple R Squared = 0.074  
 Standard errors shown in parentheses.  
 \*\*\* designates significance at the 99 percent level.

In our final simple equation, which uses the same variables, but this time expressed as a percentage of loan amount in order to control for variations in loan size, the results suggest an even lower offset. As summarized in Simple Regression D, below, the estimated offset for adjusted yield spread premiums in this formulation is estimated at 12.4 percent.

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<sup>133</sup> Adjusted direct cash payments to mortgage brokers does not include loan discount fees paid to mortgage brokers, as these fees are included in the adjusted yield spread premium measure.

**Simple Regression D: Adjusted Direct Cash Payments as a Function of Adjusted Yield Spread Premiums**

(Amounts as Percentage of Loan Amounts for Defendants' Sample; n = 2092)

$$0.817 - 0.124 \text{ O}x \text{ Adjusted Yield Spread Premium} = \text{Adjusted Direct Cash Payments}$$

(0.033\*\*\*) (0.017\*\*\*)

Notes: Adjusted Multiple R Squared = 0.025

Standard errors shown in parentheses.

\*\*\* designates significance at the 99 percent level.

**ii.) Alternative Techniques to Control for Loan Amount**

In the course of our analysis of the Defendants' Sample, we experimented with a number of different functional forms of regressions. One approach, which was also used by defendants' experts, is to employ multiple regression techniques that allow for the use of additional explanatory variables. So, for example, if direct cash payments to mortgage brokers were affected by some other factors – such as the type of loan involved or some characteristic of the borrower – multiple regression analysis affords a technique for controlling for these other factors and obtaining a clearer understanding of the true relationship between direct cash payments and yield spread premiums. Multiple regression analysis is, however, much more complex than simple regression analysis and is prone to misapplication and misinterpretation.

A good example of this complexity can be seen in the multiple regression presented below. Like Simple Regression A above, this multiple regression seeks to explain the relationship between direct cash payments to mortgage brokers and yield spread premiums. The regression differs only in that it also includes a new explanatory variable for loan amount. As interpreted by defendants' experts, the coefficient for yield spread premium in this regression (-0.327) suggests that an increase of a dollar in yield spread premiums on average reduces direct

cash compensation for mortgage brokers by just under 33 cents. While this estimate implies an offset of less than a third of the amount paid in yield spread premiums, the figure is somewhat higher than our prior estimates of offsets, which ranged from 0 cents to 26.3 cents for each dollar of yield spread premiums).

### Multiple Regression E: Direct Cash Payments as a Function of Yield Spread Premiums and Loan Amounts

(Dollar Amounts for Defendants' Sample; n = 2092)

$$867.619 - 0.327 \times \text{Yield Spread Premium} + 0.004 \times \text{Loan Amount} = \text{Direct Cash Payments}$$

(58.367\*\*\*)                      (0.019\*\*\*)                      (0.00\*\*\*)

Notes: Adjusted Multiple R Squared = 0.123

Standard errors shown in parentheses.

\*\*\* Designates significance at the 99 percent level.

There are, however, serious problems with this form of multiple regression. In the course of our analysis, we discovered that there is a relationship between the two explanatory variables in this regression – that is between yield spread premiums and loan amounts – that complicates interpretation of the regression results. This complication is known as “interaction.”<sup>134</sup> As a result of this interaction, the interpretation of multiple regressions including both yield spread premiums and loan amounts advanced by defendants’ experts must be qualified in significant respects. Accordingly, I do not rely on the results of Multiple Regression E in formulating my

<sup>134</sup> For an introduction to the concept of interaction, see James T. McClave, P. George Benson, Terry Sincich, *Statistics for Business and Economics* 574-79 (8<sup>th</sup> ed. 2001) [hereinafter cited as Benson, *Statistics*] (where interaction exists “then the first order model [– here the model using only loan amounts and yield spread premiums as explanatory variables --] is not appropriate for predicting [direct cash payments]”). In his deposition, Professor Benson acknowledged the importance of testing for interaction and claimed to have done so for his models. See Benson Deposition of Sept. 28, 2001, at 299-301. However, when we tested Multiple Regression E for interaction, we found a statistically significant coefficient for the interactive term, thus indicating the presence of interaction in the method recommended by the Benson Statistics text. As indicated above, this finding makes it inappropriate to rely upon the coefficients reported in Multiple Regression E.

opinions in this report, other than as necessary for discussing the work of defendants' experts.

Instead, I have employed two other alternative techniques to control for loan amount in analyzing the Defendants' Sample. The first technique was presented above in Regressions B and D. In those regressions, both yield spread premiums and direct cash payments to mortgage broker are expressed as percentages of loan amount. This technique fully controls for loan amount and suggests there is no systemic offset in direct cash payments when the level of yield spread premiums is increased. Indeed, in these formulations, the estimated levels of offset (14.5 cents and 12.4 cents) are actually lower than the estimates for comparable equations with dollar amounts (26.4 cents and 19.9 cents).

My second alternative technique entails a segmentation of the Defendants' Sample into ten different groups (or deciles) of approximately 210 loans. The first decile consists of the 208 smallest loans in the Defendants' Sample; the second decile consists of the next 209 next smallest loans; etc. Having segmented the sample in this way, I then ran ten different simple regressions exploring the relationship between direct cash payments to mortgage brokers and yield spread premiums. This is the same functional form used in Simple Regression A, above, for the full sample. This technique controls for loan size because the loans in each decile are basically the same size. The results of this analysis are presented in two boxes in the following pages.

**Simple Regression F1 to F5:  
Direct Cash Payments as a Function of Yield Spread Premiums**  
(Ten Sub-samples from Defendants' Sample)

Decile No. 1: Loan Amounts = \$ 19,000 to \$ 57,000 (n=208)

$$679.88 + 0.002 \times \text{Yield Spread Premium} = \text{Direct Cash Payments}$$

(81.10\*\*\*)                      (0.087)

Note: Adjusted Multiple R Squared = 0.00

Decile No. 2: Loan Amounts = \$ 57,000 to \$ 75,000 (n= 209)

$$1135.82 - 0.349 \times \text{Yield Spread Premium} = \text{Direct Cash Payments}$$

(115.15\*\*\*)                      (0.095\*\*)

Note: Adjusted Multiple R Squared = 0.057

Decile No. 3: Loan Amounts = \$ 75,000 to \$ 91,698 (n=209)

$$997.29 - 0.161 \times \text{Yield Spread Premium} = \text{Direct Cash Payments}$$

(98.55\*\*\*)                      (0.065\*\*)

Note: Adjusted Multiple R Squared = 0.024

Decile No. 4: Loan Amounts = \$ 91,800 to \$ 106,000 (n=209)

$$863.68 - 0.048 \times \text{Yield Spread Premium} = \text{Direct Cash Payments}$$

(106.46\*\*\*)                      (0.067)

Note: Adjusted Multiple R Squared = 0.000

Decile No. 5: Loan Amounts = \$ 106,000 to \$ 118,300 (n=209)

$$1216.96 - 0.237 \times \text{Yield Spread Premium} = \text{Direct Cash Payments}$$

(111.79\*\*\*)                      (0.057\*\*)

Note: Adjusted Multiple R Squared = 0.072

Standard errors shown in parentheses.

\*\* designates significance at the 95 percent level.

\*\*\* designates significance at the 99 percent level.

**Simple Regression F6 to F10:  
Direct Cash Payments as a Function of Yield Spread Premiums**  
(Ten Sub-samples from Defendants' Sample)

Decile No. 6: Loan Amounts = \$ 118,400 to \$ 132,500 (n=209)

$$1416.68 - 0.369 \times \text{Yield Spread Premium} = \text{Direct Cash Payments}$$

(108.950\*\*\*)                      (0.052\*\*\*)

Note: Adjusted Multiple R Squared = 0.189

Decile No. 7: Loan Amounts = \$ 132,500 to \$ 150,000 (n=209)

$$1444.91 - 0.365 \text{ Yield Spread Premium} = \text{Direct Cash Payments}$$

(112.29\*\*\*)                      (0.048\*\*\*)

Note: Adjusted Multiple R Squared = 0.211

Decile No. 8: Loan Amounts = \$ 150,000 to \$ 175,000 (n=209)

$$1541.83 - 0.240 \times \text{Yield Spread Premium} = \text{Direct Cash Payments}$$

(154.50\*\*\*)                      (0.062\*\*\*)

Note: Adjusted Multiple R Squared = 0.062

Decile No. 9: Loan Amounts = \$ 175,000 to \$ 210,500 (n=209)

$$1594.07 - 0.380 \text{ Yield Spread Premium} = \text{Direct Cash Payments}$$

(158.23\*\*\*)                      (0.054\*\*\*)

Note: Adjusted Multiple R Squared = 0.187

Decile No. 10: Loan Amounts = \$ 211,000 to \$ 642,100 (n=212)

$$2201.75 - 0.441 \times \text{Yield Spread Premium} = \text{Direct Cash Payments}$$

(217.81\*\*\*)                      (0.065\*\*\*)

Note: Adjusted Multiple R Squared = 0.175

Standard errors shown in parentheses.

\*\* designates significance at the 95 percent level.

\*\*\* designates significance at the 99 percent level.

The results of this decile analysis is interesting in numerous respects. To begin with, the levels of estimated offsets are all less than 45 cents on the dollar, and average 24.6 cents on the dollar – very close to the estimate of Simple Regression A (26.3 cents). Thus, even when the defendants’ sample is divided into subsamples of comparable loan amounts, there is no evidence of full financial offset. Indeed, these regression results suggest that defendants’ theory of full financial offset can be rejected at the 99 percent confidence level for all deciles.<sup>135</sup>

Our decile analysis shows several noteworthy variations across deciles. The estimated amounts of offsets are consistently lower for smaller loans and higher for larger loans. For example, the estimated offset for the smallest loans, which are in the first decile, is essentially zero and the average for the first five deciles is only 15.9 cents, whereas the estimated offset for the largest loans is 44.1 cents and the average for second five deciles is 33.3 cents.<sup>136</sup> In addition, the incidence of yield spread premiums is somewhat lower in the higher deciles, whereas the incidence of credits from mortgage brokers is somewhat higher.<sup>137</sup> While further analysis would be necessary to understand fully this data, the relationships uncovered to date are consistent with the possibility that wealthier and more sophisticated borrowers – who are likely to be obtaining larger loans – are more capable than less sophisticated borrowers – who tend to obtain smaller loans – in obtaining offsets from brokers for other direct costs. However, even the borrowers in the largest deciles get less than fifty cents of offsets, on average, for every dollar of yield spread premiums.

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<sup>135</sup> Using the coefficients and standard errors reported in the text, one can reject the theory of full financial offset which implies a coefficient of negative one for the yield spread premium variable.

<sup>136</sup> This change in off-sets across deciles is a manifestation of the interaction discussed above in note 93.

<sup>137</sup> For example, the incidence of yield spread premiums was 90.1 percent and 91.4 percent in the smallest two deciles and 86.6 percent and 81.1 percent in the largest two. Similarly, the incidence of credits was 9.1 percent and 9.1 percent in the smallest two deciles and 15.8 percent and 16.0 percent in the largest two.

**3. What evidence is there to suggest that yield spread premiums are associated with additional services being provided to borrowers in connection with loans that defendant lending institutions originated during the class period?**

In theory, one could accept the weight of the evidence presented in the previous sections of this Part – that is, accept the proposition that mortgage broker compensation and borrower costs are higher for groups of loans with high incidence of yield spread premiums and the further evidence that the payment of yield spread premiums offset direct cash costs by less than 25 cents on the dollar – and still defend the practice on the grounds that loans with yield spread premiums are somehow different and more expensive to originate than other loans and that variations in yield spread premiums are being used to compensate mortgage brokers for different levels of effort required for various transactions. That is, one could argue that the higher costs associated with these loans merely reflect more expensive services incurred in originating these loans.<sup>138</sup> My goal in this final section of this Part is to consider the plausibility of this theoretical objection.<sup>139</sup>

**a) Qualitative Reasons To Doubt the Claim**

The entire manner in which yield spread premiums are determined raises serious doubts as to whether these payments are directly tied to additional services. As outlined earlier in this report,<sup>140</sup> the formulas for calculating yield spread premiums all relate to the pricing of loans on

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<sup>138</sup> In posing this possible objection, I do not mean to imply that this claim represents a legal defense for an alleged violation of Section 8 of RESPA.

<sup>139</sup> As the quantitative analysis I had intended to present in this final section of my report was to be based in part on information that defendants have not yet supplied, my analysis here will necessarily be abbreviated and I reserve the option to supplement my analysis when I receive additional information from defendants or am able to replicate that information from other sources.

<sup>140</sup> See *supra* Box A on page 38.

the secondary mortgage market and the value of ancillary benefits to defendant lending institutions. None of these features speaks to additional services being provided to borrowers. In theory, I suppose, one could imagine mortgage brokers first calculating the additional amount of services required for a particular loan and then reverse-engineering the right type of loan terms to recommend in order to generate the yield spread premium necessary to cover the costs associated with those additional services. But this supposition is implausible on multiple dimensions. To begin with, in none of the lengthy depositions and other discovery conducted in this case have defendants' witnesses suggested that this sort of calculation is undertaken.<sup>141</sup> Indeed, their testimony has indicated an absence of the sort of records and bookkeeping that such calculations would require.<sup>142</sup> Moreover, HUD-1 instructions require all costs incurred in connection with loan originations to be reported on HUD-1 statements, and if special services were being provided in connection with these loans, one would expect them to be reported on the HUD-1 statements. On the records we reviewed, there is no evidence of such additional costs.

### **b) Reasons to Doubt the Claim Derived from Sample Data**

A further reason to question the claim that yield spread premiums are being used to compensate mortgage brokers for the extra costs associated with different borrowers is the high degree of variation in the amounts of mortgage broker compensation revealed in our samples. As explained below, within samples with a high incidence of yield spread premiums, there is a very large variation in mortgage broker compensation. This variation does not exist in samples unaffected by yield spread premiums. It is highly unlikely that unobserved services justify a wide variation in mortgage broker compensation within loans with yield spread premiums, when

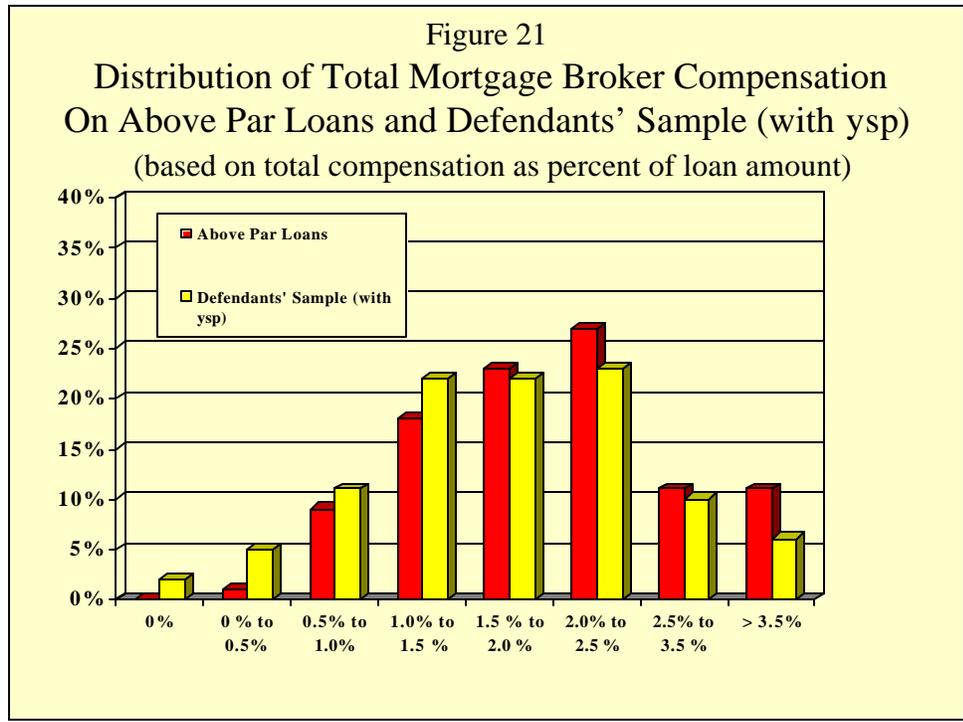
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<sup>141</sup> For evidence from representatives of defendant lending institutions that broker services are not factored into the calculation of yield spread premiums, see Deposition of Phillip Miller 29 (May 24, 2001); Deposition of David Pritchard at 44, 47 ( Mar. 11, 1998) .

<sup>142</sup> For evidence that mortgage brokers do not maintain records of itemized services associated with particular yield spread premiums, see Deposition of Ronald Altman 22 (July 8, 1998).

no similar variation exists in other samples.

The evidence of variation in mortgage broker compensation is contained in Figures 20 and 21. The first, in Figure 20, shows the distribution of total mortgage broker compensation as a percentage of loan amount for the True Par Sample. Notice the large percentage of loans in which total mortgage broker compensation is in the range of 1.0 to 1.5 percent of loan value. This indicates that, with True Par Loans, where consumers can easily observe the actual amount

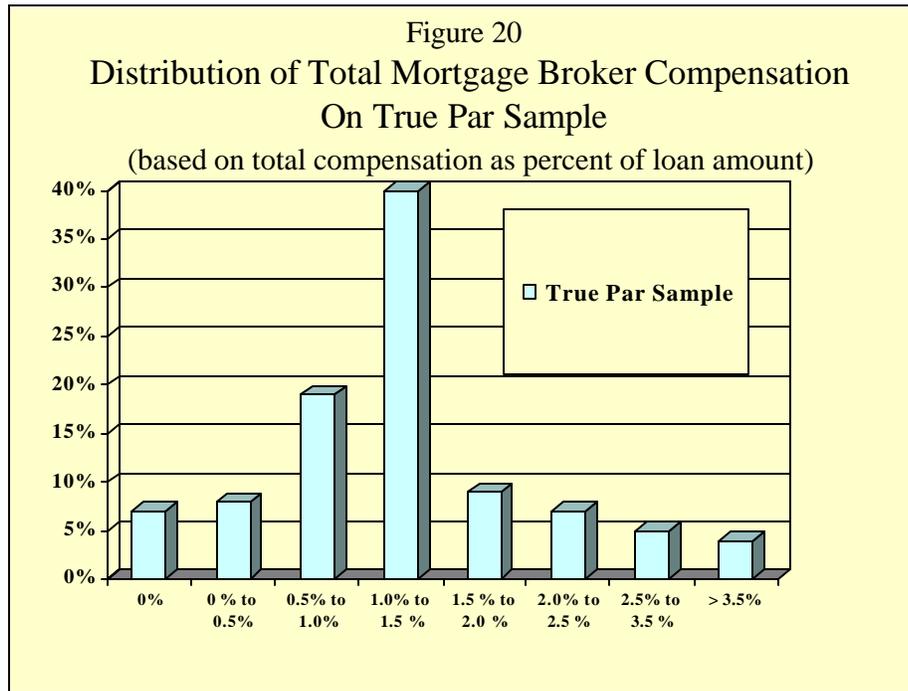


of mortgage broker compensation, total compensation is in the range of 0.5 percent to 1.5 percent of loan value for a substantial majority of loans. There is, in effect, a market price of the services that mortgage brokers

provide.

Now compare Figure 20 with Figure 21, which reports on the same scale a distribution of mortgage broker compensation for the two samples with high incidence of yield spread premiums. Notice how much flatter this distribution is, indicating that many borrowers on loans in these samples are paying total mortgage broker compensation that is much higher than the market price suggested in Figure 20. Indeed, most borrowers are paying more than 1.5 percent

of loan amounts. This is exactly the distribution that one would expect to see if mortgage brokers were using yield spread premiums to extract extra profits from vulnerable customers.



Moreover, yield spread premiums would be an extremely effective mechanism for effecting this sort of price discrimination because consumers have so little understanding of the mechanisms through which yield spread premiums are imposed.

The combined impact of the above evidence renders highly implausible the proposition that yield spread premiums are used to finance additional costs associated with groups of loans with high incidence of yield spread premiums. Rather the evidence strongly, indeed overwhelmingly, supports the view that these payments are being used for other purposes – to wit, to extract additional, excessive mortgage broker compensation from consumers. Indeed, if one thinks back to the history of abuses in the real estate settlement industry that gave rise to the enactment of RESPA in the first place, the similarities are striking. As with the kickbacks and unearned referral fees of the early 1970's, yield spread premiums appear to be imposing substantial costs on borrowers. As with the abusive practices documented in RESPA's legislative history, the costs associated with yield spread premiums are not being offset in reductions of other fees. Rather the costs of these charges are being used to inflate the compensation of mortgage brokers and increase the costs of borrowing. For precisely the same

policy reasons that motivated Congress to enact section 8 of RESPA in the first place, that provision should properly be interpreted to prohibit the payment of yield spread premiums at issue in this litigation.

### **c. Employing Multiple Regression Analysis to Explore the Relationship**

In this final section, I return to multiple regression analysis to explore the extent to which a variety of variables might explain the levels of yield spread premiums.<sup>143</sup> The form of the regressions in this portion of my report is slightly different from those in the preceding section because the variable that I am trying to predict is the level of total compensation paid to mortgage brokers (not direct cash payments or yield spread premiums). My purpose in this analysis is to explore the extent to which the existence of yield spread premiums influences the amount of total mortgage broker compensation after controlling for a variety of other factors.

I begin with a relatively straight-forward regression in which total mortgage broker compensation is the dependent variable (the variable we are attempting to predict) and there are two “dummy” explanatory variables: one for yield spread premiums and the second for discount fees paid to mortgage brokers.<sup>144</sup> What this equation represents is a statistical estimate of the average impact of yield spread premiums and discount fees paid to mortgage brokers on total

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<sup>143</sup> The multiple regressions reported in this section represent, in my view, a preliminary attempt to understand the relationship between yield spread premiums, overall mortgage broker compensation, and a variety of other factors. The analysis here is primarily intended to rebut claims made by defendants. It is not intended to provide a full explanation of mortgage broker compensation. Considerable additional analysis, including consideration of issues such as interaction among variables, exploration of alternative functional forms, and other extensions of analysis, will be necessary to complete this larger project. In the future, I plan to explore these topics in a related academic paper on the subject.

<sup>144</sup> A dummy variable is variable that has a value of one if a factor is present (such as the payment of yield spread premiums) and zero if it is not present. In regressions of this sort, the coefficient of the dummy variable represents the average effect of the factor in question.

mortgage broker compensation.<sup>145</sup> The equation indicates that, in the absence of yield spread premiums or discount fees paid to mortgage brokers, the average level of total mortgage broker compensation is \$ 1,416. When a yield spread premium is present, average total mortgage broker compensation increases by \$1,043, and when mortgage brokers receive discount fees, total mortgage broker compensation increases by another \$803. All of these estimates are significant at above the 99 percent level.

### Regression G: Impact of Yield Spread Premiums on Total Mortgage Compensation

(Dollar Amounts: Defendants' Sample; n = 2092)

$$1416 + 1043 \times \text{Dummy for YSP} + 830 \times \text{Dummy for MB Discount Fees} = \text{Total MB Compensation}$$

(102\*\*\*)                      (105\*\*\*)                      (102\*\*\*)

Notes: Adjusted Multiple R Squared = 0.058

Standard errors shown in parentheses.

\*\*\* designates significance at the 99 percent level.

Our next task was to consider whether these substantial effects remained after controlling for a variety of other factors. The factors we examined were divided into four groups. First were factors associated with the type of loans involved.<sup>146</sup> Second were factors related to the credit-worthiness of the borrower and thus the effort required of mortgage brokers in originating

<sup>145</sup> We include discount fees paid to mortgage brokers because, as explained above, see supra pp. 60-62, these fees are functionally the same as yield spread premiums and can only be imposed when a mortgage broker proposes an above par interest rate.

<sup>146</sup> These loan characteristics were the size of loans, whether the loan was a 30-year fixed rate mortgage, whether the loan was a FHA loan, whether the loan was a conventional uninsured loan, and whether the loan was for refinancing (as opposed to initial home purchase). These variables were taken from a combination of HUD-1 statements and the defendants' electronic database. We included these variables to control for the extent to which the characteristics of particular loans might explain the variable in total mortgage broker compensation.

the loan,<sup>147</sup> Third were factors related to other demographic characteristics of the borrower.<sup>148</sup> And fourth were geographic variables.<sup>149</sup> A full list of the variables we examined is set forth in the margins along with brief explanations why we thought these variables might influence total mortgage broker compensation.

After running regressions with a number of different combinations of these variables, we arrived at the formulation in Figures 22 and 23 as the most appropriate formulation.<sup>150</sup> The results are striking in numerous respects.

- First, even after controlling for all the other variables reported in Expanded Regression G, the impact of yield spread premiums (\$929) and discount fees (\$706) is largely unchanged from our initial analysis. Thus, even with this more elaborate formulation, regression analysis confirms that loans with yield spread premiums are associated with substantially higher mortgage broker compensation than other loans and further rebuts defendants' theory of full financial offset.

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<sup>147</sup> These factors included a credit score for each loan and also the loan to value ratio of each loan. Both of these variables were taken from defendants' electronic records. We included these variables to explore the extent to which variations in total mortgage broker compensation might be related to the creditworthiness of individual borrowers and thus the effort that mortgage brokers might need to expend in originating different loans.

<sup>148</sup> These variables included the appraised value of borrowers' homes as a proxy for wealth and then several dummy variables for six racial groups identified for borrowers in the defendants' electronic database. Appraised home value was derived from loan amounts and loan to value ratios. We included these variables to explore the extent to which variations in total mortgage broker compensation might be associated with either the wealth or racial identity of borrowers.

<sup>149</sup> We limited our analysis of geographic variables to the five large states: California, Florida, Illinois, New York, and Texas. We included these geographic variables to consider whether differences in local mortgage markets might explain variation in mortgage broker compensation.

<sup>150</sup> This formulation drops several variables, such as appraised value of homes and certain racial dummy variables, that did not have statistically significant explanatory power. We left a number of variables that were also not statistically significant because in certain cases the absence of a significant impact was a noteworthy finding.

- Second, a number of loan characteristics do have a statistically significant impact on the amount of total mortgage broker compensation. For example, total mortgage broker compensation is, on average, \$187 higher for 30 year fixed loans and \$303 higher for FHA loans. Furthermore, total mortgage broker compensation on conventional uninsured loans is on average \$143 lower. On the other hand, the fact that a loan is refinancing as opposed to an original home purchase loan seems to have no statistically significant impact on total mortgage broker compensation.
- Third, the variables associated with creditworthiness and, by hypothesis, mortgage broker

**Figure 22**  
**Expanded Regression G**  
(Dependent Variable = Total MB Compensation in Dollars)  
(Sample = 1677 Loans in Defendants' Sample with Available Data)

	Coefficient	Standard Error
Constant	208	358
<i>Yield Spread Premium Variables:</i>		
Yield Spread Premium Dummy	929	100***
MB Discount Fee Dummy	706	98***
<i>Loan Characteristic Variables:</i>		
Loan Size	0.011	0.001***
30-Year Fixed Dummy	187	75**
Conventional Uninsured Dummy	-143	85
Government Loan Dummy	303	135**
Refinancing Dummy	2.86	75
<i>Credit Quality/Mortgage Broker Effort Variables:</i>		
Credit Score	-1.192	0.34***
Loan to Value Ratio	8.135	2.417***
<i>Racial Variables:</i>		
Racial Group Three	474	176***
Racial Group Four	580	181***
<i>Geographic Variables:</i>		
California Dummy	-23	135
Florida Dummy	-66	109
Illinois Dummy	-133	120
New York Dummy	408	144***
Texas Dummy	-200	153
Adjusted Multiple R Squared: 0.287		
** Indicates Statistical Significance at the 95 percent Level.		
*** Indicates Statistical Significance at the 99 percent Level.		

effort also have the expected impacts. The better credit scores for borrowers are associated with lower total compensation for mortgage brokers, whereas high loan-to-value ratios tend to be associated with higher total mortgage broker compensation. While both of these effects are statistically significant, their overall impact on total

mortgage broker compensation would rarely be more than one or two hundred dollars, as the variation in credit scores and loan to value ratios is relatively limited.

- Fourth, for the most part, geographic variation seems to have very limited impact on total mortgage broker compensation. In addition, the geographic dummies we included were not statistically significant. Thus, the results of Expanded Regression G are not consistent with the hypothesis that variations in total mortgage broker compensation are explained by local market conditions.
- Finally, Expanded Regression G suggests that mortgage brokers may be varying their compensation based on the racial characteristics of borrowers. Although we could not determine which racial groups are involved, our statistical analyses indicated that Racial Group Three (African American), which constituted 3.4 percent of the Defendants' Sample, paid on average \$474 in total mortgage broker compensation, whereas Racial Group Four (Hispanic), which constituted 3.5 percent of Defendants' Sample, paid \$580 more in total mortgage broker compensation. Both of these effects are statistically significant at the 99 percent level, and are consistent with my hypothesis that mortgage brokers could be using their complex compensation mechanisms to exploit unsophisticated borrowers.

Figure 23 offers an alternative presentation of Expanded Regression G with the dependent variable, Total mortgage broker compensation, expressed as a percentage of loan amount rather than as dollars. All of the important effects – including the higher costs associated with both yield spread premiums and Racial Groups Three and Four are the same as reported above for Figure 22. The only difference in statistical significance between the two formulations is that the dummy variable for New York is not significant in this second formulation, whereas it

was for the first.

**Figure 23**  
**Expanded Regression G**  
 (Dependent Variable = Total MB Compensation as % of Loan Amount)  
 (Sample = 1677 Loans in Defendants' Sample with Available Data)

	<i>Coefficient</i>	<i>Standard Error</i>
Constant	2.751	0.0306***
<i>Yield Spread Premium Variables:</i>		
Yield Spread Premium Dummy	0.89	0.085***
MB Discount Fee Dummy	0.918	0.084***
<i>Loan Characteristic Variables:</i>		
Loan Size	-0.000	0.000***
30-Year Fixed Dummy	0.157	0.064**
Conventional Uninsured Dummy	-0.115	0.072
Government Loan Dummy	0.682	0.115***
Refinancing Dummy	0.025	0.064
<i>Credit Quality/Mortgage Broker Effort Variables:</i>		
Credit Score	-0.002	0.000***
Loan to Value Ratio	0.001	0.002
<i>Racial Variables:</i>		
Racial Group Three	0.433	0.15***
Racial Group Four	0.566	0.154***
<i>Geographic Variables:</i>		
California Dummy	0.119	0.115
Florida Dummy	0.03	0.093
Illinois Dummy	-0.161	0.102
New York Dummy	0.147	0.123
Texas Dummy	-0.112	0.131
Adjusted Multiple R Squared: 0.305		
** Indicates Statistical Significance at the 95 percent Level.		
*** Indicates Statistical Significance at the 99 percent Level.		

### **C. Conclusion**

In this Part, I have presented a large volume of information about the manner in which defendant lending institutions and their mortgage brokers make use of yield spread premiums. My principal findings, however, can be summarized fairly briefly.

First, yield spread premiums are a major source of compensation for mortgage brokers. These payments appear in between 85 and 90 percent of all transactions. The average amount of yield spread premiums is high— in the range of \$1,850 per transaction. The payments, moreover, constitute by far the largest source of compensation for mortgage brokers in loans financed by defendant lending institutions.

Second, measured either in terms of total mortgage broker compensation or total borrower costs at settlement, loans associated with yield spread premiums are substantially more expensive than other comparable loans. Though the amount of the difference varies somewhat depending on the basis of comparison, the difference is probably best estimated to average around \$1000 to \$1100 per transaction.

Third, our regression analyses convincingly refutes defendants' theory of full financial offset. In particular, we find no evidence to suggest that the payment of yield spread premiums gains borrowers a dollar for dollar offset in direct cash payments at settlement. Rather, our analyses suggest that the amount of offset is rather small, probably on the order of 20 to 25 cents per dollar. In other words, by our estimates, 75 to 80 cents of every dollar paid in yield spread premiums goes to enrich mortgage brokers. This effect persists even after using statistical means to control for a wide variety of other factors, including loan characteristics, borrower creditworthiness, loan to value ratios, geographic regions, and other demographic factors.

Fifth, one of the most disturbing aspects of yield spread premiums is that the practice appears to allow mortgage brokers to discriminate among borrowers in the amount of

compensation the industry charges. My hypothesis is that the industry uses this power to extract additional payments from unsophisticated borrowers. Our analysis, however, also suggests that industry practices allow for certain racial groups to be charged on the order of \$500 to \$600 more per transaction in mortgage broker compensation.

The analyses presented in this Part may also have important implications for the legal status of yield spread premiums for this litigation. To begin with, my statistical analyses uniformly confirm that loans with yield spread premiums are different from other loans that defendant lending institutions finance. Loans with yield spread premiums cost borrowers more than other loans. The differences are substantial, in excess of \$1000 per transaction, and invariably statistically significant at the 99 percent level or higher. In lay terms, what this evidence means is that loans with yield spread premiums have something in common that distinguish them in an important way from other loans.

My analysis also has relevance for the location of yield spread premiums in this case under Section 8 of the RESPA. To the extent that the court must determine whether yield spread premiums are illegal referral fees or bona fide compensation, my analysis strongly suggests that unearned referral fees is the better choice. Overwhelmingly, the evidence presented in this Part indicates that the largest portion of yield spread premiums goes to increasing mortgage broker compensation and only a fraction – say 20 to 25 cents on the dollar – goes to cover the costs of legitimate goods and services. If payment must be characterized as either referral fees or compensation, my analysis suggests that they should be characterized as referral fees.

Finally, to the extent that the court is called upon to opine as to the reasonableness of the yield spread premiums paid in this case,<sup>151</sup> my analysis supports a finding of unreasonableness.

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<sup>151</sup> As indicated in the previous paragraph, my own view is that the yield spread premiums in this case are best characterized as referral fees. Under this view, there would be no need for the court to reach the issue of reasonableness.

While this is admittedly a subjective determination, my view is that fees which generate borrowers only 20 to 25 cents of value for every dollar of payment are not reasonable.<sup>152</sup>

Moreover, as my analysis demonstrates that the costs for loans with yield spread premiums can be distinguished from the costs of other loans with a statistical significance of 99 percent or higher, I believe it would be appropriate for the court to make an assessment of reasonableness of these fees on a class-wide basis.

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<sup>152</sup> In this regard, see my discussion of the implicit interest rate on yield spread premium “financing” discussed *infra* 127-130.

#### **Part IV. Rebuttal of Reports from Defendants' Experts**

In this final part of my report, I respond to certain aspects of reports that defendants' experts Professor George Benson and Ms. Susan Woodward have filed in this litigation. Although my analysis covers a much broader range of issues, Professor Benson's and Ms. Woodward's reports offer statistical analyses similar to certain aspects of my report. I begin this Part with an overview of the various studies, identifying first the aspects of my analysis that Professor Benson and Ms. Woodward have not contested and then focusing on the principal issue upon which we differ: our estimate of the amount of offsets in other direct costs that borrowers obtain for yield spread premiums. While all three of us agree that the offset is not complete – that is, there is no evidence of full financial offset – we differ in our estimates of the actual degree of offset. I next provide a more detailed critique of the work of defendants' experts. While my criticisms of Professor Benson's work are largely technical, Ms. Woodward's analysis contains serious errors of data collection and statistical analysis. After summarizing these shortcomings, I rerun the principal regressions of Professor Benson and Ms. Woodward using in some instances our database, which is substantially more complete and better validated than the database upon which defendants' experts relied. Finally, I take issue with several other aspects of Ms. Woodward's analysis. First, I consider two new justifications for yield spread premiums that Ms. Woodward advances in her report and explain why these arguments are implausible in theory and entirely inconsistent with the evidence of defendant lending institutions actual practices. In addition, I identify several major mistakes in Ms. Woodward's Equation 8, which is intended to demonstrate that the interest rates on loans in the Retail Sample are substantially higher than the interest rates on other comparable loans.

## A. Overview of Studies

### 1. Issues Not Contested

Let me begin by reviewing the aspects of my analysis which defendants' experts do not contest.<sup>153</sup>

- First, neither Professor Benson nor Ms. Woodward contest my findings that the incidence of yield spread premiums among loans originated by defendant lending institutions is very high (present in 85 to 90 percent of the loans that defendant lending institutions originate through mortgage brokers); that the average amount of yield spread premiums is substantial (in excess of \$1800 per loan); and that these fees constitute the single most important source of compensation for mortgage brokers originating mortgages on behalf of defendant lending institutions.<sup>154</sup>
- Second, neither Professor Benson nor Ms. Woodward contest my analysis of the Plaintiffs' Sample in which I find robust differences between average levels of mortgage broker compensation and total borrower costs for loans with yield spread premiums as opposed to other loans that are not associated with yield spread premiums.<sup>155</sup> That is, defendants' experts do not offer alternative comparisons of average compensation across groups of loans, either using total dollar amounts of compensation or compensation as a percentage of loan amounts. Defendants' experts rely exclusively on regression analysis to address this issue.

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<sup>153</sup> I limited myself to aspects of my analysis that were fully presented in my July 9, 2001, report, which both Professor Benson and Ms. Woodward had reviewed before they made their most recent versions of their reports.

<sup>154</sup> See supra pp. 56-64.

<sup>155</sup> See supra pp. 70-83.

- Third, defendants' experts do not challenge my findings that loans with yield spread premiums have an unusual dispersion of total mortgage broker compensation, and that other loans in our samples do not have a similar dispersion in total mortgage broker compensation, but rather exhibit a much narrower (and more typical) range of payments, mostly in the neighborhood of 1.0 percent to 1.5 percent of loan amounts.<sup>156</sup>
- Finally, neither of defendants' experts offer evidence that the borrowers on loans with yield spread premiums have any observable characteristics that would justify the substantially higher levels of compensation that mortgage brokers obtain on these transactions. Nor did either expert address my opinion that the manner in which yield spread premiums are imposed makes it highly implausible that these payments were being used to compensate mortgage brokers for additional costs associated with particular loans.<sup>157</sup>

## **2. The Focus of Our Disagreement: The Extent of Financial Offset**

The principal point on which defendants' experts and I disagree is the extent to which mortgage brokers lower other forms of compensation when yield spread premiums are present. Even here, however, the extent of our disagreement is not that large. Neither of defendants' experts offers any evidence of full financial offset (that is, dollar for dollar offset). What they present is evidence of partial offset, much like the evidence I present in Part III. To be sure, the magnitudes of their estimates are somewhat greater than my own. Whereas my regression analyses suggests an offset for yield spread premiums in the range of 20 to 25 cents on the dollar, the offset estimates of defendants' experts range from 22 cents to 75 cents on the dollar and average about 55 cents. (See Figure 24 for a summary of the offset estimates of defendants'

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<sup>156</sup> See supra pp. 65-67, 101-04.

<sup>157</sup> See supra pp. 100-01.

experts.) But the critical point is that none of the statistical evidence offered by the experts in this litigation suggests anything close to full financial offset.

Quite possibly this is enough agreement to decide the case. Even if one were to credit the higher levels of offset reported in the work of defendants' experts – and, as I explain shortly, a

Figure 24  
Estimates of Offsets from Defendants Experts

Source	Estimates
<b>Defendants' Experts:</b>	
Equation 1 of Woodward (July 9th), p. 27	\$0.68
Equations 3-4 of Woodward (July 27th), p. 5 & 6	\$0.18
Equation 5 of Woodward (July 27th), p.7	\$0.32
Equations 6-7,9 of Woodward (July 27th), p.9-10	\$0.76
Equations 9 of Woodward (July 27th), p.16	\$0.71
Models 1a & 1b of Benson (July 9th) App. p.1	\$0.32
Models 2a & 2b of Benson (July 9th) App. p. 4	\$0.75
Models 3a & 3b of Benson (July 9th) App. p.7	\$0.62
Models 4a & 4b of Benson (July 9th) App. p. 10	\$0.85
Models 1a - 1c of Benson (Aug. 8th) App. pp.1-2	\$0.25
Models 2a - 2c of Benson (Aug. 8th) App. pp.3-4	\$0.66
<b>Average of Estimates</b>	<b>\$0.55</b>

number of these estimates are clearly flawed – there is no reason to believe that Congress did not intend to prohibit activities generating excessive charges of this sort. As explained above in Part I, the statutory language of section 8 has no exception for kickbacks that are offset to a certain extent. Indeed, if one looks back to the legislative history of RESPA, it is clear that Congress was principally concerned with payments in which only 10 to 30 percent were passed on as referral fees and therefore at least 70 to 90 percent were attributable to real services. Thus, the payments that motivated the enactment of section 8 were at least 70 to 90 percent offset with real

services. Yet Congress still saw fit to proscribe them. Given this legislative guidance, the evidence of defendants' own experts suggests to me that yield spread premiums are illegal referral fees under section 8 of RESPA. At a minimum, I believe, payments that generate only 55 cents of value on the dollar, are unreasonable forms of compensations and therefore actionable under Section 8.

## **B. Principal Shortcomings in the Statistical Analysis of Defendants' Experts**

In this section, I will briefly summarize the principal shortcomings of the estimates that defendants' experts made regarding offsets of yield spread premiums. Where possible, I have attempted to correct these shortcomings and recalculated the estimates, in some instances making use of our more complete database. Figure 27, which appears at the end of this section, summarizes these critiques and suggests that, correctly formulated, the analyses of defendants' experts suggests an offset of approximately 27 cents on the dollar.

### **1. Estimates Based on Small and Nonrepresentative Group of Loans**

Several of the regressions of defendants' experts must be rejected because they are based solely on the Heartland loans or a subgroup thereof. The list of affected regressions would include Ms. Woodward's Equation 1 (July 9<sup>th</sup>) and Equation 9 (July 27<sup>th</sup>), as well as Professor Benson's Models 1 through 4 (July 9<sup>h</sup>). It is a fundamental premise of inferential statistics that analysis should be based on representative samples.<sup>158</sup> While the loans in the Defendants' Sample satisfy this requirement and the loans in the Plaintiffs' Sample do as well for certain purposes, the Heartland loans do not. By definition, all of these loans were originated through a

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<sup>158</sup> See Benson, Statistics, *supra* note 93, at 16 (“[I]f we wish to apply inferential statistics, we must obtain a *representative sample*.”) (emphasis in original). See Deposition of Susan Woodward 202 (July 31, 2001) (acknowledging that Heartland loans are not a representative sample of all loans originated by defendant lending institutions). See also Deposition of George Benson 270-73 (Sept. 28, 2001).

single mortgage broker and thus cannot be assumed to be representative of the entire class.<sup>159</sup> For this reason, none of the regressions based on the Heartland Loans can be reliable estimates of the overall practices of defendant lending institutions.

## 2. Major Errors in Ms. Woodward's Analyses

A series of separate and even more fundamental errors mar much of the analysis of Ms. Woodward. Though these errors occur in a number of places, they are most evident in Equations 6 through 9 of her August 8<sup>th</sup> Report. In these regressions, she attempts to explore the influence of yield spread premiums on NETRECEIPTS, which is her measure of total mortgage broker compensation. There are two basic problems with her analysis here.

First, she commits an elementary error of statistical design in that she uses a dependent variable (NETRECEIPTS) that includes one of her explanatory variables (yield spread premiums). In my view, this is not an appropriate functional form, and it is something that neither Professor Benson<sup>160</sup> nor I do in comparable equations. Apparently, aware that she is presenting an unorthodox formulation, Ms. Woodward explains why her structure conforms to her own understanding of the problem.<sup>161</sup> But then, she goes on to make the clearly inaccurate claim that her formulation is “[s]tatistically . . . equivalent” to standard formulations. This is just wrong. As any student of regression analysis should immediately recognize, Ms. Woodward's formulation inflates the R squared of her equation. This problem renders highly misleading Ms. Woodward's assertion that her “regressions explain about 70 percent of the

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<sup>159</sup> Our examination of the Heartland loans in Part III confirms that they differ in certain important respects from the loans in the Plaintiffs' Sample and Defendants' Sample.

<sup>160</sup> See Deposition of Professor Benson at 298 (Sept. 28, 2001).

<sup>161</sup> See Woodward Report of August 8, 2001, at 9.

variation in loan-related settlement costs.”<sup>162</sup> Had Ms. Woodward constructed her regressions in the appropriate manner, her R Squared would have been in the same low range as those of mine and Professor Benson’s.<sup>163</sup>

The second major flaw in Ms. Woodward’s use of NETRECEIPTS as a dependent variable stems from fundamental problems in the construction of this variable. In reviewing the database from which Ms. Woodward derived the NETRECEIPTS, we discovered that the variable is not constructed in the manner she intended. As explained in her deposition, what Ms. Woodward intended to do was to create a dependent variable that was the sum of all revenue received by the mortgage broker in each transaction. Thus, the dependent variable would include yield spread premiums plus other direct cash payments to mortgage brokers. Then, as described above, she also proposed to use yield spread premium as one of the explanatory variables in her equation. Apparently, however, Ms. Woodward or her associates got confused when they attempted to carry out this plan. The yield spread premium variables they used in creating NETRECEIPTS (called BRYSP and SFYSP in their database) were different than the one they used as the explanatory variable (called YSP in their database) in their equation.<sup>164</sup> In my view, this is clearly not what Ms. Woodward intended, and indeed there is no theoretical reason why one definition of yield spread premium should be used for the first purpose and another for the second. Moreover, the second yield spread premium variable was poorly constructed, apparently based on an incomplete review of the HUD-1 forms, whereas the first variable came from the

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<sup>162</sup> See Woodward Report of July 9, 2001, at 23.

<sup>163</sup> I assume that Ms. Woodward understands this effect, although I must admit that certain portions of her deposition suggest that she may be confused on this elementary aspect of regression analysis. See Deposition of Susan Woodward 305 (July 31, 2001) (Question: “Do you think . . . that your R-square is higher because you put the yield spread premium on both sides of the equation?” Answer [of Woodward]: “No.”).

<sup>164</sup> See generally Deposition of Ms. Susan Woodward at 150 et seq (July 31, 2001).

defendants' electronic database.<sup>165</sup> To run the regression she intended, Ms. Woodward clearly should have used, for both purposes, the first yield spread premium variable, that is the one from defendants' electronic database. Using a correct and consistent yield-spread-premium variable substantially changes the regression results.

To give a sense of the magnitude of this error, consider Woodward's Equation 6. As summarized in the first two columns of Figure 24, the critical aspect of this equation is the 0.26 coefficient of the yield spread premium variable. According to Ms. Woodward, this coefficient suggests that for every dollar of yield spread premiums, borrowers enjoyed a 74 cent offset in other

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<sup>165</sup> See supra note 76 and accompanying text. For example, on loan 6011250601, defendants' electronic records indicate the presence of a yield spread premium of \$9,350, but the second YSP variable used in Ms. Woodward's regression showed no yield spread premium. On loan 601260998, defendants' electronic records showed a yield spread premium of \$8032, but Woodward's YSP variable again showed no such payment. Similar discrepancies exist for many other loans in the sample.

Figure 25  
Replication of Woodward Equation 6

(Dependent Variable = NETRECEITPS)							
Explanatory Variables:	In Original Report		Replicated with Erroenous Data		Replicated with Consistent YSP		
	Coefficient	Standard Error	Coefficient	Standard Error	Coefficient	Standard Error	
Constant	-206	524	-206	524	-288	424	
Loansize	-0.0043	0***	-0.004	0.001***	0.004	0***	
YSP	0.26	0.03***	0.0262	0.025***	0.687	.020***	
[13 variables not reported	---	---	---	---	---	---	
	R Squared = 0.114		R Squared = 0.114		R Squared = 0.411		
	*** Denotes statistical significance at the 99 percent level.						

costs (1.00 minus 0.26). (This is one of Ms. Woodward’s highest offset estimates.) But, as Figure 24 indicates, the only way to generate this result is to rely on the erroneous data transformation process described above.<sup>166</sup> If one use the correct data – that is, if one does what Ms. Woodward claims she initially intended to do<sup>167</sup> – the coefficient of the yield spread premium variable increases to 0.687 percent and the implicit offset drops to 31 cents (1.00 minus 0.69).

A similar data construction problem affects Ms. Woodward’s Equation 5. If rerun with

<sup>166</sup> The next two columns of Figure 24 report our regression results using the corrupted data. The substantial similarity of the critical coefficient and the identical R Square convince me that we have correctly replicated what Ms. Woodward actually did in her Equation 6.

<sup>167</sup> See Deposition of Ms. Susan Woodward at 150 et seq (July 31, 2001).

the correct yield spread premium variable, her Equation 5 regression suggests an offset of 27 cents per dollar of yield spread premiums as opposed to the 32 cents reported in Woodward's flawed formulation.

Given space and time constraints, I will only briefly summarize other flaws in Ms. Woodward's analyses. One major problem with her regression analysis is that she did not keep track of the number of different variables she considered before coming up with the multiple regression equations presented in her report.<sup>168</sup> This is a fundamental error of regression technique and is known as data mining. This practice severely compromises the value of her work as one has no idea how many explanatory variables she examined before finding the ones included in her equation. Nor does she offer any theoretical explanation why certain of her variables – such as market points or market rates – should have an impact on mortgage broker compensation. Indeed, as her colleague Professor Benson notes, Ms. Woodward's goal in conducting her regression analysis was “to come up with . . . a high R square that explained as much variation as she could possibly explain” and “to get a model that had, you know, a real high coefficient for the yield spread premium.”<sup>169</sup> These goals, in my view, are not appropriate objectives in constructing regression analyses, and they clearly compromise the integrity of Ms. Woodward's work.

## **2. Technical Critique of Professor Benson's Offset Estimates**

My comments on Professor Benson's analysis are more limited because, for the most part, his work is well-presented and professional. I do, however, have several suggestions as to how Professor Benson's analysis might be improved upon.

First, all of the models in Professor Benson's report of July 9, 2001, were based on an

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<sup>168</sup> See Deposition of Ms. Susan Woodward 288-89 (July 31, 2001).

<sup>169</sup> See Deposition of Professor George Benson 279-81 (Sept. 28, 2001).

analysis of the Heartland loans. As discussed above and as Professor Benson himself acknowledged in his deposition,<sup>170</sup> these loans do not constitute a representative sample and do not form an appropriate basis for drawing inferences about the overall activity of defendant lending institutions. Accordingly, the models presented in Professor Benson's July 9, 2001, report are not valid estimates of the overall practice of defendant lending institutions.

Second, there is the issue of interaction. In his professional writings and in his deposition, Mr. Benson has been quite clear that it is important to check for interaction between key explanatory variables in a multiple regression equation<sup>171</sup> and the appropriate mechanism for testing for interaction.<sup>172</sup> However, when we examined Model 1 from Professor Benson's August 8<sup>th</sup> Report, we discovered interaction between the yield spread premium and loan size variables.<sup>173</sup> The presence of this interaction complicates the interpretation of the regression results of Professor Benson's Model 1 analysis (and further compromises many of Ms. Woodward's multiple regressions).

Third, in my view there are problems in the functional form of the Model Two regressions included in Professor Benson's August 8<sup>th</sup> Report. Although we had some difficulty replicating Professor's Benson's results in this model,<sup>174</sup> we were largely able to reproduce his analysis using similar variables from our database. Presented in Figure 26 below are Professor Benson's original results for Model 2b and then our best guess at replicating the analysis. Both

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<sup>170</sup> See Deposition of Professor George Benson 265-66 (Sept. 28, 2001).

<sup>171</sup> See id at 300-301.

<sup>172</sup> See id. at 302.

<sup>173</sup> See supra note 93 and accompanying text (reporting the same interaction in similar multiple regressions).

<sup>174</sup> In his deposition, Professor Benson was unable to explain how his dependent variable was constructed. See id at 151 et seq.

Professor Benson's model and our replication are limited to the Defendants' Sample.

Figure 26  
Replication of Benson Model 2b

Explanatory Variables:	In Benson Report		Replicated with Our Database		Replicated with Additional Dummy	
	Coefficient	Standard Error	Coefficient	Standard Error	Coefficient	Standard Error
Constant	1685	89***	1628	93***	1087	95***
Loansize	0.00274	0***	0.001	0.000**	0.001	0.000**
YSP Dummy	-1277	75***	-1033	78***	-693	78***
Discount Fee to MB Dummy	---	---	---	---	1148	76***
	R Squared = 0.143		R Squared = 0.079		R Squared = 0.171	
	*** Denotes statistical significance at the 99 percent level.					
	** Denotes statistical significance at the 95 percent level.					

As Figure 26 indicates, we were able to replicate Benson's analysis with a reasonable degree of accuracy. The critical element of this regression is the coefficient of the dummy variable for yield spread premiums. Professor Benson's model suggests that other compensation goes down by \$1,277 when a yield spread premium is paid; our replication of his analysis suggests an offset of \$1,033. Both formulations imply an offset of more than fifty cents on the dollar because the average size of yield spread premiums in the Defendants' Sample is \$1,848. To be more specific, Professor Benson's original analysis suggests an offset of 69 cents on the dollar, whereas our replication suggests an offset of 56 cents.

The problem with both formulations, however, is that they do not control for the fact that yield spread premiums influence mortgage broker compensation in indirect ways. As mentioned above, discount fees paid to mortgage brokers are functionally equivalent to yield spread premiums and they inflate mortgage broker compensation in a substantial number of cases.<sup>175</sup> In an effort to control for this effect, I reran Professor Benson's Model 2b with the addition of a dummy variable for transactions in which mortgage brokers receive discount fees as part of their compensation. As indicated in Figure 26, this new dummy variable had a substantial impact on the equation. Most notably, the coefficient for yield spread premiums dropped from negative 1033 to negative 693. This new estimate implies an offset of only 38 cents for every dollar of yield spread premium, which is more consistent with our other estimates of yield spread premium offsets and, in my view, a more accurate formulation of the impact of yield spread premiums.

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<sup>175</sup> See supra pp 60-62.

### 3. Summary

In an effort to summarize the foregoing analysis, I have presented in Figure 27 a review of the original estimates of defendants' experts and my reformulation of those estimates. As indicated, once the refinements outlined above are taken into account, the average level of offsets suggested by the analytical techniques of defendants' experts declines to an average of 27 cents -- still a bit higher than my own average estimate (22 cents), but not far off. In my view, this is the level of offset for yield spread premiums implied by the regression analyses of defendants' experts, once corrected for clear errors in design.

Figure 27 Summary of Offset Estimates of Defendants' Experts (original and corrected)			
<i>Source</i>	<i>Original Estimates</i>	<i>Summary of Technical Problems</i>	<i>Corrected Estimates</i>
<b>Defendants' Experts:</b>			
Equation 1 of Woodward (July 9th), p. 27	\$0.68	Not a Representative Sample	---
Equations 3-4 of Woodward (July 27th), p. 5 & 6	\$0.18	Interactivity Not Reported	\$0.18
Equation 5 of Woodward (July 27th), p.7	\$0.32	Interactivity & Data Entry Error	\$0.26
Equations 6-7 of Woodward (July 27th), p.9-10	\$0.76	Interactivity & Data Entry Error	\$0.31
Equations 9 of Woodward (July 27th), p.16	\$0.71	Not a Representative Sample	---
Models 1a & 1b of Benson (July 9th) App. p.1	\$0.32	Not a Representative Sample	---
Models 2a & 2b of Benson (July 9th) App. p. 4	\$0.75	Not a Representative Sample	---
Models 3a & 3b of Benson (July 9th) App. p.7	\$0.62	Not a Representative Sample	---
Models 4a & 4b of Benson (July 9th) App. p. 10	\$0.85	Not a Representative Sample	---
Models 1a - 1c of Benson (Aug. 8th) App. pp.1-2	\$0.25	Interactivity & Variable Undefined	\$0.25
Models 2a - 2c of Benson (Aug. 8th) App. pp.3-4	\$0.66	Omitted Variable & Variable Undefined	\$0.38
<b>Average of Estimates</b>	<b>\$0.55</b>		<b>\$0.27</b>

### **C. Critique of Other Aspects of Ms. Woodward's Report**

In this final section, I address three other elements of Ms. Woodward's report: her claim that the payment of yield spread premiums constitutes a reasonable mechanism for financing up-front settlement costs; her assertion that higher settlement costs on loans with yield spread premiums are a plausible artifact of the Internal Revenue Code; and her Equation 8 which purports to demonstrate the loans in the Retail Sample have substantially higher interest rates than other comparable loans. In my view, each of these arguments is patently and demonstrably incorrect.

#### **1. Yield Spread Premiums as a Mechanism for Financing Settlement Costs**

In her report, Ms. Woodward makes the claim that yield spread premiums constitute a legitimate mechanism for financing a borrower's settlement costs.<sup>176</sup> And, she implies that failure of mortgage brokers to offer a full financial offset for yield spread premiums is reasonable because the difference represents some sort of interest or finance charge.<sup>177</sup> Whether this characterization is plausible for some other lenders, it is clearly not how defendant lending institutions and their mortgage brokers are using yield spread premiums.<sup>178</sup>

To begin with, as far as I know, none of the industry witnesses in this litigation described

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<sup>176</sup> See, e.g., Woodward Report of July 27, 2001, at 11 ("yield-spread premiums are not referral fees but are financial transactions that brokers are compensated for arranging").

<sup>177</sup> Id.

<sup>178</sup> In its recent policy statement, the Department of Housing and Urban Development has suggested that some lenders and brokers may in fact be using yield spread premiums as legitimate financing transactions, see HUD RESPA Statement of Policy 2001-1, *supra* note 86, at 8, but also recognized that other "less scrupulous brokers and lenders take advantage of the complexity of settlement transactions and use yield spread premiums as a way to enhance the profitability of mortgage transactions without offering the borrower lower up front fees." Id. at 9. The implicit interest rates reported in the text – as well as the low offset estimates discussed elsewhere – suggest to me at least that defendant lending institutions and their brokers fall in the latter category.

the payment of yield spread premiums in this manner. Borrowers were not told that yield spread premiums are being imposed as a financing mechanism, and the disclosures required for consumer finance – such as the Truth in Lending Act requirements – were never made in these transactions with respect to payment of yield spread premiums. It is difficult to understand how yield spread premiums can properly be characterized as mechanisms of financing when none of the parties to the transaction understood the payments in this way.

Moreover, if one takes Ms. Woodward’s assertion seriously and attempts to calculate the financing charge implicit in the yield spread premiums charged in this case, the results are breathtaking. For example, in Figure 28, I calculate the “financing” cost of the yield spread premium in the transaction that I used to illustrate how yield spread premiums are imposed earlier in this report. I accepted Ms. Woodward’s characterization that borrowers pay the cost of the yield spread premium in order to finance the purchase of a certain amount of broker services.

The cost of the yield spread premium is the amount by which monthly payments on the above par loan actually made in this case exceeded the monthly payments that the borrower would have had to make on a par loan of the same amount at the same time.<sup>179</sup> To calculate the amount of services financed, I relied first on the average estimate of defendants’ own experts regarding the amount by which yield spread premiums actually reduce up-front costs: that is 55 percent. As alternative formulations, I also used my own average estimate of yield spread premium offsets (22 percent) as well as the

average of my corrected estimates of defendants’ experts (27 percent).

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<sup>179</sup> To make this calculation, I used the rate sheet applicable to the loan, and I assumed that the loan would stay outstanding for seven years – the average duration of a residential mortgage in the United States.

In all three formulations, the implicit interest rates on “yield spread premium financing”

**Figure 28**  
**Derivation of Interest Rates Implicit in Ms. Woodward’s Financing Theory**

<b>An Example of YSP Financing: Loan 604006859</b>							
(Loan Amount = \$106,850; YSP = \$ 2137; Loan Rate = 7.13%; Contemporaneous Par Rate = 6.5%)							
	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6	Year 7 with Payoff
Payments on Loan As Structured	\$8,719	\$8,719	\$8,719	\$8,719	\$8,719	\$8,719	\$105,961
Payments If at Par without YSP	\$8,182	\$8,182	\$8,182	\$8,182	\$8,182	\$8,182	\$104,542
Cost of "YSP Financing"	\$537	\$537	\$537	\$537	\$537	\$537	\$1,419
<b>Amount of Goods and Services Financed and Implicit Cost of YSP Financing</b>							
<i>Offset Estimate</i>	<i>Value of YSP</i>			<i>Implicit Interest Rate</i>			
Average Original Offset Estimate of Defendants' Experts (55 cents):			\$1,175				44.8 percent per year
Average Corrected Offset Estimate of Defendants' Experts (27 cents):			\$577				93.5 percent per year
My Average Offset Estimate Estimate (22 cents):			\$470				114.6 percent per year

are usurious. Using the average estimate of defendants’ experts, the implicit interest rate on yield spread premium financing is 44.8 percent per year. With what I believe to be the more plausible offset estimates of my own and the defendants’ experts, this rate of interest rises to the stratospheric level of 114.6 percent per year and 93.5 percent per annum, respectively. Clearly these are not reasonable interest charges, and – in my view – equally clear financing up-front costs is not the true function of yield spread premiums.

Further evidence that yield spread premiums are not a bona fide source of financing can be seen from a casual inspection of the loan to value ratios of individual borrowers. Within the Defendants' Sample, a substantial majority of borrowers were not at the maximum loan to value ratio for their loans.<sup>180</sup> What this fact demonstrates is that most of these borrowers could have easily raised the amount of their loan had they wanted to finance up-front settlement costs. We know exactly what these borrowers would have paid for this financing: the interest rate charged on par loans at the time, which was typically between seven and eight percent per year. It is inconceivable that so many borrowers with this readily available low-cost source of financing would have willingly chosen to resort instead to the yield spread premium "financing" at the rates our analyses – and the analyses of defendants' experts – imply. Why would anyone borrow money at rates in excess of 44 percent per year, when alternative financing of under eight percent was readily available?

## **2. Yield Spread Premiums as an Artifact of the Internal Revenue Code**

A further, equally contrived claim in Ms. Woodward's report is her assertion that the Internal Revenue Code somehow explains the high levels of mortgage broker compensation on loans with yield spread premiums.<sup>181</sup> As I understand the argument, Ms. Woodward is asserting that, on an after-tax basis, the cost of mortgage broker compensation for loans with yield spread premiums is closer – or perhaps even equal to – the cost of mortgage broker compensation on other loans. Putting aside the fact that Ms. Woodward makes no serious effort to quantify this

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<sup>180</sup> In particular, of the 1806 loans in the Defendants' Sample with yield spread premiums, 46 percent had loan to value ratios of less than 80 percent and 79 percent had loan to value ratios of less than 95 percent. Further analysis indicates that the borrowers of 77.4 percent of all loans in the Defendants' Sample with yield spread premiums had sufficient excess capacity to borrow the full amount of their yield spread premiums without exceeding the 95 percent loan to value ratio that defendant lending institutions typically set for their loans.

<sup>181</sup> See Woodward Report of July 27, 2001, at 17-20.

hypothetical tax code effect,<sup>182</sup> I think it is fairly easy to demonstrate that the claim is clearly incorrect.

Let me begin with the theoretical point itself. Ms. Woodward's argument seems to be that it is appropriate for mortgage brokers to raise their fees whenever Congress extends a tax benefit to home mortgage borrowers. In fact, she would have us assume that mortgage brokers should take the full amount of this tax benefit and that borrowers should face the same after-tax costs for home financing as they did before the tax benefit was put into place. This strikes me as a dubious and improper understanding of the tax code.

In addition, Ms. Woodward's understanding of the tax code is itself clearly incomplete. The income tax effect she is describing – which allows deductions for interest charges but not for up-front origination fees – is only applicable to refinancings. On home purchase loan, borrowers can deduct both customary origination fees and interest payments.<sup>183</sup> Most of the borrowers in our samples were obtaining home purchase loans not refinancing loans. For example, in the Defendants' Sample, only thirty-nine percent of the loans were refinancings; the rest were home purchase loans. Accordingly, Ms. Woodward's asserted tax effect is not even theoretically applicable to the majority of loans at issue here.

Finally, if one focuses on the refinancing loans, it is clear that Ms. Woodward's asserted effect is not present. In both her regressions and some of my own, a dummy for refinancing loans was included as an explanatory variable. In all contexts, this variable was not statistically

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<sup>182</sup> For example, she does not consider how many borrowers itemize their deductions or into what tax brackets these borrowers fall.

<sup>183</sup> For an overview of the tax treatment of home purchases, see IRS Publication 530: Tax Information for First-Time Homeowners (2000) (available at [http://www.irs.gov/forms\\_pubs/pubs/p530toc.htm](http://www.irs.gov/forms_pubs/pubs/p530toc.htm)).

significant.<sup>184</sup> If Ms. Woodward were correct that mortgage brokers were marking up their fees on loans where yield spread premiums were tax favored, then the refinancing dummy would have picked up this effect. The absence of a statistically significant coefficient for the refinancing dummy conclusively rebuts Ms. Woodward's hypothesized tax effect.

### 3. Errors in Ms. Woodward's Equation 8

A final element of Ms. Woodward's Report is her effort to demonstrate that interest rates on loans in the Retail Sample were actually much higher than interest rates on other comparable loans. According to the regression reported in her Equation 8, interest rates on these retail loans are 44 basis points higher than other comparable loans. Defendants have already relied on this finding in briefs filed in this case.<sup>185</sup> Unfortunately, Equation 8 is flawed by serious errors in data manipulation.

The problem with Equation 8 is that Ms. Woodward included several explanatory variables for which her database had only incomplete information. In particular, the dummy variables for 30 year fixed mortgages and the dummy variable for jumbo loans did not include any information for loans from the Retail Sample – presumably because the Retail Sample was created in a slightly different way than the other samples. We know from independent analysis of these variables that a number of loans in the Retail Sample were jumbo loans, and we have strong reasons to believe

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<sup>184</sup> See, e.g., Woodward Report of July 27, 2001, at 12 (Equation 8). See also *supra* pp. 107, 110 (Expanded Regression G).

<sup>185</sup> See, e.g., Defendant Standard Federal Bank's Memorandum of Law in Opposition to Plaintiffs' Motion for Summary Judgment at 6 (Sept. 10, 2001).

that a substantial number of loans in the Retail Sample were fixed rate 30-year mortgages. The correct way of dealing with this problem would have been either to obtain the missing information for the incomplete variables or to omit these variables from the equation. In her deposition, Ms. Woodward acknowledged this point, noting that the alternative – converting the missing fields into zeros – would produce “junk.” Nevertheless, that is precisely what she or her assistants did in Equation 8. In her database, all of the entries for the 30-year fixed dummy and jumbo dummy are zero.

In Figure 28, we summarize Ms. Woodward’s reported results for Equation 8 and then present an alternative formulation in which the 30-year fixed dummy is removed and a completed jumbo dummy included. In the alternative formulation, the coefficient of the retail dummy drops precipitously from 0.44 to 0.087. This suggests that the rate differential between

Figure 29  
Ms. Woodward’s Equation 8: Original and Reformulated  
(n= 3082)

	In Original Report		Reformulated Without 30-Year Fixed Dummy And With Corrected Jumbo Dummy	
	Coefficient	Standard Error	Coefficient	Standard Error
Constant	-0.627	0.034***	-0.108	0.038***
Retail Dummy	0.441	0.028***	0.087	0.032***
30-Year Fixed Dummy	0.522	0.015***	---	---
Original Jumbo Dummy	0.327	0.040***	---	---
Corrected Jumbo Dummy	---	---	0.329	0.047***
[14-15 variables not reported]	---	---	---	---
	R Squared = 0.550		R Squared = 0.353	

interest rates on loans in the Retail Sample and other comparable loans is less than a fifth of

what Ms. Woodward reported. Moreover, this alternative formulation entirely undercuts her larger point that higher interest rates on retail loans offsets the dramatically lower settlement costs we discovered on loans in the Retail Sample.<sup>186</sup>

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<sup>186</sup> See *supra* pp.82-83.