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MEMORANDUM

TO: CLIENTS AND FRIENDS OF THE FIRM

FROM: Al Alsup

DATE: December 31, 2001

SUBJECT: A RESPA Compliance Strategy for Compensating Mortgage Brokers through Payment of Yield Spread Premiums in the Aftermath of *Culpepper* and HUD's Statement of Policy 2001-1

BACKGROUND: THE AMBIGUITY OF THE LEGALITY OF YIELD SPREAD PREMIUMS

Today's mortgage lenders ask what they can do to minimize regulatory compliance and civil liability risks in the face of *Culpepper* and the more than 100 other lawsuits nationwide challenging the legality of the common industry practice of compensating mortgage brokers through the payment of "yield spread premiums." These back-end fees, also referred to sometimes as "yield differentials" or "servicing release premiums," are typically paid by wholesale lenders outside of closing and are derived from a premium interest rate charged the borrower. The yield spread premium is calculated according to a formula that takes into account the loan amount and the spread, or percentage difference, between the wholesale lender's par interest rate quoted the mortgage broker when the loan application is registered and the actual contract interest rate of the loan when delivered by the mortgage broker. The higher the contract interest rate, the greater the compensation paid the mortgage broker by the wholesale lender.

The Culpepper Decision — the Threat of Class Certification

It is this basic formula for determining the amount of the yield spread premium to be paid in connection with any loan that led the United States Eleventh Circuit Court of Appeals recently in *Culpepper v. Irwin Mortgage Corporation*, 253 F.3d 1324 (11th Cir. 2001), to uphold an Alabama district court's class certification of the Culpeppers' claim that such payments are illegal kickbacks or referral fees prohibited by Section 8 of the Real Estate Settlement Procedures Act (RESPA). Section 8 prohibits the payment of referral fees, kick-backs or other things of value as consideration for the referral of settlement services in connection with federally related mortgage loans, but expressly permits payments for services actually performed or goods or facilities actually furnished.

When a complaint is certified as a class action under federal procedural rules, the plaintiffs are permitted to represent a whole class of persons similarly situated, which in this case includes all persons who during a four-year period preceding certification obtained an FHA mortgage loan from Irwin Mortgage in which the mortgage broker was paid both a 1% loan origination fee and a yield spread premium. Class certification is significant because it provides these numerous borrowers the means for prosecuting virtually identical complaints that otherwise would not be economically feasible if brought individually.

The Culpepper Rationale for Class Certification

The appellate court in *Culpepper* recognized that yield spread premiums are legal if meeting a two-part test espoused by the Department of Housing and Urban Development (HUD) in its Statement of Policy 1999-1 (64 F.R. 10079) interpreting RESPA, Section 8 (the "HUD Two-Part Test"). Under the HUD Two-Part Test, a court first must determine if services were actually performed or goods or facilities actually furnished in exchange for the yield spread compensation paid and, if so, next determine if the amount of the compensation paid is reasonably related to the value of the services performed or goods or facilities furnished. But the appellate court in this case found the policy statement ambiguous as to a threshold question for granting or denying class certification, which is whether it is necessary to produce transaction-specific evidence at the trial to prove liability.

One of the factors that the appellate court had to consider in upholding class certification was whether there are questions of law or fact common to all class members or, instead, if evidence specific to each plaintiff's loan transaction would predominate at trial, making class treatment improper. A *common* question for this purpose is one that, when answered as to one class member, will affect all or a significant number of the other putative class members. Class certification must be denied if the trial court would be burdened with examining the particular facts of each loan transaction to determine the extent of services performed and the reasonableness of compensation paid. The appellate court concluded that this so-called *commonality* factor was satisfied in this case because, under the Culpeppers' core theory of liability, it would be unnecessary to make a loan-by-loan factual determination of the nature or extent of services performed by the mortgage brokers. The Culpeppers allege that the yield spread premiums paid by Irwin Mortgage were unlawful referral fees under RESPA, and that the plaintiff class can prevail solely by showing that the yield spread premiums were referral fees and not service fees.

Under Culpeppers' core theory of liability, the appellate court reasoned, it would be irrelevant that the mortgage brokers performed some services in connection with these loans if the yield spread premiums were not specifically paid as part of a "services-for-money exchange" required by RESPA. The appellate court agreed with the Culpeppers' interpretation that the first part of HUD's two-part test for legality of yield spread premiums under RESPA, Section 8, requires a determination not only that the mortgage brokers performed some services, but also that the yield spread premiums were compensation for those services — rather than for the referral of the loans. If the Culpeppers could prove that the yield spread premiums were paid as referral fees, liability under RESPA, Section 8, would be established and it would be unnecessary to reach the second part of HUD's two-part test, which is whether the mortgage brokers' total compensation was reasonable.

The appellate court observed in that regard that the record of the proceedings of the district court failed to establish that the yield spread premiums paid by Irwin Mortgage in these many loans were payments to mortgage brokers for services actually performed, rather than unlawful referral fees. The formula for determining the amounts of the yield spread premiums in question did not take into account the amount or quality of work the mortgage brokers actually performed in originating the loans or how much the borrowers may have additionally paid in fees for the mortgage brokers' services. Furthermore, nothing in the mortgage brokers' written agreements with Irwin Mortgage indicated that the amount paid to the mortgage brokers was in any way dependent on the services performed or that Irwin Mortgage ever inquired into how much work the brokers actually performed in connection with any loan. Rather, the evidence tended to show that Irwin Mortgage paid yield spread premiums according to standardized terms common to all the loans based solely on the calculated spread between the contract interest rate and the quoted par rate, without regard to services performed. Class certification is appropriate under these circumstances, the appellate court concluded, because the Culpeppers could prevail in the suit without presenting loan-by-loan evidence of services performed by the mortgage brokers solely by proving that amounts paid to mortgage brokers by Irwin Mortgage under standardized terms and conditions based on a rate sheet were compensation for referring loans rather than bona fide fees for services.

HUD's Refutation of the Culpepper Decision

The Department of Housing and Urban Development (HUD) issued its Statement of Policy 2001-1 on October 18, 2001 (66 F.R. 53052) for the stated purposes of (i) eliminating any ambiguity found by the *Culpepper* court in applying the HUD Two-Part Test for determining the legality under RESPA, Section 8, of back-funded lender payments to mortgage brokers characterized as yield spread premiums and (ii) reiterating its long-standing interpretation of RESPA, Section 8(b)'s prohibitions. Statement of Policy 2001-1 reaffirms HUD's position that yield spread premiums are not *per se* legal or illegal and clarifies the HUD Two-Part Test for determining legality of such payments under RESPA, Section 8, originally espoused in its Statement of Policy 1999-1.

HUD in its Statement of Policy 2001-1 recognizes that the payment of yield spread premiums can benefit borrowers and foster homeownership by reducing borrowers' "up front" cash requirements. One of the significant barriers to home ownership is the up-front cash needed to obtain or refinance a home mortgage, and the practice of compensating mortgage brokers through the payment of yield spread premiums provides an alternative means of financing those cash requirements. For borrowers without the available cash, particularly those who cannot finance closing costs by adding the costs to the principal balance of the loan because the loan amount is already capped at the maximum permitted loan-to-value ratio, yield spread premiums permit homeowners to qualify for the loan and pay some or all of the up-front loan closing costs indirectly over the term of the loan through the payment of a higher, or "premium," interest rate. However, if the yield spread premium is used merely as a means of enhancing profitability of mortgage transactions without lowering up-front costs, total compensation paid the mortgage broker in any case may exceed the reasonable value of the origination services provided by the broker and fail to satisfy the second part of the HUD Two-Part Test for legality.

In determining whether such a payment by a lender to a mortgage broker is permissible under RESPA, Section 8, HUD reaffirms in its Statement of Policy 2001-1 that the HUD Two-Part Test must be applied, under which:

> First – HUD will determine whether services were actually performed or goods or facilities were actually furnished in exchange for the compensation paid; and, if so
>
> Second – HUD will next determine whether the amount of the compensation is reasonably related to the value of services actually performed or the goods or facilities actually furnished.

But HUD in its Statement of Policy 2001-1 refutes the court's interpretation and application of the HUD Two-Part Test in *Culpepper* in several important respects, which, if proper deference is shown by the courts to this new interpretive rule, should preclude class certification of future cases challenging the legality of yield spread premiums under RESPA, Section 8. In its clarification, HUD states:

- The test is a two-part test, and if compensable services are performed, *both parts of the test must be applied* before a determination can be made regarding the legality under RESPA of a lender's payment to a mortgage broker;
- In order to discern whether a yield spread premium was paid in any case for goods, facilities, or services under the first part of the test, *it is necessary to examine each transaction individually* (including examining all goods and facilities provided or services performed by the broker in the transaction, whether paid for by the borrower, the lender, or both); and

- A yield spread premium cannot be presumed to be a referral fee under the test solely because the yield spread premium in any case is based upon a rate sheet or because the lender does not have specific knowledge of what services the broker has performed. HUD observes that a yield spread premium by definition is derived from the interest rate of the loan, and the rate sheet is merely a mechanism for displaying the interest rate and yield spread premium. The legality of a yield spread premium cannot be determined by reference to a rate sheet, therefore, but only by a determination whether the yield spread premium is a reasonable payment for goods, facilities or services under the HUD Two-Part Test. Moreover, HUD believes that it would be a rare occurrence under common industry practices in which loan files are reviewed for compliance with underwriting standards that any lender would not know whether a mortgage broker had performed the necessary services to meet its standards.

The Meaning of Compensable Services

In determining whether compensable services were actually performed under the first part of the HUD Two-Part Test, HUD states that its Statement of Policy 1999-1 should be used as a guide. HUD in that regard reiterates that it will look for the types of services first described in its informal opinion letter to the Independent Bankers Association of America dated February 14, 1995, (the "IBAA Opinion") regarding the nature and extent of loan origination services that a mortgage broker or other agent or contractor must perform to justify compensation under RESPA, Section 8. The IABB Opinion, as adopted by HUD's Statement of Policy 1999-1, enumerated 13 distinct services, in addition to the taking of the loan application, that are normally performed in the origination of a residential mortgage loan. These services generally include pre-qualifying prospective borrowers to determine their eligibility for the loan and the maximum mortgage loan amount they can afford, counseling them on the home buying and financing process, collecting financial information needed to underwrite the loan, verifying the information, ordering related settlement services such as appraisals, inspections, flood zone determinations and legal documents, providing applicants regulatory disclosures about settlement costs and procedures, assisting them in clearing credit problems, maintaining contact with them throughout the application process, and participating in the loan closing. In applying the first part of the HUD Two-Part Test set out under the new ruling, Statement of Policy 1999-1 adopted this same standard for reviewing whether sufficient origination work has been performed in any case to justify compensation. Services other than these 13 also may be evaluated and acknowledged as compensable by HUD if they are meaningful services akin to those set out in the IBAA Opinion. However, HUD considers that higher interest rates *alone* cannot justify higher total compensation to the broker, and that simply delivering a loan with a higher interest rate is not a compensable service.

[NOTE: Under the IBAA Opinion, HUD set out more stringent standards for qualifying for payment when relying on the taking of an application and performing *only* counseling type services: HUD in that instance must conclude that *meaningful* counseling was provided the borrower and that the borrower was given the opportunity to consider loan products of at least three different lenders from which the broker, agent, or contractor stood to receive essentially the same compensation. Furthermore, while *taking the application* is generally required to qualify for compensation under the IBAA Opinion, a subsequent HUD opinion clarified that the *substantially equivalent* service in that case of obtaining income and debt information, which is used together with an in-file credit report to develop a worksheet showing loan programs and maximum loan amounts for which the applicant may qualify, may be substituted for the act of filling out the loan application.]

The Meaning of Compensable Goods or Facilities

HUD in its Statement of Policy 1999-1 also recognized that, in addition to services, mortgage brokers may furnish goods or facilities to the lender for which the broker is entitled to compensation. For example, appraisals, credit reports, and similar documents needed to complete a loan file may be regarded as *goods* and a portion of the brokers' retail premises, or "store front" operation, as *facilities* for this purpose. However, the loan itself arranged by the mortgage broker cannot be regarded as a *good* that the broker can be said to sell to the lender for its market value based upon the loan's yield or other value as a secured debt instrument.

The mortgage broker's compensation must reasonably relate to the value of goods or facilities actually furnished, of course. In that regard, HUD in its earlier Statement of Policy 1996-3 established a *general market value* standard for measuring the reasonable value of facilities furnished to be assured that the rent of facilities was not in part a disguised referral fee. In a rental context, the general market value is the rent that a non-settlement service provider, such as a dentist, would pay for the same amount of space and facilities in the same or a comparable building — not the higher rent that a settlement service provider, such as a lender, may be willing to pay in anticipation of receiving loan referrals. Under that policy, HUD indicated that when such a settlement service provider is renting space from a person who is referring settlement services to that provider, any rental payments either exceeding the *general market value* of the facilities or based in any way on the number or value of referrals made would be considered unlawful referral fees in violation of Section 8.

The Meaning of Reasonable Compensation

In applying the second part of the HUD Two-Part Test — whether the payments by the lender to the mortgage broker reasonably relate to the value of the services actually performed or goods or facilities provided — HUD reiterates that it will scrutinize the *total compensation* received by the broker, including direct origination and other fees paid by the borrower, yield spread premiums and similar lender-paid fees derived from the interest rate (which HUD regards as paid indirectly by the borrower), and any volume-based compensation (which HUD generally regards as illegal referral compensation when solely based on the volume or value of business transacted). It is neither necessary nor feasible according to HUD to attempt to identify or allocate which goods or services are provided for the benefit of the borrower or that of the lender because all services, goods and facilities benefit both the borrower and lender in the sense that they make the loan possible. Instead, HUD will evaluate total compensation paid the broker in relation to total services performed and goods or facilities furnished. Total compensation must be evaluated in light of the price structures and practices for compensating brokers for similar transactions in the same or similar market area to determine reasonableness of the compensation. The level of services provided by the mortgage broker in particular transactions may also be considered as well in determining reasonableness of total compensation in any case, such as the difficulty in qualifying applicants for particular loan programs or additional services the mortgage broker may be required to perform under servicing or processing arrangements with different wholesale lenders. Total compensation must be commensurate with the amount normally charged for similar services, goods or facilities for loans of similar size and similar characteristics within similar geographic markets. Any excess over this market rate may be used by HUD as evidence of a compensated referral or an unearned fee in violation of RESPA, Section 8. The charging by a mortgage broker of *unearned fees* may constitute a separate violation of RESPA, Section 8(b) according to HUD in its Statement of Policy 2001-1. Section 8(b) prohibits duplicative and unearned fees, including fees charged by a mortgage broker for no, nominal, or duplicative services or fees added to the cost of services performed by another settlement service provider without the mortgage broker having provided additional actual, necessary, and distinct services, goods, or facilities to justify the additional charge.

A RESPA COMPLIANCE STRATEGY IN THE AFTERMATH OF *CULPEPPER*

HUD's official interpretations under its Statements of Policy 1999-1 and 2001-1 regarding the legality of lender-paid compensation to mortgage brokers under RESPA, Section 8, suggest the framework for an ongoing compliance strategy in the aftermath of *Culpepper*. The following steps describe the actions that we believe wholesale mortgage lenders can and should now undertake to minimize their exposure to claims of compliance violations and civil liability arising out of their practices of compensating mortgage brokers for loan origination services.

1. **Operate within the "Reliance on Rule" Protections of HUD's Interpretive Rules.** Lenders should cloak themselves in the protections of HUD's interpretive rulemaking authority delegated by Congress to the Secretary of Housing and Urban Development under RESPA, Section 19. HUD's Statements of Policy 1999-1 and 2001-1 are interpretive rules issued under the authority of Section 19(a), which provides lenders protection from liability under RESPA when acting in good faith reliance on a rule, regulation or interpretation of the statute by HUD. Any document such as these that HUD designates as an "interpretation," "interpretive rule," or a "statement of policy" and publishes in the *Federal Register* constitutes an official interpretation upon which lenders are entitled to rely. No provision of RESPA or the laws of any state may impose liability for any act done or omitted in good faith by a mortgage lender or mortgage broker in conformity with any such rule, regulation, or interpretation by HUD (or the Attorney General) even if, after the act or omission has occurred, the rule, regulation, or interpretation is amended, rescinded, or determined by any judicial or other authority to be invalid for any reason. So, mortgage lenders should read the rules and put written procedures in place to assure that their employees operate within those guidelines.

2. **Set Standards of Reasonableness for Total Broker Compensation in Each Market Area and Consider Imposing Fee Caps on an Exception Basis.** Lenders should conduct informal surveys or otherwise collect data for each market area in which they conduct loan activities to document that their practices regarding the scope of services required of mortgage brokers and the total compensation paid mortgage brokers are reasonable and within the mainstream of the marketplace. The total compensation paid to any mortgage broker in connection with a federally related mortgage loan must be reasonably related to the values of services actually performed, and any excessive amounts may be deemed to be unlawful compensation for the referral, or "steering" of the loan under RESPA, Section 8. Total compensation for purposes of this *reasonableness* test includes direct origination and other fees paid by the borrower, indirect fees paid by the lender derived from the interest rate to be paid by the borrower, such as yield spread premiums, and, when applicable, volume-based compensation.

   Total mortgage broker compensation from all sources must be reasonable in relation to "price structures and practices in similar transactions and in similar markets." This appears to be a sort of "mainstream marketplace" standard under which HUD will compare total broker compensation, in any case, with the norm for fees, or the range of fees, charged by mortgage brokers for comparable services performed in connection with similar loan transactions in the same or similar market areas. Broker pricing that exceeds the norm would have to be justified based upon the scope or quality of services performed.

   Based on their analysis of each market area, mortgage lenders should consider imposing fee caps on total compensation, including yield spread premiums, to be paid any mortgage broker that do not exceed the norms for similar loan programs and amounts in the same market area. For example, if the norm for total broker compensation based on current survey information in a particular market area is 3-5% of the loan amount, the mortgage lender could adopt a policy requiring any mortgage broker compensation exceeding 5% in total to be approved by the underwriting manager on an exception basis. That is, the policy would provide that total broker compensation with respect to any loan shall not exceed 5% unless the additional compensation upon review is found to be justified based upon the nature or extent of services actually performed, such as more extensive processing services and extraordinary time and effort devoted to the task of qualifying an applicant for a particular loan program or overcoming underwriting conditions to credit approval. HUD indicates in its Statement of Policy 2001-1 that these "level of difficulty" factors would be considered as relevant in assessing the reasonableness of total mortgage broker compensation, as well as comparing total broker compensation with that for loans of similar size and characteristics within similar geographic markets.

3. **Review and Update Terms of Standardized Mortgage Broker Contracts to Document "Money for Services" Exchange Required by RESPA.** The loan origination, processing, and closing services to be performed by the mortgage broker should be set forth in a written mortgage loan brokerage agreement with the mortgage lender and, in any case, consist in scope of taking the loan application and performing at least five (5) additional services from a list of 13 distinct services enumerated in the IBAA Opinion adopted by Statement of Policy 1999-1. The *Culpepper* court looked to the form of the mortgage brokers' written agreements with Irwin Mortgage for evidence that the yield spread premiums paid by that lender were intended as compensation for services, but found that nothing in those contracts indicated that the amount paid to the mortgage brokers was in any way dependent on the services performed by the broker. Although HUD refutes the *Culpepper* court's implication that an unlawful referral fee can be inferred from the fact that Irwin Mortgage did not have specific knowledge of what services the broker had actually performed when paying the yield spread premium in that case, a clear "money for services" link nevertheless should be spelled out in the form of a written broker contract. The contract should document that total compensation payable to the mortgage broker from all sources is in consideration of the described services to be performed by the broker and is not intended to exceed the reasonable value of services actually performed by the broker. While HUD recognizes that a lender may additionally compensate a mortgage broker for the reasonable value of goods or facilities actually furnished, these amounts should prove to contribute comparatively little in the overall *reasonableness* analysis of total compensation, considering the *general market value* standard established by HUD in earlier rulemaking.

4. **Require Mortgage Brokers to Make Enhanced "Best Practices" Disclosures.** Current RESPA regulations require at a minimum that all fees or other compensation paid to a mortgage broker be clearly labeled and estimated on the Good Faith Estimate at loan application and the actual amount of the compensation and the broker's name be clearly labeled and listed on the HUD-1 or HUD-1A settlement statement at closing. While not mandating disclosures beyond that currently required by RESPA, HUD continues to emphasize the importance of making meaningful disclosure of yield spread premiums, borrower compensation to the mortgage broker, and the terms of the mortgage loan so that the borrower may evaluate and choose among alternative loan options. HUD reiterates that mortgage brokers should provide borrowers with information about the broker's services and compensation as early as possible in the loan shopping process and obtain agreement by the borrower to the arrangement before the borrower makes application for the loan. The true market price for the mortgage broker's services could be best attained, HUD believes, under practices of this kind in which the fee a borrower will pay (along with its relationship to the interest rate and points charged by the lender and the compensation paid by the lender to the broker) is fully disclosed by the broker and agreed upon before application is made.

   HUD regards providing meaningful disclosures, and obtaining the written acknowledgment by the borrower of having received the disclosures, at the earliest possible time to be a recommended "best practice." "Meaningful disclosures" envisioned by HUD include information about what services the broker will perform, the amount of the broker's total compensation for performing those services (including the amount of any yield spread premium to be paid by the lender), an explanation of whether or not the broker will have an agency or fiduciary relationship with the borrower, and an explanation that generally the borrower may pay higher "up-front" costs for a mortgage with a lower interest rate or, conversely, lower up-front costs for a mortgage with a higher interest rate, and what the specific trade-offs would be for the borrower between the interest rate, up-front costs, and monthly mortgage payments. Although not reviewed or commented on by HUD, the form of Model Mortgage Loan Origination Agreement adopted by the National Association of Mortgage Brokers (NAMB) on June 22, 1997, for voluntary use of its members, if properly completed and timely given before application is made, should satisfy this "best practice" standard. HUD affirms in its Statement of Policy 2001-1 that in the future "full and early disclosures are factors that the Department would weigh favorably in exercising its enforcement discretion in cases involving mortgage broker fees."

5. **Label Back-End Broker Compensation as a "Mortgage Broker Fee" and Properly Disclose the Mortgage Broker Fee in the Good Faith Estimate and HUD-1 Settlement Statements.** Any back-end fee paid by a lender to a mortgage broker for its services should be denominated a "mortgage broker fee" – and clearly labeled and disclosed in the 800 series of both the Good Faith Estimate and the HUD-1 or HUD-1A Settlement Statement as paid outside of closing (P.O.C.). Any confusing labels and code-like abbreviations, such as "YSP to DBG, POC" should be eliminated in favor of clear and understandable disclosures. While HUD appears indifferent to the precise label given the fee in these disclosures and has stated that it "does not view the name of the payment as the appropriate issue under RESPA," the best practice would seem to be to avoid secondary market terms, such as "yield spread premium," "yield differential," and "servicing release premium," suggesting that payment is being made for other than services performed. It is noteworthy in that regard that HUD's own instruction for proper disclosure given in its Statement of Policy 1999-1 describes the payment as a *mortgage broker fee* and sets out the following example of a proper disclosure:

809. Mortgage Broker Fee from Lender to XYZ Corporation (P.O.C.) $ 1,000.00 _______ ________

(NOTE: Line "809," "$1,000," and the column blanks in above example added for illustration)

If the mortgage broker delivers the Good Faith Estimate, a narrative statement such as "A mortgage broker fee ranging from $ ____ to $ ____ is being paid by the Lender to [Name of mortgage broker] for this transaction" would satisfy the GFE disclosure requirement based on past rulemaking, if the precise amount of the fee is then unknown. If both front-end and back-end fees are to be collected by the mortgage broker for its services, of course, the separate sources and amounts of its compensation must be properly disclosed to and, ideally, acknowledged by the borrower.

It should be noted that HUD in its Statement of Policy 2001-1 suggests an alternative form of disclosing yield spread premiums on the HUD-1 Settlement Statement that it believes better informs the borrower of the purpose of the payment, which HUD observes is to reduce the borrower's up-front closing costs. Although under current RESPA regulations yield spread premiums must be disclosed in the 800 series of the HUD-1 in the manner illustrated above, HUD suggests that the yield spread premium could be reported as a credit in the 200 series among the "Amounts Paid by or in Behalf of Borrowers." The borrower could then see that the yield spread premium reduces closing costs and the extent of the reduction. HUD believes that, when used together, improved early disclosures about mortgage broker compensation and disclosure of yield spread premiums on the Good Faith Estimate and HUD-1 Settlement Statement as credits to the borrower's cash requirements "offer greater assurance that lender payments to mortgage brokers serve borrowers' best interests."

Despite its enthusiasm for this suggested alternative approach, HUD fails to provide the necessary guidance mortgage lenders would need to actually implement the disclosure. It is unclear if HUD merely intends for the identical disclosure of the lender's P.O.C payment that now appears in the 800 series to instead be shown in the 200 series. In that case little additional information would seem to be provided to the borrower because no amounts would be entered in the columns used to compute the total credits and the net cash amounts due from the borrower. If HUD intends for the amount of the fee to be actually credited against closing costs, of course, the amount of the mortgage broker compensation would have to be shown as charged to the Borrower in the 800 series and a like amount shown as a credit by the lender in the 200 series to offset that charge. The lender in that case, rather than making the payment to the broker directly outside of closing under traditional practices, would have to advance the amount to be credited in its wire of proceeds to the settlement agent for escrow and disbursement, and the settlement agent in turn would have to disburse from escrow the payment to the mortgage broker (presumably according to an invoice submitted by the mortgage broker) at closing in the same manner that other settlement service providers are paid at closing. In that unlikely case, mortgage lenders throughout the industry would be required to overhaul their closing and funding procedures to accommodate this alternative disclosure. Until further rulemaking by HUD establishing the precise form of such a 200 series disclosure that satisfies RESPA requirements, therefore, mortgage lenders should rely of the official rule for disclosure of mortgage broker compensation in the 800 series in accordance with guidance set out in HUD's Statement of Policy 1999-1 and the instructions for completing Section L of the HUD-1 Settlement Statement set out in Appendix A to Regulation X.

6. **When Possible, Seek Shelter in the "Safe Harbor" of RESPA's Secondary Market Transaction Exemption.** RESPA's regulation of mortgage lenders' compensation to third-party originators applies only to payments made to mortgage brokers in *table funding* transactions or *intermediary* brokered transactions, in which the mortgage broker is not the real source of funds, and does not apply to secondary market transactions, which are exempt from RESPA coverage. The *secondary market transaction* exemption provides a "safe harbor" for mortgage lenders and brokers seeking to insulate themselves from potential liability under HUD enforcement actions or *Culpepper*-inspired class-action claims. Bona fide transfers of loans in the secondary market are exempt from RESPA coverage under the provisions of Regulation X. Thus, amounts paid by mortgage investors as yield spread and servicing-released premiums when purchasing a loan in the secondary market are not subject to Section 8 scrutiny.

   But the common practice of table *funding* in which a loan originated by a mortgage broker is actually funded at closing by a wholesale lender who receives a contemporaneous assignment of the loan, expressly does not qualify as a secondary market transaction for purposes of this exemption. Even though the mortgage broker is the named payee in the note instrument in table funded transactions, the wholesale lender who funds the loan at settlement and to whom the note and other documents are initially assigned at or after settlement is defined by Regulation X as the lender, and the broker's assignment is not recognized as a transfer of the loan obligation in the secondary market.

   For an assignment of a note and other loan documents to qualify as an exempt secondary market transaction, it is necessary that the mortgage originator both close the loan in its own name (i.e., the originator is the named payee in the debt instrument and beneficiary in the security instrument) and fund the loan with its own capital or funds advanced from a *bona fide* warehouse line of credit or other credit facility for which it is liable. Once the loan transaction is consummated and the mortgage originator is the *bona fide* holder of the note, a subsequent transfer and sale of the loan to a mortgage investor is then an exempt secondary market transaction.

> Attempts to qualify a loan as a secondary market transaction through funding arrangements in which the loan originator's funds are not actually utilized to disburse the loan (e.g., where there is an exchange or offsetting of funding checks) or in which funds are advanced from a purported warehouse line for which the loan originator has no actual risk of liability (e.g., where the loan originator is given immediate credit for loans that are sold to the warehouse lender itself or its affiliate) likely would be disregarded under HUD's enforcement policy as mere shams. Thus, to be assured of qualifying for exemption under this provision, the wholesale lender's purchase of loans from third-party originators on a flow basis should be transacted through the independent warehouse lender funding the loan, and not through the settlement agent as in a table funding. An elapse of time of a day, or more, between the date of the primary loan closing and the subsequent transfer of the loan would also be desirable to establish evidentially that the two transactions are distinct and that the transfer of the loan to the wholesale lender qualifies as a secondary market transaction.

THE FUTURE: NEW RESPA RULEMAKING AND STEPPED-UP ENFORCEMENT IN 2002

A suddenly activist HUD plans new RESPA rulemaking in early 2002, according to recent public pronouncements by FHA Commissioner John Weicher. Most recently, Commissioner Weicher on December 13, 2001, announced to an audience of Women in Housing and Finance in Washington D.C. that HUD would issue a new rule in "early 2002," possibly as early as January, that likely would include new forms and timing requirements for disclosures by mortgage lenders. The rulemaking would be expected to "codify" the so-called *best practices* that HUD recommended in its Statement of Policy 2001-1, but stopped short of mandating. (See discussion in Step 4 of the preceding section.) The new rulemaking in 2002 would mandate the best practices designed to assure that up-front disclosures about the costs and other important settlement information are given to consumers early enough in the home financing process to be useful to consumers in shopping for settlement services, and in any event before consumers commit to a particular lender or pay any non-refundable fees. The National Association of Mortgage Brokers (NAMB) itself, having seen the "handwriting on the wall," has endorsed the mandatory use of such a mortgage originator disclosure form to be given consumers prior to loan application, so long as the disclosures are required of mortgage brokers and retail mortgage lenders alike. Although generally applauded by the lending community, HUD is not without its detractors. Senate Banking Committee chairman, Paul Sarbanes, (D-Md.), has complained that HUD's Statement of Policy 2001-1 could undercut legitimate court challenges to the legality of yield spread premiums and has announced his plans to conduct a hearing on the implications of HUD's yield spread premium policy in 2002, possibly in January.

Secretary of Housing and Urban Development, Mel R. Martinez, when appearing before the Senate Banking Committee on December 13, 2001, promised to lead a comprehensive RESPA reform effort in 2002 to ensure that borrowers will be given the information needed to make an informed home financing decision, including a firm and accurate estimate of closing costs prior to loan application or payment of non-refundable fees. Secretary Martinez also has announced that HUD is stepping up enforcement of RESPA violations and is committing significant budgetary resources in 2002 to the RESPA enforcement division for that purpose. HUD announced in November that as part of its enforcement crackdown it had concluded investigations and entered into settlement agreements with various named national mortgage lenders, national flood determination and tax certificate settlement service providers, and a large Florida homebuilder totaling over $2.25 million to be used for consumer housing counseling and education, refunds to homebuyers, and penalties to the government. HUD is reported to have investigated approximately 900 RESPA complaints in 2001, and as of November had entered into 38 settlements with mortgage lenders for violations of the anti-kickback provisions of RESPA.

Despite the clamor in Congress for RESPA reform legislation to combat perceived abusive lending practices, HUD's Statement of Policy 2001-1 effectively settles for now the issue of the legality under RESPA, Section 8, of the practice of compensating mortgage brokers through the payment of yield spread premiums. Mortgage lenders should now be taking stock of their policies and procedures to be assured that they are operating within the protections that this official interpretive rule provides them against the risks of regulatory enforcement actions or civil liability based on complaints that the payment of yield spread premiums violates RESPA, Section 8.

THIS MEMORANDUM IS NOT INTENDED TO BE A COMPREHENSIVE ANALYSIS OF THE *CULPEPPER* DECISION OR STATEMENT OF POLICY 2001-1. PROVISIONS OF STATEMENT OF POLICY 2001-1, PART C, REGARDING "UNEARNED FEES" WILL BE DISCUSSED IN A SEPARATE CLIENT MEMORANDUM TO BE PUBLISHED IN JANUARY, 2002. THIS MEMORANDUM IS PROVIDED FOR THE GENERAL INFORMATION OF THE CLIENTS AND FRIENDS OF OUR FIRM ONLY AND IS NOT INTENDED AS SPECIFIC LEGAL ADVICE. YOU SHOULD NOT PLACE RELIANCE ON THIS GENERAL INFORMATION ALONE BUT SHOULD CONSULT COUNSEL REGARDING THE APPLICATION OF THE LAWS AND REGULATIONS DISCUSSED IN THIS MEMORANDUM TO YOUR SPECIFIC CASE OR CIRCUMSTANCES.