

Are Discount Mortgage Brokers Upfront?

By Jack Guttentag
The Mortgage Professor

February 7, 2005

"In my market search I have come across Discount Brokers, who seem to uphold many of the same ethical standards as Upfront Mortgage Brokers (UMBs), but do not charge any fees for their service - they claim they are compensated by the lenders. Isn't that even better?"

Do Discount Mortgage Brokers Charge Less?

The term "discount broker" implies that the broker is providing services at a bargain price. Nothing could be further from the truth. If they were practicing full and candid disclosure, here is what they would say to you:

"You are paying me in the interest rate, which is higher than it would be otherwise. I prefer to charge you this way because I fear you will resist paying out of pocket and will haggle about the amount. By charging you in the rate, payment is spread out over time in the form of a higher monthly mortgage payment. This will upset you less than a cash payment, especially since you are unlikely even to be aware of how much higher the mortgage payment is. This is really win-win, since I get to charge you more and my fee upsets you less."

The Different Ways Borrowers Pay Mortgage Brokers

Borrowers and only borrowers pay mortgage broker fees. However, payment can be made in two ways. One way is to pay the broker in cash at closing, in which case the broker fee becomes a closing cost to the borrower.

The second way is to pay a premium interest rate to the lender, who pays the broker's fee at closing as a quid pro quo for the higher rate. In this case, the broker's fee is not a closing cost to the borrower. Rather, the borrower pays for it every month as an increment to the mortgage payment.

Here is an illustration. On a 30-year fixed rate mortgage, the lender quotes a rate of 6% at zero points, 5.75% at 2.5 points, and 6.25% at - 2 points. The lender will pay 2 points for a 6.25% rate, a payment referred to in the trade as a "rebate" or "yield spread premium".

If the borrower agrees to the 6.25% rate and the broker receives the rebate as his compensation, the broker typically tells the borrower that "my fee is being paid by the lender". But this is true only in the most superficial sense. The lender pays the rebate in order to get the higher interest rate, and the borrower pays the higher rate. The 2 points paid by the lender to the broker is the present value of the higher payments the borrowers will be making in the future.

Why Mortgage Brokers Prefer Being Paid by Lenders

Bottom line, the borrower pays the broker fee one way or the other. But many borrowers do not understand how the process works, and are much more focused on the cash required to close than on future payments. Further, the amount of any rebate paid to the broker is not readily apparent on required disclosure forms. The borrower knows what the broker fee is when he pays it out of his pocket, but may have little idea of what it is when he pays for it in the rate.

The result is that borrower resistance to broker fees is much weaker when the fees appear to be paid by the lender. And increasingly, brokers seek their compensation entirely in this way. The so-called "discount brokers" have merely formalized the process.

There is nothing wrong with a borrower electing to pay the broker with a higher rate rather than cash, provided that this is a deliberate selection. For a borrower with a short time horizon who won't be paying the high rate very long, paying with a higher rate makes sense. On the other hand, a borrower who expects to have the mortgage a long time and has the cash, does better using it to pay the broker.

If you are a shopper who intends to select a loan provider based on price comparisons, the broker's fee is irrelevant. Neither does it matter whether a loan provider is a broker or a lender. You find the loan provider who offers the best combination of rates and total fees, period.

But if you are not up to price shopping, which is extremely difficult to do effectively, and you prefer to retain a broker to shop for you, then you should know what you are paying for this service. Upfront Mortgage Brokers tell you, Discount Brokers don't.

Copyright Jack Guttentag 2005