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Mortgage Brokers: Friends or Foes?

Amid Mounting Defaults, State and U.S. Lawmakers Weigh Measures to Make Profession More Accountable to Borrowers

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The political debate over how to deal with a surge in defaults on home loans is raising a question that consumers ought to consider: Is my mortgage broker really working for me?

Borrowers often see mortgage brokers as their allies, searching far and wide for just the right home loan at an attractively low price. But many brokers are making it clear they don't see things that way. They are fighting efforts by federal and state politicians to impose a fiduciary duty on them to put their customers' interests first, as lawyers, real-estate agents and financial planners generally are required to do with their clients.

"The mortgage broker does not represent the borrower," says Chris Holbert, president of the Colorado Mortgage Lenders Association. "We sell access to money." The industry group recently opposed language in Colorado legislation that would have required mortgage brokers to act "primarily for the benefit of the borrower." That provision was later deleted.

Brokers, most of whom are lightly regulated by state agencies, are involved in originating around 60% of all home loans, according to Wholesale Access, a research firm in Columbia, Md. The industry is under scrutiny in Washington and state capitols because rogue brokers have been accused of contributing to the spike in mortgage defaults and foreclosures by encouraging borrowers to take risky loans and by charging excessive fees.

That doesn't mean consumers should shun all brokers. Many provide good service and can help people sort through the complexities of choosing a loan. Consumers don't necessarily get a better deal by going directly to lenders, which also can charge excessive rates and fees.

To protect yourself, one strategy is to shop for a home loan directly at a few lenders and then see whether a broker can find a better deal. When choosing a broker, borrowers should ask tough questions first. Among them: In searching for loans, do you feel obliged to put my interests ahead of yours? Exactly how much will you earn on this loan? And how many lenders do you check regularly for rates and terms?

Some brokers offer to fix their fees in advance so they won't have any incentive to recommend a loan that would be more lucrative for them. Trade group Upfront Mortgage Brokers Association (www.upfrontmortgagebrokers.org) maintains a list of brokers who set their fees in advance.

Camilo Ramos, a house painter and remodeler in Minneapolis, wishes he had asked a few more questions of his broker before refinancing a home loan last year. Mr. Ramos says he wasn't warned how much his monthly payment on the $300,000 adjustable-rate mortgage could jump after an initial low-payment period. The brokerage firm, Source Lending Corp., Brooklyn Park, Minn., received total compensation of $13,517 from the transaction, says Jeff Skrenes, a member of the Minnesota branch of the Association of Community Organizations for Reform Now, a nonprofit advocacy group, which is trying to help Mr. Ramos refinance into a more suitable loan.

Chris Hacker, owner of Source Lending, says his firm did nothing wrong in this transaction and adds, "We have thousands of satisfied clients."

The National Association of Mortgage Brokers, the main nationwide trade group for brokers, argues that brokers work neither for consumers nor for lenders. Imposing a fiduciary duty would increase the risk of litigation over whether brokers are to blame for loans that go bad, says Joseph Falk, legislative chairman of the association. He adds that the group favors clear disclosures to consumers and no hiding of important details.

For now, most states lack any legal provision spelling out whether brokers have a fiduciary duty. Many brokers sell a relatively small range of products without being obliged to make sure the consumer gets the best terms known to the broker on a suitable loan.

They receive fees -- often totaling between about 1% and 3% of the loan, but occasionally even more -- for finding customers and guiding them through the loan process. These fees come either from borrowers or through payments from lenders known as yield-spread premiums, or YSP, or through a combination of the two.

Often the broker's incentives run counter to the borrower's interests. Lenders pay YSP to the broker when the borrower is paying a higher interest rate than the best he or she could qualify for, which makes the loan more profitable for the lender. The higher the rate, the higher the payment to the broker. (Some lenders put a ceiling on YSP.) Lenders may also pay brokers a bonus for loans with prepayment penalties, which make it expensive for borrowers to refinance within the first few years.

YSP amounts to "a payment for giving the homeowner a worse deal," says Prentiss Cox, an associate professor of law at the University of Minnesota who previously investigated lenders as an official in the state attorney general's office.

In some cases, paying a slightly higher rate and allowing the broker to receive YSP can make sense for cash-strapped borrowers who don't want to pay an immediate fee to the broker. With YSP, the cost of the broker's service is spread over the life of the loan in the form of higher interest.

But Howell Jackson, a professor at Harvard Law School who has analyzed thousands of home loans, says YSP is confusing for consumers and can allow brokers to "extract excessive payments" from unwary borrowers. In some cases, he found, brokers' total compensation, including YSP, came to more than 3.5% of the loan amount.

For consumers, even shopping around can be difficult. With different combinations of fees and terms, it's hard to compare one loan to another. And the exact level of fees may not be apparent until the borrower is at the closing table, when it may be too late to seek a better deal elsewhere.

Borrowers eyes "are glazed over with all the paperwork," says Jeff Lazerson, president of Mortgage Grader Inc., a mortgage broker in Laguna Niguel, Calif., that sets a fixed fee in advance for clients. Their confusion, he says, gives unscrupulous brokers "a license to lie."

In Washington, legislation was introduced this month by Sens. Charles Schumer (D., N.Y.), Sherrod Brown (D., Ohio) and Bob Casey (D., Pa.) that would impose on brokers a fiduciary duty to put their customers' interests first. The proposed legislation is considered a long shot for this year.

In Minnesota, legislation enacted last month specifies that brokers have "an agency relationship" with borrowers, meaning they must act in a borrower's best interest and can't put the broker's interests first.

Colorado legislators recently shied away from imposing such a standard. Instead, the state House and Senate passed bills stating that brokers have only "a duty of good faith and fair dealing."

California is an exception. A 1979 ruling by the state Supreme Court established that mortgage brokers there do have fiduciary duties. Pete Ogilvie, president-elect of the California Association of Mortgage Brokers says that hasn't caused him any problems and clarifies his role.

Whose Interests?

Questions to ask when choosing a mortgage broker:

- What will be your total compensation, from me and the lender, for any loan you help me obtain?
- Will that compensation depend on what type of loan I choose, the interest rate or any prepayment penalties?
- Are you willing to work for a flat fee specified in advance and rebate to me any compensation beyond that level that you get from the lender?
- How many lenders do you work with on a regular basis? Do any of them account for a majority of your business?