(32) The varying of interest rates on notes purchased by lenders from private mortgage insurers does not violate RESPA if the increased interest rate can be shown to be based on increased value delivered by the lender based on loss performance.

February 17, 1998

This is in response to your letter of October 13, 1997, requesting that HUD analyze the Performance Note program of the ABC Group (ABC) as it relates to Section 8 of the Real Estate Settlement Procedures Act (RESPA).

As a general rule, the Department does not analyze individual business plans or programs under RESPA. Instead, HUD issues rules or statements of policy setting forth general principles regarding RESPA which may be applied to a wide variety of fact patterns. However, because the legality of Performance Notes effectively has been referred to us by another Federal regulator (the Office of Thrift Supervision), we will address this issue using the program you represented as a model. After issuance of this letter, we anticipate that we will transform its advice into a Statement of Policy as contemplated under Section 3500.4(a)(ii) of Regulation X, the RESPA regulation, perhaps in conjunction with other policy statements involving private mortgage insurance.

The following details the performance note program as represented to us, including an analysis of relevant law, and indicates how the Department will scrutinize these arrangements to determine whether they are permissible under RESPA.

THE PERFORMANCE NOTE PROGRAM

Under the program represented to us, a private mortgage insurance company (MI) offers interest bearing notes for purchase by mortgage lenders which refer mortgage insurance business to the MI. In its sole discretion, a lender may invest in all, part or none of the Performance Notes offered. The terms of the notes are seven years following a one year origination period. For approximately the first three years, the interest rate on the notes is set at a base rate which equals the market interest rate for unsecured obligations of established companies, which you represent is currently 12%. For the next approximately 5 years, until the end of the notes' terms, the interest rate on a lender's notes may be adjusted upward or downward based on the cumulative performance or claims ratio of all the mortgage loans originated by the lender or its affiliates and insured by the MI.

The claims ratio is computed from the rate or incidence of defaults, the frequency with which insurance claims are paid, the severity of claims losses, and the rates of loan prepayment and persistency (the levels of home sales and refinancings) of the lender's loans with the MI or those in a pool associated with that note. The interest rate adjustment may go to zero or up to a cap of 50%. The adjustment range is established in an agreement between the lender and the MI that is collateral to the notes. The agreement

also provides for a substantial cancellation penalty if the lender wishes to cancel before the end of the term (which might happen, for instance, if the lender's loans were substantially underperforming). The agreement requires the lender to represent to the MI that it will provide a meaningful disclosure and choice to the consumer about having his or her loan included under the Performance Note program.

Since both mortgage origination and private mortgage insurance are settlement services covered by RESPA, the question raised is whether this proposed transaction violates either Section 8(a) or Section 8(b) of RESPA.

Section 8(a) of RESPA provides that "[n]o 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." 12 U.S.C.A. 2607(a). A "thing of value" is further described in the Department's regulations as including "without limitation, monies, things, discounts, salaries, commissions, fees, duplicate payments of a charge, stock, dividends, distributions of partnership profits, franchise royalties, credits representing monies that may be paid at a future date, the opportunity to participate in a money-making program." 24 C.F.R. 3500.14(d). Section 8(b) prohibits the giving or accepting of any portion, split or percentage of any charge made or received for the rendering of a real estate settlement service "other than for services actually performed." 12 U.S.C.A. 2607(b). The prohibitions against referrals and unearned fees are very broad and cover a variety of activities.

Section 8(c) of RESPA provides, however, that nothing in the statute prohibits "payment for goods and facilities actually furnished or services actually performed," even if the person making the payment also receives a referral from the payee. 12 U.S.C.A. 2607(c). HUD considers that if the payment is reasonably related to the value of the goods, facilities, or services actually provided or performed, HUD assumes the payment to be permissible as compensation for that provided and not for the referral.

The Department's view of the Performance Note program, as more fully explained below, is that the arrangement is permissible under RESPA if the payments to the lender are: (1) reasonably related to the value of the loans actually furnished and/or services performed by the lender for that MI, and (2) such payments are *bona fide* compensation that does not exceed the value of such loans or services. The rationale behind this analysis is that, in instances in which a lender selects a mortgage insurer for a particular transaction, the lender's action constitutes a referral of a loan to a mortgage insurer. See 24 C.F.R. § 3500.14(f). If the mortgage insurer gives a thing of value in return for the referral or otherwise delivers an unearned fee, then Section 8(a) or (b) would be violated. For instance, an above market interest rate or the potential for such a rate would constitute a thing of value, whether or not there is a certainty that the increase will be delivered to the lender. Also, the payment may be regarded as a payment for the referral of business or a split of fees for settlement services. Nor would Section 8 permit Performance Note arrangements in which payments are made for loans which are not more valuable than other loans insured by the MI or for which the payments to the lender

are not *bona fide* compensation and do not reflect a true difference in the value of loans.

If, however, it can be **shown** that the **lender provides loans** with **a better claims** ratio than the average book of loan business sent to the mortgage insurer and/or the lender provides additional compensable qualification services for the MI's benefit that exceed the services ordinarily provided by the lender for loans sent to a private insurer and/or that the lender provides services which effectively mitigate losses to the insurer, as well as that the mortgage insurer's payment to the lender in the form of the above market rate of interest is reasonably related to the difference in the value of such loans or services, then such payments would be permissible under Section 8(c) as goods or services actually delivered or performed. As the Department stated in the context of performance based payments involving lender-pay mortgage insurance: "Pricing in the mortgage marketplace is increasingly dependent upon loan quality and performance. In determining whether or not payment is being made for a referral, the Department recognizes the real economic value to the insurer of better performing loans and the desire to establish market-based incentives to improve that performance."

The Department further noted that the value of the services/goods must not be speculative or theoretical. In addition, there must be clear evidence that the value provided for the services or goods-in the case of performance notes the above market rate-must be reasonably related to the value of the services/goods (the selection and delivery of high quality loans, and the mitigation of loss if they do not perform).

DETERMINING WHETHER PERFORMANCE NOTE ARRANGEMENTS COMPLY WITH RESPA

The Department will analyze Performance Note arrangements under RESPA and, as with captive reinsurance arrangements, the Department will look at several factors to determine whether there (1) is a bona fide arrangement under which goods and/or services are provided by the lender (or whether the arrangement is simply a means of compensation for referrals), and (2) whether the compensation paid does not exceed the value of the goods or services provided.

In order to conclude that goods or services which are provided under a Performance Note arrangement meet RESPA standards:

a. there must be legally binding notes and/or a collateral agreement under the program that evidences that the lender has invested capital at the note amount and the MI agrees to pay interest; and
b. the note and/or agreement must detail the terms of the payments to be made under the program including the base interest rate and the criteria for adjustments in the rate.

In order to conclude that the compensation paid for the loan or any services provided does not exceed the value of the goods or services:

a. the base interest rate on the notes must equal the market rate of interest for equivalent debt (As we understand the program, this rate is made available to lenders with a book of business which may perform on average. Accordingly, to avoid the possibility that any portion of the payments is regarded as a referral fee, the rate must meet a marketplace test of comparability to the rate for equivalent obligations. Otherwise, the base rate may in itself constitute a thing of value inducing the lender to refer loans to the private mortgage insurer), and

b. all increases in interest rate above the base rate and payments pursuant thereto must be directly related to the increased value of the loans or services provided by the lender. The value of such adjustments must bear a clear empirical relationship to the value of such goods or services. If the adjustments do not bear a clear relationship to such adjustment these payments will be regarded as compensation for referrals in violation of RESPA.

In order to ascertain whether these tests are met, relevant data on the historical and current performance of insured loans by participating and non-participating lenders may serve as useful evidence.

RISK MANAGEMENT

In previous letters regarding private mortgage insurance, the Department has noted the trends towards risk prediction and risk diversification, and generally supported such efforts if the provision s of RESPA did not preclude them. In reviewing the Performance Note program, we have concluded, much as we did in reviewing the captive reinsurance program, that it may also be a way of increasing the management of risk, particularly by providing incentives for better loan origination to lenders who do not choose to create a captive reinsurance program.

CONCLUSION

Accordingly, we conclude that Performance Note programs consisting of essentially similar characteristics as the program represented here are permissible under Section 8(c)(2) of RESPA, so long as payments thereunder are solely "for goods and facilities actually provided or services actually performed." The Department, as always, reserves its right (including its subpoena authority) to obtain data from the originator, the private mortgage insurance company, and other sources to assist its analysis of whether the tests set forth above have been met. Of course, the lender and MI would be prudent to also conduct their own such analysis prior to initiating any such programs.

Sincerely,
Nicolas P. Retsinas
Assistant Secretary