

Mortgage Brokers in the UK versus the US
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To gain perspective on institutional practices, nothing beats seeing how the practices differ somewhere else. Recently I looked at how mortgage brokers and the lenders they deal with operate in the UK. I have had invaluable help from Richard Hobson, a broker in the UK for many years who is now a broker in the US.

The Basic Economics of Mortgage Brokerage

The basic economics of the industry are essentially the same on both sides of the Atlantic. Assuming that the lender is satisfied that the broker is properly licensed or certified, the arrangement between them is very simple. In effect, the lender says to the broker “Here are my prices and eligibility requirements, you bring me an eligible customer and I’ll make the loan.”

Lenders find it advantageous to work through brokers because it gives them nationwide distribution capacity without branches or loan officer employees. Even a single-office lender can offer loans wherever there are brokers with whom it can do business. Lending through brokers is flexible; the lender who wants to cut its loan volume simply prices a little higher so the loans stop coming. It isn’t necessary to fire anyone or close offices.

On the broker side, mortgage brokerage is an attractive occupation for energetic self-starters who like to be their own bosses and reap the full rewards of their own efforts. They must be capable of meeting the legal requirements, which are generally low in the US, higher in the UK as discussed below. If the opportunities are provided by lenders, there is never a shortage of brokers.

Pricing Practices: UK Versus US

Yet mortgage brokerage practices in the UK evolved differently than in the US. Perhaps the most important difference is that the pricing of broker services is much more transparent in the UK. This greater transparency is closely related to differences in the way that lenders price mortgages.

The prices quoted by lenders in the UK are the *retail prices* available to borrowers through brokers. These prices are viewed as public information, and some lenders advertise them in various media and/or on their web sites. An eligible borrower who seeks out such a price knows that he can obtain that price from any broker dealing with that lender.

In the US, in contrast, lenders deliver *wholesale prices*, and only to the brokers with which they deal. Brokers then add their markups before quoting retail prices to borrowers. Lenders never publicly disclose their wholesale prices. With the exception of Upfront Mortgage Brokers, brokers don’t disclose them either, since that would be tantamount to disclosing their markups, which brokers view as nobody’s business but theirs.

Lender Payments to Brokers: UK Versus US

In both countries, brokers are most often paid by the lender rather than the borrower, because borrowers generally prefer it that way, but there is a major difference in the way this works. In the UK, payments to brokers are set by lenders. While there are some differences, most lenders pay a fee of .35% of the loan amount on standard products to borrowers with good credit. On loans for investment rather than occupancy, the fee is about .55%. On sub-prime loans, the fee is .75% to 1%. These lender-paid fees do not vary with the interest rate on the loan.

In the US, in contrast, lender payments to the broker are determined by the interest rate the broker delivers to the lender on the individual loan. Some brokers standardize the charge, referred to as the “yield spread premium”, but many don’t, charging what the traffic will bear.

Fees Charged Directly to Borrowers: UK Versus US

In both countries, the broker may or may not charge an additional fee directly to the borrower. Where there is such a fee, the broker in the UK is legally obliged to inform the borrower of it *at their first meeting*. In the US, the borrower may not be informed of the broker’s fee until he receives a Good Faith Estimate of disclosure, which is not due until after the borrower submits an application.

Total Charges to Borrowers: UK Versus US

A major consequence of the difference in transparency is that many brokers in the US engage in opportunistic pricing, adjusting their markups to what they believe they can induce the borrower to pay. There is no opportunity for this in the UK. The average markup in the US is over 2%, which is at least twice as large as in the UK.

UK brokers perform the same functions as US brokers, and they are burdened with regulatory duties that US brokers don’t have (see below). US brokers may work as hard per dollar of income, however, because they spend so much time on transactions that never close, and therefore don’t generate any income. Lack of transparency generates distrust, and distrust causes many borrowers to try to protect themselves by flitting from one broker to another, or by trying to play one broker off against another.

Regulation of Brokers in the UK and US

The regulation of mortgage brokers also is very different. In the UK, a series of sweeping changes beginning in 1997 placed most financial regulation under a new Financial Services Authority (FSA). FSA is an independent non-governmental body but it is answerable to the Treasury and ultimately to the Parliament.

In 2004, the FSA took over regulation of the mortgage sector, including mortgage brokers. Mortgage brokers in the UK are thus subject to one set of rules, and borrowers know

where to go to register a complaint. All FSA rules described below apply to loan officer employees of lenders as well as to brokers.

In the US, brokers have to obtain separate licenses for every state in which they want to do business, and are subject to a different set of rules in every state. A new initiative to create a nationwide licensing system would streamline the process of applying for licenses, and ultimately create a national data base of mortgage brokers and loan officers which could be accessed by borrowers. We are years away from that, however, and even when it materializes, every state will retain its licensing authority.

Note: Brokers in the US are subject to a few provisions of the Federal Truth in Lending Act and the Real Estate Settlement Procedures Act, both of which soon may be tightened.

In the UK, FSA has ruled that every broker and loan officer must pass a competency exam. According to Richard Hobson who was a broker in the UK and took the exam, it was far more difficult than the one he had to take to be licensed in the state of Washington. And that state is one of the few that require an exam.

Disclosure Rules: UK Versus US

The FSA has three sets of disclosure rules. At their first meeting, the broker gives the borrower an Initial Disclosure Document (IDD). The IDD indicates whether the broker has access to mortgages from all lenders in the market, only some lenders, or only one lender. It also provides complete information on the broker's fee, including amount, when payable, and how it relates to lender fees paid to the broker. If the broker also sells insurance - a common practice in the UK - the same information is required for the insurance transaction.

There is no counterpart to the IDD in the US. However, proposals from both HUD and the Federal Reserve would require fuller disclosure of broker fees.

The second set of UK disclosure rules applies after the broker, in consultation with the borrower, has identified one loan program that appears to meet the borrower's needs. This is called a Key Facts Illustration (KFI), and it is a kind of an amalgam of the Good Faith Estimate and the Truth in Lending disclosure documents in the US. The KFI is a little better because it is only one document, has as much useful information, and less useless information.

The third disclosure, which has no counterpart in the US, is the Mortgage Record of Suitability, or MROS, which has two major parts. The first is a statement of the borrower's circumstances that bear on the mortgage selection. It includes how the borrower intends to use the loan proceeds, and what features of the loan the borrower views as most important.

The second part of the MROS is the broker's comment about all major features of the recommended loan, and why the broker is recommending it. This includes the broker's statement regarding why the loan is affordable to the borrower, now and in the future.

One consequence of the FSA rules is a heavy compliance burden, which makes it difficult to operate as a one-person firm. Most brokers belong to larger firms that can provide compliance as well as other types of support.

Relationship Versus Transaction Orientation

An article I wrote last year argues that making brokers and loan officers responsible for determining mortgage suitability was not workable because most of them were transaction-oriented and strongly averse to providing any information that might jeopardize a deal. But Richard Hobson argues that brokers in the UK are relationship-oriented, and view borrowers as potential clients for life. He is a firm believer in the UK system, and is using the model in his Seattle, Washington business.

Why is a relationship as opposed to a transaction orientation much more common in the UK? I plan to write about this as soon as I understand it better.

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