GSE Activity Report

Monday, April 8, 2024

Discounting Discount Points

Summary

It wasn't hard for us to forecast that, after NEC Director Brainard endorsed CFPB Director Chopra's jihad against mortgage "junk fees," that the discount points that received particular opprobrium would be moved up the priority ladder for federal restriction. A Friday CFPB report makes clear that this is indeed very much in the works. We expect new standards to mandate additional protections for borrowers through more complex disclosures, sharp restrictions on comparison-shopping and lead-generation sites, and maybe even a UDAAP edict requiring that discount points be in a borrower's best interest based on the likely break-even point.

Impact

Looking at HMDA data from 2019 to 2023, the Bureau's report finds that almost nine out of ten cash-out refi borrowers elect discount points and buy more of them than home-purchase borrowers. The Bureau attributes this to the ease of getting rate buydowns from equity proceeds, concluding that it is nonetheless potentially costly since most cash-outs are to service pre-existing consumer debt. Fewer proceeds with which to pay this down and a higher-balance mortgage are, the Bureau believes, a bad mix for most cash-out borrowers, noting also how many there are even now as rates shot up due to greater problems with household debt-service capacity.

The CFPB report also compares discount-point use based on rates, finding for example that cash-out use soared almost thirty percentage points from 2021 to 2023 as rates rose. Discount-point use almost doubled over this same period for other refi and home-purchase borrowers, with the greatest use of discount points overall found in lower-score FHA borrowers. The Bureau is particularly troubled by discount-point use by FHA borrowers because so many are first-time borrowers and thus are said to know so little about the borrowing process.

These data lead the Bureau to conclude that discount points are masked in comparison-shopping and similar marketing because they are to be found only in the "fine print," making offered interest rates seem to be "more competitive." The report acknowledges that discount points are subsequently acknowledged at numerous points in loan-origination and -closing documentation, but it deems this insufficient for consumers who do not understand how discount points work in part because they would need to get several offers with the same top-line rate or same discount points to make a meaningful front-end comparison. The report also notes that, even if borrowers fully understand discount points, they may not understand break-even dividing lines between various offers based on the borrower's personal expectations about matters such as how long they plan to remain in the residence.

One of the more interesting effects of discount-window limits hits the secondary market with potentially perverse results: Discount points that reduce a loan's interest rate reduce prepay risk and thus enhance pricing in a secondary-market transaction usually reflected in the originator's pricing. The report clearly understands this, but it fails to consider its consequences, especially now. Loans without points in the

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current environment are particularly prone to prepayment risk along with adverse selection in remaining loans in the pool. Clearly, investors will demand better pricing for loans without points, pricing that is likely to hike loan costs to borrowers atop those associated with higher rates.

Outlook

Our forecast of what the Bureau will do next is derived from our understanding of what it's done so far to credit card late fees and comparison shopping. As detailed in prior FedFin analyses, the Bureau has finalized tough rules restricting credit-card late fees along with significant restrictions on any card comparison-shopping marketing relying on digital technology or third-party lead generation. Compared to discount points, the law related to card late fees gives the Bureau more scope to set dollar thresholds on these fees – or so it thinks pending the outcome of industry litigation contesting this fundamental point. In the absence of any like-kind authority for discount points of which we are aware beyond the UDAAP catch-all (see below), we think the Bureau will turn instead to mandatory disclosures giving prospective borrowers comparisons between payment rates with and without discount points over periods of time that clarify the break-even decision.

The card comparison-shopping restrictions come via a circular that says it also applies to "other products," look for a "clarification" from the Bureau expressly applying the card restrictions to discount-point calculations, essentially banning them unless the lender or third-party marketer can demonstrate that digital comparisons are truly objective and lay out all material decision criteria. This policy is critical to the White House's focused demand for front-end clarity along with what the Bureau clearly considers to be only back-end disclosures covering discount points under current requirements.

Could there also be a mandatory best-interest test? Judging by the Bureau's UDAAP policy and subsequent actions, the answer is clearly yes. Would this stand up in court? Hard to know, but it would be costly unless or until the industry finds out.

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