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Final Rule Governing Loan Originator Compensation Practices

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Background

On August 16, 2010, the Federal Reserve Board ("Board") issued two proposed rules and three final rules governing federal Truth-in-Lending Act ("TILA") requirements for residential mortgage loans. This Client Alert summarizes the Board's final rule that governs loan originator compensation practices.

Previous Client Alerts address three of the Board's issuances, and a later Client Alert will discuss the final issuance.

History and Effective Date of Final Rule

- Section 129(1)(2) of TILA authorizes the Board to prohibit acts or practices relating to mortgage loans that it finds to be unfair, deceptive, or designed to evade provisions of the Home Ownership and Equity Act ("HOEPA"). This section also authorizes the Board to prohibit acts or practices relating to refinancings that the Board finds to be associated with abusive lending practices or that otherwise are not in the interests of a borrower.
- Section 226.36 of Regulation Z currently prohibits acts and practices in connection with credit secured by the consumer's principal dwelling. More specifically, the existing regulation prohibits certain abusive practices relating to the appraisal process and servicing. These restrictions are not affected by the Board's final rule and will remain in place.
- In 2008, the Board issued a proposed rule that would have prohibited a creditor from paying a mortgage broker any compensation greater than the amount the consumer previously agreed in writing that the broker would receive. The broker and consumer would have had to enter into an agreement that contained certain disclosures. As a result of the comments received and some consumer testing, the Board ultimately withdrew the proposed revisions relating to broker compensation.
- On August 26, 2009, the Board proposed a sweeping revision to the provisions of Regulation Z that relate to closed-end mortgages. Among other things, the Board proposed to prohibit certain compensation and steering practices relating to loan originators. That proposal provides the framework for the final rule issued on August 16th.
- The Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") was enacted on July 21, 2010. Section 1403 of the Dodd-Frank Act, which enacts a new Section 129B of TILA, imposes certain restrictions on loan originator compensation practices and restricts certain steering practices by loan originators.
- The Board has now decided to amend Section 226.36 of Regulation Z to impose restrictions on loan originator compensation practices and restrict steering by loan originators. This amendment covers some, but not all, of the restrictions required by Section 1403 of the Dodd-Frank Act.
- The final rule is effective on April 1, 2011. This means that the amendments to Section 226.36 of Regulation Z will apply to loan originator compensation for any transaction relating to an application received by a creditor on or after April 1, 2011. For example, if a loan originator takes an application on December 31, 2010 but does not submit the application to the creditor until April 1, 2011, the amended regulation will apply. See Paragraph 226.36-2 of the Regulation Z Commentary ("Commentary").

Highlights of Final Rule and Analysis

- *Types of Loans Covered (Paragraph 226.36-1 of the Regulation Z Commentary)*
  - Any consumer credit transaction secured by a dwelling. The dwelling need not be the consumer's principal dwelling.
    - In contrast, note that Section 226.36(b) and (c), governing appraisal and servicing practices, continue to apply only to consumer credit transactions secured by *principal* dwellings.
  - The dwelling may, but need not, be secured by real property. A loan on real property that does not contain a dwelling is not covered, although the Board may revisit this issue at a later time.
  - Both first and subordinate lien loans are covered.
  - Both prime and non-prime loans are covered. The rule applies regardless of the interest rate or the dollar amount of the loan.
  - The substantive provisions added by the amended regulation are found in Section 226.36(d) and (e) of Regulation Z.
  - Open-end home equity lines of credit that are governed by Section 226.5b of Regulation Z ("HELOCs") are exempt from Section 226.36. Loans secured by consumers' interests in certain timeshare plans are exempt from Section 226.36(d) and (e). Section 226.36, including the new subsections, continues to apply to closed-end reverse mortgages.
- *Types of Loan Originators Covered by the New Regulation (Section 226.36(a) of Regulation Z)*
  - A "loan originator" is a person who, for or in the expectation of compensation or other monetary gain, arranges, negotiates, or otherwise obtains an extension of consumer credit for another person.
    - This is somewhat similar to the definition of a "mortgage originator" in Section 1401 of the Dodd-Frank Act, which adds a new §103(cc)(3) to TILA. The Dodd-Frank definition is more detailed, and also includes a person who takes a residential mortgage loan application, offers terms on a residential mortgage loan, or represents to the public that he/she/it can or will provide any of the services of a mortgage originator.
    - Section 103(cc)(3) of TILA, as added by Dodd-Frank, contains a limited exemption from "mortgage originator" for a person that provides mortgage financing for the sale of one property in any 36-month period where the loan is fully amortizing, the seller determines in good faith and documents that the buyer has a reasonable ability to repay, has a fixed rate or an adjustable rate that is adjustable after five or more years (and is subject to reasonable annual and lifetime rate caps), and meets other criteria established by the Board. The Board's Supplementary Information confirms that persons providing such seller financing would be creditors, not "loan originators," under Section 226.36.
    - The Board will consider whether other regulatory changes will be necessary to further implement the definition in new §103(cc)(3) to TILA.
  - The term "loan originator" includes both individuals and entities.
  - Third-party mortgage brokers are loan originators.
    - For purposes of Section 226.36, a "mortgage broker" is any loan originator who is not an employee of the creditor.
    - Employees of mortgage brokers who engage in loan originator activities are themselves treated as loan originators and mortgage brokers.
    - Section 226.36(d)'s prohibitions on payments to loan originators (discussed below) apply both to

payments made directly to mortgage brokers as well as payments made by a mortgage broker to its own employees who act as loan originators.

- Employees of a creditor who engage in loan originator activities are loan originators. This means that mortgage loan officers who qualify as loan originators will be covered.
- In a table-funded loan, the closing lender is a loan originator.
  - Because Regulation Z generally defines the term "creditor" to mean the person to whom the credit obligation is initially payable, the closing lender also will be the creditor in the transaction for all purposes under Regulation Z other than Section 226.36. This means that, in a table-funded transaction, the closing lender is subject to the new restrictions on loan originator compensation and anti-steering and, in addition, is required to provide Regulation Z disclosures and otherwise comply with all of the provisions of Regulation Z that govern creditors.
  - In contrast, if the closing lender closes the loan in its own name and funds the loan from a bona fide warehouse line of credit (or from its own moneys or from deposits held by the creditor), and then promptly sells the loan to a third party following closing, it is the creditor in the transaction under Regulation Z but not a "loan originator" for purposes of Section 226.36. This is similar to the rule under the Real Estate Settlement Procedures Act ("RESPA") and HUD's Regulation X, which do not treat mortgage broker transactions that are table-funded as "secondary market transactions." If a mortgage broker closes a loan in its own name and funds the loan with its own money or from a wholesale line of credit in its name in a bona fide transaction, this should qualify as a secondary market transaction (which generally is exempt from RESPA and Regulation X). See 24 C.F.R. §3500.5(b)(7) and App. B (Q&A #5).
- Managers and administrative staff who are employed by a creditor or loan originator, but who are not themselves engaged in loan originator activities, and whose compensation is not based on whether any particular loan is originated, are not "loan originators" for purposes of Section 226.36.
- If a loan servicer modifies an existing loan, and the modification does not constitute a "refinancing" under Section 226.20(a) of Regulation Z, the servicer is not acting as a "loan originator" in that transaction for purposes of Section 226.36.
  - In general, a "refinancing" occurs when an existing closed-end transaction subject to Regulation Z is satisfied and replaced by a new obligation undertaken by the same consumer. (There are five specific situations described in Section 226.20(a) where there will be no refinancing even if the existing obligation is satisfied and replaced.) However, if the rate is increased based on a variable rate feature not previously disclosed, or a variable rate feature is added to the existing obligation, this *will* be treated as a refinancing, suggesting that the servicer will be treated as a loan originator in those contexts. See Paragraph 226.20(a)-3 of the Commentary.
- A person who performs only real estate brokerage services is not a loan originator. However, there is a "slippery slope" to watch out for here – if the real estate broker sells a home to a consumer, and assists the consumer by arranging financing in return for compensation, then he/she is a loan originator for purposes of Section 226.36.
- A consumer will not be a loan originator in his/her own mortgage transaction.
- The definition of "loan originator" under the Board's final rule is not co-extensive with the definition of a "mortgage originator" under the S.A.F.E. Mortgage Licensing Act of 2008 (12 U.S.C. §5101 *et seq.*) ("S.A.F.E. Act") or its implementing federal regulations or state laws. Among other things, a "mortgage originator" under the S.A.F.E. Act can only be an individual.

- *Prohibited Payments to Loan Originators – Payments Based on Transaction Terms or Conditions (Section 226.36(d)(1) of Regulation Z)*
    - A loan originator may not receive, directly or indirectly, compensation in an amount that is based upon any of the terms or conditions of the loan. There is a corresponding provision that prohibits a creditor, investor, or other person from paying any such compensation.
    - For this purpose, "compensation" is broadly defined. Among other things, it includes salaries, commissions, periodic bonuses, awards (*e.g.,* merchandise, services, trips, similar prizes), and any financial or similar incentives based on any of the terms or conditions of the loan.
    - The name or label given to a payment or thing is irrelevant in determining whether it is impermissible compensation. The substance of the situation, rather than the name, controls. For example, the Commentary states that a "processing fee" paid to the loan originator is subject to the prohibition regardless of whether the loan originator actually performs processing services or not.
    - This prohibition clearly is directed at yield spread premiums ("YSPs") paid by creditors to loan originators. Given the broad definition of "loan originator," the prohibition applies both to payments by a creditor to a mortgage broker as well as payments by a creditor to its own loan officer. The prohibition is not limited to YSPs, but will apply to any payment, however denominated, based on the terms or conditions of the loan.
    - Funds that the loan originator receives and pays out for bona fide and reasonable third-party charges are not subject to this prohibition.
        - The Commentary provides, as an example, bona fide and reasonable title insurance and appraisal charges.
        - If the loan originator cannot determine with accuracy what the actual third-party charges will be before consummation of the loan, the difference between the charge collected from the consumer and the actual charge paid to the third-party will not be treated as "compensation" for purposes of the prohibition if the charge imposed on the consumer (i) was bona fide and reasonable, and (ii) complied with state or other applicable law. The Board's Supplementary Information indicates that a loan originator can legitimately use an "average charge," but notes that, to meet the bona fide and reasonable test, the charge must comply with HUD Regulation X's provisions relating to average charges. See 24 C.F.R. §3500.8(b). More generally, whether the charge is "reasonable" will depend upon the applicable facts and circumstances.
        - In contrast, if the loan originator purposefully upcharges the third party's charges, the amount of the upcharge will be treated as "compensation" for purposes of the prohibition.
        - This suggests the need for tight policies and procedures, and careful monitoring, to make sure that third-party charges do not inadvertently lead to the payment and receipt of unlawful compensation.
        - Note that the practice of charging fees in excess of a third-party service provider's actual charges raises separate issues under §8(b) of RESPA. There is a split among several of the federal courts of appeal regarding whether such fees violate §8(b).
    - Any compensation to a loan originator that varies based on features such as interest rate, annual percentage rate, loan-to-value ratio, or existence of a prepayment penalty violates the prohibition.
    - The prohibition also is violated if compensation to a loan originator varies based upon any "proxy" for a loan term or condition, such as a debt-to-income ratio ("DTI"), credit score, or credit history.
        - Although DTI, credit score and credit history are not loan terms or conditions as such, if any of these vary along with a factor that *is* a loan term or condition (*e.g.,* interest rate), then the loan originator's compensation may not be tied to the DTI, credit score or credit history.
        - As a practical matter, differences in DTI, credit score or credit history almost always will impact the loan's interest rate. If so, these factors will be treated as proxies for the terms or conditions of the

loan, which means that the loan originator's compensation may not vary based upon DTI, credit score or credit history.

  - Other underwriting factors similarly will be treated as impermissible proxies *if* the interest rate or other loan terms or conditions vary with changes in those underwriting factors. Examples include gross income, residual income, and net worth. This means that the loan originator's compensation may not vary based upon these items as well.

- In contrast, compensation to the loan originator may vary based upon the dollar amount of the loan, but only if the compensation is based on a fixed percentage of the loan amount.

  - Notwithstanding the dollar amount of the loan, the creditor may establish a minimum and/or maximum fee to be paid to the loan originator for each loan.

  - An example of a permissible compensation arrangement – a loan originator fee equal to a fixed 1% of the loan amount, with a floor of $500 and a ceiling of $5,000.

  - The percentage used to calculate the loan originator's compensation must be fixed. It cannot vary based on the amount of credit extended.

  - The Commentary gives the following example of an impermissible compensation arrangement: 1% of the amount of credit extended for loans of $300,000 or more, 2% of the amount of credit extended for loans of $200,000 - $300,000, and 3% of the amount of credit extended for loans of less than $200,000.

- The Commentary states that compensation paid to the loan originator on any of the following additional bases do not violate the rule: (i) the loan originator's overall loan volume delivered to the creditor (that is, the total dollar amount of credit extended or the total number of loans originated); (ii) the long-term performance of the originator's loans; (iii) an hourly rate of pay to compensate the loan originator for the actual number of hours worked; (iv) whether the consumer is an existing customer of the creditor or a new customer; (v) a fixed fee, agreed to in advance, for each loan arranged by the loan originator (whether or not on a sliding scale); (vi) the percentage of applications submitted to the loan originator that result in consummated transactions; (vii) the quality of the loan originator's loan files submitted to the creditor; or (viii) legitimate business expenses, such as fixed overhead costs. These are characterized by the Commentary as "illustrative examples" rather than an exhaustive list.

  Any compensation arrangement needs to be vetted for compliance with other applicable laws and regulations. Section 8 of RESPA prohibits the payment of fees to a mortgage broker unless the broker is performing actual and compensable settlement services and the fees bear a reasonable relationship to the value of the goods, services or facilities actually provided by the broker. In addition, while volume-based compensation arrangements do not violate the Board's new rule, providing those arrangements to mortgage brokers may raise issues under §8 of RESPA. See HUD Statements of Policy 1999-1 and 2001-1. In addition, any incentive compensation arrangements for banking organizations must take into account credit and other risks in a manner that is consistent with safe and sound banking practices. See Interagency Guidance on Sound Incentive Compensation Policies, 75 Fed. Reg. 36395 (June 25, 2010).

- Creditors have flexibility in setting their loan terms. The final rule does not impose underwriting standards (although the existing rules for high-cost mortgages and higher-priced mortgage loans, as well as the new ability to repay rules established by Section 1411 of the Dodd-Frank Act, do and will impose minimal underwriting standards). Creditors may continue to utilize risk-based pricing in setting their loan terms (keeping in mind that certain disclosure requirements may be triggered under the Board's and FTC's new risk-based pricing rules that become applicable on January 1, 2011. For more information on the risk-based pricing rules, see http://www.mofo.com//files//Uploads/Images/100402Pricing.pdf). A creditor may charge a higher interest rate to a consumer who wishes to finance more of his/her transaction costs (*i.e.,* rather than paying them out-of-pocket). Also, a creditor can add a fixed percentage to the interest rate of each consumer as a means of recouping the cost of compensating loan originators. However, in each instance, the loan originator's compensation may not vary based upon the loan's terms or conditions.

- If a creditor and loan originator have established an agreed amount of compensation for a particular loan, the compensation amount cannot thereafter be increased or decreased based upon a change in the terms of the loan. The Board stated that allowing this type of flexibility would create loopholes and permit evasion of the final rule.
  - For example, if the creditor is to pay the loan originator $X, the interest rate of the loan is 7%, and the creditor later agrees to lower the interest rate of the loan to 6.5%, the creditor may not reduce the loan originator's compensation to an amount that is less than $X.
  - If the creditor is to pay the loan originator $X, the loan carries an adjustable interest rate, the creditor and consumer later agree that the consumer will receive a loan with a fixed interest rate, the creditor may not increase the loan originator's compensation to an amount that is higher than $X.
  - Similarly, if the consumer is able to obtain the same loan at a lower amount of points from another person, and the creditor responds by matching the lower points, the loan originator's compensation cannot be reduced to an amount that is less than $X.
- A creditor may compensate third-party mortgage brokers differently than it compensates its in-house loan officers.
- Similarly, a creditor may compensate one in-house loan officer differently than another in-house loan officer. This is because the prohibition is on paying compensation to each individual loan originator based on the terms or conditions of the loan that he/she delivers to the creditor.
- The Board's Supplementary Information states that the rule does not allow the payment of higher compensation to a loan originator based upon the type of loan – for example, small loans, first-time homebuyer program loans, low-and-moderate income ("LMI") program loans, and loans designed to meet Community Reinvestment Act ("CRA") obligations. Historically, many creditors were willing to pay mortgage brokers and in-house loan officers higher fees for their production of LMI and CRA loans because of the additional amount of time and effort that often goes into the generation of these loans. The Board stated that allowing loan originator compensation to vary based upon loan type would permit unfair compensation practices to persist for loan programs offered to vulnerable consumers. As noted above, however, a creditor is permitted to pay an hourly rate to compensate the loan originator for the actual number of hours worked.
- Although the Board's proposed revisions to the Commentary allowed differences in a loan originator's compensation based upon the geographic area of the security property, the final rule did not include this comment. The Commentary does allow loan originator compensation to take account of differences in the costs of origination (such as fixed overhead costs), and this provides flexibility for covering geographic differences in those costs. However, this leaves at risk any program that pays different compensation to a loan originator based solely on geography.
- Once a creditor's compensation arrangement with its loan originator is established, that arrangement is not set in stone. The Commentary makes clear that the parties can periodically revise their compensation arrangements, as well as other transaction terms and conditions.
  - The Commentary identifies the following as factors that the creditor and loan originator may consider in revising their compensation arrangement: (i) loan performance; (ii) transaction volume; and (iii) current market conditions for loan originator compensation.
  - Other factors can be considered in revising the loan originator's compensation so long as they do not involve tying loan originator compensation to the terms or conditions of the loans. For example, it should be permissible for a creditor to pay its loan officer a bonus based on the number of his/

her years of service with the creditor. At the same time, it would be impermissible to increase a loan originator's compensation rate based upon the extent to which the average interest rate on the originator's loans exceeded some benchmark rate established by the creditor.

- The Commentary indicates that any increase in the loan originator's compensation rate must be applied prospectively.
- It would be advisable for the agreement between the loan originator and creditor to identify the frequency with which their compensation arrangement will be reviewed for a possible revision.
- Unduly frequent revisions to a loan originator's compensation arrangement will likely draw scrutiny from examiners and others. These situations will likely be carefully reviewed to determine if the frequent revisions are designed to circumvent the prohibition on tying loan originator compensation to the terms or conditions of loans generated by the loan originator.
- As noted above, volume-based compensation arrangements may raise issues under §8 of RESPA.

➢ Notwithstanding the literal wording of Section 226.36(d)(1), the rule against paying compensation to a loan originator based on the terms or conditions of the loan does not apply to compensation that the loan originator receives "directly" from the consumer him/herself. However, if the loan originator receives compensation directly from the consumer, then Section 226.36(d)(2) (discussed below) states that no other person may provide any compensation to the loan originator, whether directly or indirectly.

- The consumer's payment of money to a loan originator certainly qualifies as a direct payment by the consumer, and is not subject to the Section 226.36(d)(1) prohibition.
- If the loan originator receives money out of the loan proceeds, this also qualifies as a direct payment by the consumer, and is not subject to the Section 226.36(d)(1) prohibition. Note that Section 1433 of the Dodd-Frank Act, when effective, prohibits the financing of points and fees – including mortgage originator fees – from any high-cost mortgage loan.
- However, if the loan originator receives money out of the loan proceeds, and this money is related to an increased interest rate, this will *not* qualify as a direct payment by the consumer. To the contrary, this will be treated as a YSP, and will be a violation of Section 226.36(d)(1), which prohibits the payment of compensation to a loan originator based on the terms or conditions of the loan.
- As can be readily seen, there may be a thin line between a permissible and impermissible payment of loan proceeds to the loan originator. The creditor needs to document the permissibility of the payment.
- Points paid by the consumer to the creditor are *not* considered payments received by the loan originator directly from the consumer. The creditor may use those points to compensate the loan originator. However, in that event, the loan originator may not receive any compensation directly from the consumer. This is because of the rule in Section 226.36(d)(2) (discussed below) that prohibits any other person from compensating the loan originator if the consumer directly compensates the loan originator.

• *Prohibited Payments to Loan Originators – Payments by Persons Other than the Consumer (Section 226.36(d)(2)of Regulation Z)*

➢ If a loan originator receives any compensation directly from the consumer, he/she/it may not also receive compensation, directly or indirectly, from the creditor (or any other person) in connection with the same transaction. Similarly, if a creditor (or other person) knows or has reason to know that the consumer has paid direct compensation to the loan originator, it is prohibited from paying any compensation directly or indirectly to the loan originator in connection with the same transaction. These rules are designed to make sure that there is no circumvention of the Section 226.36(d)(1) prohibition on the varying of a loan originator's compensation based on the loan terms or conditions.

- This establishes a "one or the other" rule with respect to loan originator compensation for a specific transaction. The loan originator may receive direct compensation from the consumer, in which event he/she/it may not also receive compensation from the creditor, investor or any other person. If the loan originator receives compensation from the creditor, investor or any other person, he/she/it may not also receive direct compensation from the consumer.
- This prohibition does not apply to compensation that is not paid in connection with a specific transaction. For example, if the consumer directly pays a fee to a mortgage broker, the rule does not prohibit the mortgage broker from paying a salary or hourly wage (assuming these are not tied to that transaction) to its employee.
- The Commentary observes that HUD Regulation X treats a creditor-paid YSP as a "credit" that reduces the consumer's settlement charges, but then notes that, under Section 226.36(d)(2), this "credit" will not be treated as a fee paid directly by the consumer to the loan originator. This is another way of saying that the lender-paid YSP is not authorized by the provision (discussed above), stating that a direct payment of a fee by the consumer to the loan originator is not prohibited by Section 226.36(d)(1). To the contrary, the creditor-paid YSP is flatly prohibited by Section 226.36(d)(1).
- Section 226.36(d)(2) defines "compensation" in the same manner as Section 226.36(d)(1).

- *Treatment of Affiliated Entities (Section 226.36(d)(3) of Regulation Z)*
  - For purposes of the prohibitions in Section 226.36(d)(1) and Section 226.36(d)(2), affiliates are treated as the same person.
  - For example, this means that two or more creditors that are affiliates will be treated as one creditor under the rule. As a result, the affiliated creditors may not pay different amounts to a given loan originator based upon the terms or conditions of the loans he/she/it produces for those creditors. So, if the loan originator produces a loan at 8% for affiliated creditor "A" that will result in the receipt of a $X fee, that same originator who produces a loan at 9% for affiliated creditor "B" may not receive a fee in excess of $X.
  - Similarly, if two loan originators are affiliates, they will be treated as one loan originator. So, if affiliated loan originator "A" produces a loan at 8% for a creditor that will result in a $X fee, then affiliated loan originator "B" that produces a loan at 9% for the creditor may not receive a fee in excess of $X.
  - The term "affiliate" is defined for this purpose to mean any company that controls, is controlled by, or is under common control with another company, citing the definition in the Bank Holding Company Act of 1956. See 12 C.F.R. §226.32(b)(2).

- *Prohibition on Steering (Section 226.36(e)(1) of Regulation Z)*
  - A loan originator may not direct ("steer") a consumer into a credit transaction on the basis that he/she/it will receive more compensation from the creditor in that transaction than would be received in other transactions that the loan originator offered or could offer to the consumer, *unless* the consummated transaction (*i.e.,* the transaction that provides more compensation to the loan originator) is in the consumer's interest. This prohibition is designed to prevent loan originators from circumventing the prohibition in Section 226.36(d)(1) against the originator's receipt of compensation based on the loan's terms or conditions.
    - For this purpose, "steering" is broadly defined to mean advising, counseling, or otherwise influencing a consumer to accept a particular transaction. A consumer will not be deemed to have been steered into a particular transaction unless the consumer actually consummates the transaction. The term is somewhat similar to, but not co-extensive with, a "referral" that occurs under RESPA and HUD Regulation X. See 24 C.F.R. §3500.14(f).

- See discussion relating to Section 226.36(d)(1) regarding what constitutes "compensation" and the exclusion of bona fide and reasonable third-party charges.

➢ In determining whether the consummated transaction is "in the consumer's interest," the transaction must be compared with other possible loan offers available through the same loan originator and for which the consumer will likely qualify at the time that the consummated transaction was offered to the consumer.

➢ The loan originator is required to consider possible loan offers if they could be obtained from a creditor with which the loan originator regularly does business. The loan originator is not required to establish new creditor relationships to comply. A "possible loan offer" is one that the creditor is likely to extend upon receipt of an application, based on the creditor's current underwriting standards and current rate sheets (or their equivalent). It is not necessary that the consumer actually would receive a loan offer from the creditor. There is no duty on the part of a loan originator to present a loan if he/she/it makes a good faith determination that the consumer is not likely to qualify for it.

➢ For example, a mortgage broker may not steer a consumer into a non-prime loan from creditor "A" that provides more compensation to the broker than a prime loan that likely would be obtained for the consumer from creditor "A" or creditor "B," unless the consummated loan from creditor "A" is in the consumer's interest. The prohibition similarly would apply if the loan from creditor "A" were not a non-prime loan.

➢ As a practical matter, it will be extremely difficult to know whether the more remunerative loan (from the loan originator's perspective) is going to be in the consumer's interest, because this necessarily will involve a highly subjective determination based on a number of fact-specific issues that are personal to the consumer (*e.g.,* how long the consumer expects to hold the loan, whether a prepayment penalty is acceptable to the consumer, whether the consumer is willing or able to pay up-front charges). Accordingly, it ordinarily will be risky to rely on the "in the consumer's interest" exception. Instead, loan originators are widely expected to utilize the safe harbor in Section 226.36(e)(2) – (4) described below.

➢ In addition to the safe harbor described below, the Commentary provides protection from a violation of the Section 226.36(e)(1) prohibition in two additional situations:

  - First, where the loan originator reviews loan options from a "significant number" of creditors with which he/she/it regularly does business, and directs the consumer to the loan that results in the least amount of creditor-paid compensation, the requirements of Section 226.36(e)(1) are deemed met. This should not be read to suggest that the loan originator must always direct the consumer to the loan that provides the least amount of creditor-paid compensation. If the consumer is directed to a more remunerative loan, the loan originator may still achieve compliance if the consummated loan is in the consumer's interest or if the transaction comes within the safe harbor described above.

  - Second, where the consumer is directed to a loan with higher creditor-paid compensation, the loan originator is not in violation of Section 226.36(e)(1) if the terms and conditions of the consummated loan and other loans for which the consumer likely qualifies are the same.

➢ The prohibition in Section 226.36(e)(1) is primarily focused on the activities of third-party mortgage brokers. A loan originator who is an employee of a creditor, and who generates a loan for that creditor, will be deemed to comply with Section 226.36(e)(1) if he/she is not receiving compensation that is directly or indirectly based on any of the loan's terms or conditions (see discussion of Section 226.36(d)(1), above). However, if the loan originator/employee acts as a mortgage broker by forwarding the consumer's loan application to some other creditor, and he/she is compensated for arranging that loan with the other creditor, then the Section 226.36(e)(1) prohibition applies, just as it would to any other mortgage broker.

➢ The new rule does not limit the amount of compensation that can be received by a creditor that sells a loan into the secondary market, or the compensation that the secondary market investor can receive. This is consistent with the exemption from RESPA and HUD Regulation X for bona fide secondary market transactions discussed above.

- *Prohibition on Steering – Safe Harbor (Section 226.36(e)(2) – (4) of Regulation Z)*

  - The Board has provided a "safe harbor" that a loan originator can use. If the credit transaction comes within the safe harbor, the loan originator will know that he/she/it is not in violation of the anti-steering prohibition described above.
  - To come within the safe harbor, the loan originator must present the consumer with loan options (described below) for each "type" of transaction in which the consumer has expressed an interest.
  - The safe harbor recognizes three "types" of transactions: (i) a loan with an annual percentage rate ("APR") that cannot increase (*e.g.,* a fixed-rate loan); (ii) a loan with an APR that may increase (*e.g.,* an adjustable rate mortgage ("ARM"), an Option ARM, a step rate loan, or a fixed-rate employee loan whose interest rate discount will be lost upon the cessation of employment); and (iii) a closed-end reverse mortgage.
  - The "loan options" that must be presented to the consumer for each of the foregoing "types" of transactions must meet the following criteria: (i) the loan with the lowest interest rate; (ii) the loan with the lowest interest rate, but whose terms do not include any of the following – negative amortization, a prepayment penalty, interest-only payments, a balloon payment within the first seven years of the loan, a demand feature, shared equity, or shared appreciation (or, in the case of a reverse mortgage, the loan terms must not include a prepayment penalty, shared equity, or shared appreciation); and (iii) the loan with the lowest total dollar amount for origination points or fees and discount points.
    - The Commentary provides the following rules for ascertaining what the "lowest interest rate" is: If a loan has an initial rate that is fixed for at least five years, that initial rate is treated as the loan's interest rate. If a loan does not have an initial rate that is fixed for at least five years, and interest rate changes are tied to an index, the fully indexed rate at consummation (without regard to any initial discount or premium) is treated as the loan's interest rate. If the loan does not have an initial rate that is fixed for at least five years, and the interest rate is a step rate, the highest interest rate that will apply during the first five years is treated as the loan's interest rate.
    - If the loan originator cannot form the requisite good faith belief for the three loan options for any particular type of loan, the loan originator may still comply with the safe harbor by presenting *all* loan options for which the consumer likely qualifies and otherwise complying with the requirements of the safe harbor for that type of loan.
    - If a single loan satisfies all of the above criteria for any specific loan type, the loan originator can comply by presenting only that loan option for that loan type.
    - There is no arbitrary limit on the number of loan options that the loan originator may present. If more than three options are provided for any particular type of loan, the loan originator is required to highlight the three loans that meet the criteria stated above. Paragraph 226.36(e)(2)-2 of the Commentary states that presenting more than four loan options for any type of loan would "not likely help the consumer make a meaningful choice." This is analogous to Paragraph 202.9(b)(2)-1 of the Federal Reserve Commentary to Regulation B, which provides that stating more than four reasons for the taking of adverse action in an adverse action notice is "not likely to be helpful to the applicant."
  - The loan originator must have a "good faith belief" that the loan options presented are loans for which the consumer likely qualifies.
    - The "good faith belief" is to be based on information reasonably available to the loan originator at the time that the loan options are presented.
    - The loan originator is entitled to rely on information provided by the consumer (*e.g.,* income, debts, assets, social security number), even if that information later turns out to be incorrect. This standard does not allow the loan originator to induce or coach the consumer to provide inaccurate information.

    - While the loan originator is not required to know all aspects of the creditor's underwriting criteria, the originator is charged with knowledge of information routinely provided by the creditor (*e.g.,* rate sheets that show current pricing, required credit scores, and other eligibility criteria). The loan originator also will be expected to know other information made available by the creditor, such as on the portion of the creditor's web site that is dedicated to the creditor's approved mortgage brokers.

  - The loan originator must obtain the loan options from a "significant number of creditors" with which the originator "regularly does business."
    - A "significant number of creditors" means that if the loan originator regularly does business with more than three creditors, it is only required to obtain loan options from three of those creditors. If the loan originator regularly does business with only one or two creditors, it can comply with the safe harbor by obtaining loan options from all of those creditor(s). Although the loan originator must *obtain* loan options as stated above, it is only required to *present* the loan options that meet the criteria stated above for each type of loan in which the consumer has expressed an interest. For example, the Commentary acknowledges that a loan originator may obtain loan options from multiple creditors but present qualifying loan options from only one of those creditors. The Board's Supplementary Information confirms that loan originators are not required to establish new business relationships with creditors in order to comply with the rule.
    - A loan originator "regularly does business" with a creditor if (i) there is a written agreement between the originator and creditor governing the originator's submission of loans to the creditor, or (ii) the creditor has made dwelling-secured loans to one or more consumers during the current or previous calendar month based on loan applications submitted by the originator, or (iii) the creditor has made dwelling-secured loans 25 or more times during the previous 12 calendar months based on loan applications submitted by the originator (with the 12-month period beginning with the calendar month that preceded the month in which the originator accepted the consumer's application).

  - The "safe harbor" is a real safe harbor – if the transaction comes within the safe harbor, that is the end of the analysis, and the loan originator is deemed to be in compliance with Section 226.36(e)(1). The Board rejected the suggestion by some commenters that this be established instead as a "rebuttable presumption." If the transaction does not come within the safe harbor, there is no presumption that it violates the prohibition in Section 226.36(e)(1).

- *Record Retention (Paragraph 226.25(a)(5) of the Commentary)*

  - A creditor is to maintain a record of compensation it provides to its loan originator for each specific transaction as well as a copy of the compensation agreement in effect on the date that the interest rate is set for the transaction.
    - The date that the interest rate is set means the date the transaction's interest rate is set (or locked) before consummation. If the interest rate is reset one or more times before consummation, then this means the last date the interest rate is set before consummation.
    - The compensation agreement means both the base agreement as well as any addenda, modifications, side letters, or the like that alter the terms of the base agreement.
    - The term "loan originator" includes third-party mortgage brokers, in-house loan officers, and the funding lender in a table-funded loan. Accordingly, the record retention requirement applies to all of these persons.

  - A copy of any compensation or other mortgage broker agreement that complies with Section 226.25 of Regulation Z (record retention requirements) and as required by applicable state law is presumed to be a record of the amount actually paid to the broker. This most likely is a rebuttable presumption that can be overcome with sufficient contrary evidence.

Comments

- As noted above, Section 1403 of the Dodd-Frank Act enacts a new Section 129B of TILA, which will impose restrictions on certain loan originator compensation practices and restricts certain steering practices by loan originators. This final rule might be thought of as "Section 129B lite" because it does not cover all of the items within the scope of Section 129B. The Board acknowledges this and has advised that another cycle of rulemaking will be required to implement all of the loan originator compensation restrictions and anti-steering restrictions required by Congress. Therefore, creditors and loan originators alike will need to undertake two rounds of modifications to their practices, policies, and procedures. For a detailed discussion of Section 129B and other mortgage origination provisions of the Dodd-Frank Act, see http://www.mofo.com/files/Uploads/Images/ResidentialMortgage.pdf.
- In addition to the Board's final rule, it is necessary to comply with all other applicable federal and state laws that may bear on loan originator compensation. For example, state licensing laws often impose disclosure requirements and limitations on compensation for loan originators, the Equal Credit Opportunity Act and Fair Housing Act (together with their implementing regulations) prohibit discrimination on any prohibited basis, and the Fair Credit Reporting Act requires disclosures to home loan applicants if the loan originator utilizes a credit score. Moreover, Section 8 of RESPA imposes restrictions on mortgage broker compensation practices. The fact that a particular practice is permitted by the Board's final rule does not mean that the practice is lawful under another applicable law or regulation.
- The payment of YSPs by creditors to mortgage brokers has been the subject of countless lawsuits under Section 8 of RESPA for more than a decade. Although HUD has indicated that certain YSPs are compliant with Section 8, the Board's final rule under TILA has delivered the death knell to YSPs. The prohibition of YSPs is also mandated by Section 1403 of the Dodd-Frank Act, so this was inevitable.
- As in the case of other recent Board regulations, this final rule was greatly influenced by consumer research. According to the Board, that research indicated that consumers do not understand how a loan originator is compensated, the nature of a YSP, the fact that a loan originator is not necessarily looking out for the consumer's best interests, or much else regarding the loan origination process. While the providing of disclosures has been the backbone of TILA and Regulation Z for over 40 years, the Board's Supplementary Information states that sometimes disclosure is not sufficient to avoid consumer harm. Valid or not, that same principle is reflected in many of the new prohibitions and requirements imposed by the Dodd-Frank Act.
- While the APR remains the term that describes the overall cost of consumer credit, the safe harbor under Section 226.36(e)(2) – (4) requires loan originators to present loan options based on the lowest interest rate, the lowest interest rate without certain loan features, and the dollar amount of origination points or fees and discount points. Consumers struggle with the APR concept, but they believe that they understand interest rates and origination charges.
- The final rule brings an end to the existing model for compensating loan originators. While the elimination of YSP payments to mortgage brokers has received considerable attention, the impact of the final rule on in-house loan officers – whose employer-paid compensation generally has been free from scrutiny under §8 of RESPA – may be even greater. Creditors will need to develop effective and compliant new financial models for compensating mortgage brokers, loan officers, and correspondents that engage in table fundings.
- The treatment of affiliated entities as a single entity for purposes of Section 226.36(d)(1) (prohibition against compensating a loan originator based on the terms or conditions of the loan) will create significant operational challenges for many financial institutions. Many banks have created separate legal units to serve their prime and non-prime customer bases, and those units typically established their own compensation arrangements for mortgage brokers. Under the Board's final rule, a mortgage broker who delivers loans to both units cannot be paid different amounts by those units based on the terms or conditions of the loans. For example, the broker cannot be paid a larger fee for generating a loan with a higher interest rate for the non-prime unit than he/she/it would be paid for generating a loan with a lower interest rate for the prime unit. This means that affiliated creditors must consult

with one another and coordinate their loan originator compensation practices. In the same way, the new affiliate rule also applies to affiliated loan originators. For example, affiliated mortgage brokers will be treated as a single entity, which means that they, too, will need to coordinate their receipt of compensation.

- The Board has acknowledged that the safe harbor created for its anti-steering prohibition will not necessarily protect against all steering abuses. The Board stated that it expects the safe harbor to address the most egregious practices, and therefore rejected the suggestion by consumer groups and others that a rebuttable presumption be used in place of the safe harbor. If the Board (or, later, the new Bureau of Consumer Financial Protection) concludes in the future that the safe harbor is not working as envisioned, it is possible that this will be reconsidered.
- As noted above, the Board's authority to issue the final rule is derived from provisions of TILA that empower it to prohibit mortgage loan practices that are unfair, deceptive, or abusive. In its Supplementary Information, the Board stated that it has looked to the standards employed for interpreting state unfair and deceptive trade practices statutes and Section 5(a) of the Federal Trade Commission Act. This leaves open the possibility that the Board (or, later, the Bureau) will issue additional regulations designed to prohibit unfair, deceptive, or abusive mortgage loan practices.
- The Board's Supplementary Information makes clear that compliance with the final rule is not required until the April 1, 2011 effective date as described above. The Board concludes that the final rule and the Board's analysis therefore have no bearing on the question of whether acts and practices that are prohibited by the final rule are deemed to be unfair or deceptive if engaged in before the effective date. In this regard, the Board notes that the implementation period preceding the effective date is integral to the Board's decision to restrict or prohibit these acts and practices by regulation. Notwithstanding these statements, loan originators and creditors will need to decide for themselves whether it will be prudent to implement the required changes on an accelerated basis.

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