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The Mini-Correspondent Channel: Pros and Cons

Several years ago, our firm, Lenders Compliance Group, provided unique guidance to the mortgage division of a bank.* The bank wished to build a special origination platform for its mortgage brokers. At that time, the prevailing regulations required disclosure of the Yield Spread Premium (YSP), and the bank wanted to give their Third Party Originators (TPOs) an opportunity to close in their own name, with their own funds, and, among other things, by-pass disclosure of the YSP. In building the platform for the bank, many features were needed to implement these relationships in accordance with federal and state law, as well as safety and soundness metrics. This all took place at a time when a 3% fee cap on broker revenue was not even a glimmer in the eyes of legislators or regulators, and Elizabeth Warren[i] had yet to promote the creation of the Consumer Financial Protection Bureau (CFPB).

As Shakespeare wrote in *The Tempest*, “What’s past is prologue.”

Since the early part of this year, many lenders are building a new origination channel. The proximate cause for the new channel is found in the Final Rule pertaining to the Ability-to-Repay guidelines and the requirements of a Qualified Mortgage (Rule).[ii]

The new channel is meant specifically for brokers who hope to by-pass a 3% cap on loan amounts above $100,000, the new CFPB requirement that substantially and principally affects broker TPOs.[iii] The loans covered by the Rule are first lien and junior lien mortgage loans that are closed-end mortgage loans secured by a dwelling, including home purchase, refinance and home equity loans. (Excluded loans are HELOCs; Timeshares; Reverses; Bridges with a term of 12 months or less and loans to purchase a new dwelling where the consumer plans to sell another dwelling within 12 months; Vacant Lot loans; Loan Modifications not subject to the "refinancing" provisions under TILA; and Business Loans.)[iv]

In particular, many brokers usually seek to charge fees between 2% and 3% per loan transaction; however, as of January 10, 2014,[v] any excess above 3% in total points and fees virtually guarantees that such loans, originated by brokers, will not be eligible for treatment as a Qualified Mortgage (QM). The result of the Final Rule and specifically the 3% cap is to create an incentive for many brokers to morph into a new kind of correspondent, termed the “Mini-Correspondent.” The new origination channel developed by some wholesale lenders is aptly called the “Mini-Correspondent Channel.”

One of us, Jonathan Foxx, has written extensively – both in magazine articles and newsletters – about the Ability-to-Repay guidelines (ATR), the Qualified Mortgage, and the Non-Qualified Mortgage (viz., which he has titled the “NQM”). For additional details and guidance, please read those publications.[vi]

In this article, we are going to explore two interrelated issues. First, we will discuss the 3% cap, its implementation and placement within the QM framework, and the way it affects the originations of the mortgage broker. To do that, we will provide the QM framework into which the 3% cap is situated. Secondly, we will discuss the structure of and certain requirements relating to a mini-correspondent TPO. Bear in mind that this new type of TPO is taking place in a dynamic regulatory environment and loan origination market; therefore, aspects of our observations may change, due to a regulatory response, or other material factors, that pertain to originating loans through this new channel.

Two Classes of Qualified Mortgages

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Essentially, the Rule creates two types of QMs, one of which provides a safe harbor from liability and another which does not provide a safe harbor, but does offer a rebuttable presumption of compliance with the Rule. Obviously, the former is preferred, though the latter is not without its merits.

The safe harbor is only available if the creditor complies with all aspects of the Rule, including, at minimum, all the ATR guidelines, and where the Annual Percentage Rate (APR) on a first lien loan must be within 1.5 percentage points of the "average prime offer rate" (APOR) as of the date the interest rate is set (viz., the APR on a junior lien must be within 3.5 percentage points of the APOR).[vii] If the APR threshold is exceeded, the creditor has a rebuttable presumption of compliance.

The distinction between the *safe harbor* and *rebuttable presumption* is very significant. With the safe harbor, a lender obtains a *conclusive presumption of compliance* and may refute a claim that it violated the Rule, such as not complying with the ATR guidelines. But if the lender obtains only a *rebuttable presumption of compliance*, a claim can be litigated on the basis of a creditor not making a "reasonable" and "good faith" determination of the borrower's ability to repay, irrespective of a lender's complying fully with various aspects of the Rule, such as the ATR guidelines.

The ATR test promulgated by the Rule consists of eight factors. Neither the safe harbor nor the rebuttable presumption is available to a lender solely because a loan is underwritten to the ATR test's guidelines. The ATR factors require the lender to underwrite and verify (1) current or reasonably expected income or assets, other than the value of the dwelling, (2) current employment status (viz., if the creditor is relying on employment income), (3) monthly payment, (4) monthly payment on any "simultaneous loan" of which the creditor is (or should be) aware, (5) mortgage-related obligations, (6) current debt obligations (including alimony, palimony, and child support), (7) monthly Debt-to-Income (DTI) ratio or residual income, and (8) borrower credit history. It should be noted that the ATR test itself does not place limits on points and fees.

Qualified Mortgage and the 3% Cap

As mentioned above, a QM with an APR that does not exceed the APOR thresholds receives a safe harbor from liability (i.e., compliance with the ATR guidelines). If the APOR thresholds are exceeded, this means that the loan is a higher-priced QM, and, as such, receives the rebuttable presumption of compliance. In effect, the two classes of QM constitute a prime and non-prime market, with the prime entitled to safe harbor and the non-prime entitled to a rebuttable presumption.[viii]

But there are several challenges that a lender must overcome in order to use the safe harbor defense, one of which is the 3% cap. The Rule excludes from the points and fees 3% cap any compensation paid, per transaction, by a mortgage broker to an employee of the mortgage broker and compensation paid by a creditor to its loan officers. Compensation paid by a creditor to a loan originator other than an employee of the creditor (i.e., paid to a broker by a creditor on a lender paid transaction) is included in the 3% cap along with other upfront charges paid by the consumer to the creditor or its affiliates.[ix] Furthermore, the 3% cap includes certain fees paid to affiliates, mortgage originator compensation paid directly or indirectly by the consumer, and amounts imposed by secondary market investors and passed through to borrowers to compensate for credit risk. When these "points and fees" are factored into the loan origination costs, many loans will exceed the 3% limit.[x]

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