LOAN ORIGINATOR COMPENSATION: PAST IS PROLOGUE - PART II

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If you can see the light at the end of the tunnel, you are looking the wrong way.
Barry Commoner

In the first part of this two-part series,[1] I considered the recent proposal, issued by the Consumer Financial Protection Bureau (CFPB) on August 17, 2012, which contains certain proposed rules governing mortgage loan originations, especially relating to Mortgage Loan Originator (MLO) compensation guidelines in Regulation Z, the implementing regulation of the Truth in Lending Act. Comments for this proposal were due by October 16, 2012.[2]

In that article I discussed the Small Business Review Panel, which was impaneled to consider, among other things, the economic and regulatory impact of the proposal rules and obtain feedback from representatives of the small entities that would be subject to the rule.[3] When preparing the proposed rule and an initial regulatory flexibility analysis, the CFPB is expected to consider this panel's findings and also public comments, rendering its final rules by January 2013.[4]

In this second part of the series, I will explore the CFPB proposed rules (Proposals) in some depth, specifically the clarification of and expansion on existing regulations governing MLO compensation and qualifications.[5] These Proposals clarify and expand existing regulations relating to loan originator compensation and qualifications. They also promulgate new laws. The Proposals are meant to implement provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) governing MLO compensation.[6]

There are certain salient regulatory compliance requirements implemented in the Proposals.[7]

The proposed rules concern and include:

- Restrictions on Upfront Points and/or Fees
- Restrictions on Loan Originator Compensation
- Loan Originator Qualification Requirements

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I will discuss the above-mentioned categories included in and affected by the Proposals.[8] Afterward, I will provide certain considerations regarding the potential, effectuating outcomes inherent in their implementation. The entirety of the Proposals is quite extensive. In the context of this article, I can only hope to provide a broad sense of their implications.

Please keep in mind that, as is the case with many aspects of legal and regulatory compliance, these Proposals contain many mandates that reach across an extensive regulatory framework. Recourse to a competent risk management professional is essential to obtain comprehensive guidance and reliable information.

RESTRICTION ON UPFRONT POINTS AND/OR FEES

Government is not reason; it is not eloquent; it is force.
Like fire, it is a dangerous servant and a fearful master.
George Washington

The Proposals create a category, called the "zero-zero alternative" (Zero-Zero). It is a contrivance that must be tooled with prior to a lender or a mortgage broker being permitted to charge upfront points and/or fees.[9] The Zero-Zero is an "alternative loan" with no upfront discount points, origination points, or fees that are retained by the lender, broker, or an affiliate of either.[10] The Zero-Zero would not be required if the consumer is unlikely to qualify for the Zero-Zero in the first place.

Using the Zero-Zero offers a safe harbor in the following scenarios:

- Transactions involving a lender: A safe harbor is available if, any time prior to application for a loan containing upfront points and/or fees, the lender also provides a quote for a Zero-Zero.

- Transactions involving a mortgage broker: A safe harbor is available under which lenders provide a mortgage broker with the pricing for that lender's Zero-Zero products.

In the mortgage broker scenario, consumers would be given quotes based on the Zero-Zero, as part of the available loan options.

Offering the Zero-Zero "quote" *prior to taking an application* essentially makes this metric into a creature that the CFPB has named, somewhat enigmatically, an "informal quote."

The CFPB plans to issue a final rule using the following decision parameters:

- Whether a *bona fide* requirement should be adopted "to ensure that consumers receive value" in return for paying upfront points and/or fees, and different options for structuring such a requirement.[11]

- Whether additional adjustments to the Proposals concerning affiliate fees would make it easier for consumers to compare offers between two or more lenders.

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- Whether to take a different approach concerning situations in which a consumer does not qualify for a Zero-Zero.

- Whether a Zero-Zero's quotes, terms, and conditions should be disclosed in advertising and at the time that consumers are provided disclosures within three days after application.

RESTRICTIONS ON LOAN ORIGINATOR COMPENSATION

All I ask is the chance to prove that money can't make me happy.
Spike Milligan

The position promulgated in the Proposals with respect to loan originator compensation may be bifurcated into outright *Bans and Refinements*, and *Clarifications and Revisions*. Let's first take a look at the *Bans and Refinements*.

Bans and Refinements

The CFPB would continue the general ban on paying or receiving commissions or other loan originator compensation based on the terms of the transaction (other than the loan amount).[12] However, there are several revisions or "refinements," as the CFPB coyly describes these adjustments.

The refinement to the simmering controversy over "unanticipated increases" in closing costs from non-affiliated third parties is resolved by allowing reductions in loan originator compensation under certain circumstances.

Additionally, the ban remains in place on loan originators being compensated by both consumers and other parties. Here, too, there are refinements. For instance, the Proposals allow mortgage brokerage firms that are paid by the consumer to now be able to pay their individual brokers a commission on the transaction, so long as the commission is not based on the terms of the transaction. A further refinement allows certain funds contributed toward closing costs by sellers, home builders, home-improvement contractors, or similar parties, when used to compensate a loan originator, to be considered payments made directly to the loan originator by the consumer.

There are revisions to permissible contractual agreements. The Proposals ban general agreements that require consumers to submit any disputes arising from a loan transaction to mandatory arbitration rather than filing suit in court.

A remnant of a long debated concern is resolved with respect to financing of premiums for credit insurance. The Proposals would ban such financing arrangements.

Clarifications and Revisions

Clarification is provided for "proxy" compensation, that is, when a factor used as a basis for compensation is prohibited as a "proxy" for a transaction term. The clarification was sought by the Small Entity Representatives (SERs) on the Small Business Review Panel, which urged the CFPB to use its

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rulemaking authority to clarify when a factor used to determine compensation for a loan originator is a proxy for a loan term.[13] Although the CFPB did not believe that any departure from the approach to proxies is necessitated by Dodd- Frank, it also "understands there has been considerable uncertainty on this issue" and its Proposals contain clarifications meant to enable lenders and loan originators to determine whether a factor on which compensation would be based is a proxy for a transaction's terms.

In the clarification, the CFPB states that a factor (that is not itself a term of a transaction originated by the loan originator) is a proxy for the transaction's terms if:

1. The factor substantially correlates with a term or terms of the transaction, and

2. The loan originator can, directly or indirectly, add, drop, or change the factor when originating the transaction.

Both aforementioned conditions must be satisfied for a factor to be considered a proxy for a transaction's terms.

If a factor does not "substantially" correlate with a term of a transaction originated by the loan originator, the factor is not a proxy for a transaction's terms.[14]

If the factor substantially correlates with a term of a transaction (Step One), then the factor must be analyzed under the second condition, whether the loan originator can, directly or indirectly, add, drop, or change the factor when originating the transaction (Step Two). Thus, the conclusion reached by the CFPB clearly is that where a loan originator has no or minimal ability directly or indirectly to add, drop, or change a factor, that factor cannot be a proxy for the transaction's terms, because such a factor cannot be the basis for incentives to steer consumers inappropriately.

The CFPB takes the position that a credit score proxy may or may not be a proxy for a transaction's terms, depending on the facts and circumstances. In other words, it is not automatically a proxy, as many lenders and loan originators have maintained.

Further, the Proposals clarify that the rule does not prohibit compensating loan originators differently on different transactions, provided such differences in compensation are not based on a transaction's terms or a proxy for a transaction's terms.

The Proposals also address restrictions on pooled compensation, profit-sharing, and bonus plans for loan originators, depending on the potential incentives to steer consumers to different transaction terms, as follows:

- Employers would be permitted to make contributions from general profits derived from mortgage activity to 401(k) plans, employee stock plans, and other "qualified plans" under tax and employment law.

- The Proposal s permit employers to pay bonuses or make contributions to non-qualified profit-sharing or retirement plans from general profits derived from mortgage activity if:

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- Either: the loan originator affected has originated five or fewer mortgage transactions during the last 12 months;
- Or: the company’s mortgage business revenues are limited.
  - The CFPB proposes two alternatives for applicable tests: a 25 percent or 50 percent of total revenues.

- The amounts of contributions and bonuses, though such contributions and bonuses could be funded from general mortgage profits, may not be based on the terms of the transactions.

LOAN ORIGINATOR QUALIFICATION REQUIREMENTS

Data is not information,
information is not knowledge,
knowledge is not understanding,
understanding is not wisdom.
Clifford Stoll

Dodd-Frank contains a provision requiring both individual loan originators and their employers to be “qualified” and to include their license or registration numbers on certain specified loan documents. Consequently, the Proposals set forth specific mandates regarding loan origination qualifications.

We already know that the Secure and Fair Enforcement for Mortgage Licensing Act (SAFE) requires licensing and registration of loan originators. Under the Proposals, the loan originator’s employer must ensure that the loan originator meets character, fitness, and criminal background check standards that are equivalent to the SAFE requirements as well as receive training “commensurate with the loan originator’s duties.”

Employers and individual loan originators, if primarily *responsible for a particular transaction,* would be required to list their license or registration numbers on certain key loan documents.

Issues and Controversies

There ain't no answer.
There ain't gonna be any answer.
There never has been an answer.
That's the answer.
Gertrude Stein

Let’s now take into consideration several, specific details of the Proposals. These are some, but certainly not all, of the issues and concerns that have become pronounced since the loan originator compensation rule became effective in April 2011. It is important, therefore, to consider how the CFPB is endeavoring to go about resolving them. My remarks will be limited to the Proposals themselves and not the controversies involved in each instance.

Point Banks

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The CFPB has determined that there are no circumstances under which point banks are permissible, and they therefore continue to be prohibited.

If you are not familiar with how point banks work, this is a generic description:

1. Each time a loan originator closes a transaction, the lender contributes some agreed upon, small percentage of that transaction's principal amount (for example, 0.15 percent, or 15 "basis points") into the loan originator's point bank account. (The point bank account is not actually a deposit account with the creditor or any depository institution but is only a continuously maintained accounting balance of basis points credited for originations and amounts debited when "spent" by the loan originator.)

2. The loan originator may spend any amount up to the current balance in the point bank to obtain pricing concessions from the creditor on the consumer's behalf for any transaction. (For example, the loan originator may pay discount points to the creditor from the loan originator's point bank to obtain a lower rate for the consumer.)

The CFPB maintains that payments to point banks serve as a form of loan originator compensation "because they enable additional transactions to be consummated and loan originators to receive compensation on these transactions." Accordingly, they are a "financial incentive" to the loan originator and, therefore, point banks are compensation.[15]

To the extent such payments are based on the transaction's terms or a factor that operates as a proxy for the transaction's terms, they are a direct violation of Dodd-Frank.[16] Even if the contribution to a loan originator's point bank for a given transaction is not based on the transaction's terms (or a proxy), the CFPB holds that a loan originator's subsequent spending of amounts from the point bank on other transactions is an impermissible pricing concession.[17]

Furthermore, the CFPB closes out even the so-called "pricing concessions" use of reserved funds in a point bank. The view is that a point bank whose funds could be reserved for use in the unique circumstances where pricing concessions would be permitted – even this application of funds cannot be legitimate because the criteria set forth in the pricing concessions provision limit such concessions to unusual and infrequent cases of unforeseen increases in closing costs and, by definition, a point bank contemplates "routine use," which is contrary to TILA's intent.

I should point out here, as mentioned in Part I of this series, that the CFPB's decision not to propose to allow point banks was also influenced by the negative consensus view of SERs participating in the Small Business Review Panel process and the negative views expressed by many other stakeholders.[18]

Pricing Concessions

The Proposals contain revisions to the actual staff commentary addressing loan originator pricing concessions.

In the existing comment, a lender and loan originator may not agree to set the originator's

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compensation at a certain level and then subsequently lower it in selective cases (such as where the consumer is offered a reduced rate to meet a quote from another creditor). The compensation is not subject to change (increase or decrease) based on whether different loan terms are negotiated.

Under the Proposals, the CFPB asserts that, while the creditor may change loan terms or pricing – for instance, in order to match a competitor, avoid triggering high-cost loan provisions, or for other reasons – the loan originator's compensation on that transaction may not be changed. Thus, the revised comment of the Proposals clarifies that a loan originator may not agree to reduce its compensation or provide a credit to the consumer to pay a portion of the consumer's closing costs.[19]

The CFPB also intends to delete an existing comment that pertains to transactions in which any loan originator receives compensation directly from the consumer (i.e., "consumer-paid transactions"). The Proposals now also include a new comment addressing a discrete issue related to pricing concessions. This proposed comment provides that loan originators are not prohibited from decreasing their compensation to cover unanticipated increases in non-affiliated third-party closing costs which result in the actual amounts of such closing costs exceeding limits imposed by applicable law (i.e., tolerance violations under Regulation X, the implementing regulation of the Real Estate Settlement Procedures Act (RESPA)).

Note: this interpretation does not apply if the creditor or the loan originator knows or should reasonably be expected to know the amount of any third-party closing costs in advance. To unpack this language for you, this means that a loan originator is reasonably expected to know the amount of the third-party closing costs in advance if the loan originator allows the consumer to choose from among only three pre-approved third-party service providers.

It is interesting to recognize that the CFPB seems to believe here that such pricing concessions, when made in response to unforeseen events outside the loan originator's control to comply with otherwise applicable legal requirements, do not raise concerns about the potential for steering consumers to different loan terms. That is, as the CFPB clearly states, "if the excess closing cost is truly unanticipated and results in the loan originator having to take less compensation to cure the violation of applicable law, no steering issues are present because the loan originator's compensation is being decreased after-the-fact."[20]

Thus, the CFPB is concluding that, in the absence of the aforementioned clarification, lenders and loan originators might incorrectly surmise that such pricing concessions being borne by a loan originator would violate those provisions, or they could face unnecessary uncertainty with regard to compliance with these provisions and other laws, such as Regulation X's tolerance requirements.

Again, another loophole is closed in the Proposals, because under the proposed comment, a loan originator cannot make a pricing concession where the loan originator knows or reasonably is expected to know the amount of the third-party closing costs in advance. If a loan originator makes repeated pricing concessions for the same categories of closing costs across multiple transactions, based on a series of purportedly unanticipated expenses, the CFPB believes the loan originator is reasonably expected to know the closing costs across multiple transactions. In order to prevent that gambit, such pricing concessions would raise concerns about impermissible pricing concessions due to the fact that

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that loan originators could knowingly overestimate the closing costs and then selectively reduce the closing costs as a concession.

Alternative Loan Dilemma

As I discussed above, under the proposal, a lender is not required to make available a comparable, alternative loan if the consumer is unlikely to qualify for that loan. The Proposal solicits comment on whether consumers should be informed that they were not given information about a comparable, alternative loan because they were unlikely to qualify for that loan.

On the one hand, in transactions that do not involve a loan originator entity (i.e., a mortgage broker), should lenders be required either to make the comparable, alternative loan available to the consumer if the consumer likely qualifies for that loan or to inform consumers that the lender is not making the comparable, alternative loan available because the consumer is unlikely to qualify for that loan?

On the other hand, in transactions that involve a loan originator entity, should a loan originator entity using the above-mentioned safe harbor[21] be required to disclose to a consumer that the loan originator entity did not present a loan that does not include discount points and origination points or fees because the consumer was unlikely to qualify for that loan from the creditors with whom the loan originator organization regularly does business?

So, the ponderable question becomes: would it be useful to consumers to be informed that they were unlikely to qualify for the comparable, alternative loan?

A loophole may exist: if lenders who do not wish to make loans that do not include discount points and origination points, or fees available to particular consumers, could possibly manipulate their underwriting standards so that those consumers do not qualify for such a loan. This is why the CFPB is seeking to avoid such a practice by prohibiting lenders from changing their qualification standards, such as loan-to-value ratios and credit score requirements, solely for the purpose of disqualifying consumers from receiving loans that do not include discount points and origination points or fees.

The Proposals suggest that an alternative would make clear that lenders must make available the loan that does not include discount points and origination points or fees unless, as a result of the increased monthly payment resulting from the higher interest rate on the loan that does not include discount points and origination points or fees, the consumer cannot satisfy the lender's underwriting rules. The CFPB hopes to determine whether there is a risk that, absent such a requirement, some lenders "might manipulate their underwriting standards and whether the Bureau should adopt a rule against doing so."[22]

Nevertheless, the CFPB believes that even if underwriting standards could not be manipulated, lenders who do not want to make loans that do not include discount points and origination points or fees could set the interest rates high for certain consumers, which would thereby increase the monthly payment on those loans to be high so that those consumers cannot satisfy the creditor's underwriting rules. Therefore, an alternative is under consideration, whereby a creditor would be able to make available a loan that includes discount points and origination points or fees only when the consumer also qualifies

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for a comparable, alternative loan that does not include discount points and origination points or fees.

On the one hand, a potential advantage of this alternative is that it would effectively limit lenders' opportunity to manipulate their underwriting standards or charge above-market interest rates to prevent particular consumers from qualifying for a loan that does not include discount points and origination points or fees.

On the other hand, the CFPB is concerned that adoption of such an alternative may impact consumers' access to credit.

One more thing: the Proposal recognizes that there are some lenders who will not make a loan where the debt-to-income ratio exceeds a certain level, and that there may be some consumers for whom the difference between the interest rate on a loan that includes and does not include discount points and origination points or fees will determine whether the consumer can satisfy the creditor's debt-to-income standard. In such a scenario, consumers who do not qualify for specific loans that do not include discount points and origination points or fees would also not be able to receive from the lender the same type of loans that include discount points and origination points or fees. This could harm those consumers who might prefer to obtain from a lender a specific type of loan that includes discount points and origination points or fees, rather than not be able to obtain that type of loan at all from the lender.

Facilitating Consumer Shopping

The Proposals also seek to facilitate consumer shopping "by enhancing the ability of consumers to make comparisons using loans that do not include discount points and origination points or fees made available by different creditors as a basis for comparison."[23]

As discussed above, for retail transactions, a creditor will be deemed to be making the loan available if, at any time the creditor provides a quote specific to the consumer for a loan that includes discount points and origination points or fees, the creditor also provides a quote for a comparable, alternative loan that does not include discount points and origination points or fees (unless the consumer is unlikely to qualify for the loan). Nonetheless, the CFPB is concerned that by the time consumers receive a quote from a particular lender for a loan that does not include discount points and origination points or fees, they may have already completed their shopping in comparing loans from different lenders.

Thus, the Proposals include a solicitation for comments on whether the existing advertising rules[24] should be revised to enable consumers to make comparisons using loans that do not include discount points and origination points or fees made available by different creditors as a basis for comparison.

Currently, if an advertisement includes a "trigger term," the advertisement must contain certain additional information (i.e., amount or percentage of any down payment, the number of payments or periods of repayment, and so forth). The CFPB now is contemplating whether an advertisement that contains the interest rate for a loan that includes discount points and origination points or fees also must contain the following information for the comparable, alternative loan that does not include discount points and origination points or fees: (1) The interest rate, (2) the amount or percentage of the down payment, (3) the terms of repayment, which reflect the repayment obligations over the full terms

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of the loan, including any balloon payment, and (4) the “annual percentage rate,” using that term, and, if the rate may be increased after consummation, that fact. The scope here is obviously expanded to require that a lender that must provide in an advertisement the interest rate for a loan that includes discount points and origination points or fees also to include in such advertisement certain information for a comparable, alternative loan that does not include discount points and origination points or fees. So, the CFPB is determining whether this information about the loan that does not include discount points and origination points or fees must be contained in origination points or fees.

The goal is to make it easier for consumers to compare the loan pricing on loans that do not include discount points and origination points or fees available from different creditors because most of the cost of the loans would be incorporated into the interest rate. A consumer could compare the interest rates on such loans available from different creditors, without having to consider a variety of different discount points and origination points or fees that might be charged on each loan.

ALL THINGS CONSIDERED

Hell, there are no rules here - we're trying to accomplish something.
Thomas A. Edison

The CFPB published its Proposals in order to implement statutory changes made by Dodd-Frank to Regulation Z’s current loan originator compensation provisions. As I have indicated above, and as elaborated in Part I of this series, the Proposals include a new, additional restriction on the imposition of any upfront discount points, origination points, or fees on consumers under certain circumstances. In addition, the proposal implements additional requirements imposed by Dodd- Frank concerning proper qualification and registration or licensing of loan originators. The Proposals also implement Dodd-Frank restrictions on mandatory arbitration and the financing of certain credit insurance premiums. Finally, they provide additional guidance and clarification under the existing regulation’s provisions restricting loan originator compensation practices, including guidance on the application of those provisions to certain profit- sharing plans and the appropriate analysis of payments to loan originators based on factors that are not terms but that may act as proxies for a transaction’s terms. In this article I have offered some insight into several of these categories.

There have been significant reviews and comments offered by many firms, individuals, and associations. Let us now bring back into discussion the topics covered and view them from the viewpoint of their potential impact on consumers, lenders, and loan originators. The positions of the Mortgage Bankers Association (MBA), as stated in its comment letter on the Proposals, are consistent with the views of many industry participants.[25] For this reason, I intend to follow some of its insights in construing a range of possible eventualities.

Restrictions on Upfront Points and/or Fees

The idea of restricting upfront points and/or fees, while also requiring Zero-Zero alternatives can cause adverse consequences for consumers and mortgage industry participants. If they both are implemented, the outcome could lead to consumers having less choice, not more choice. For one reason, lenders might reasonably be expected to withdraw from allowing compensation to loan originators based on

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commissions, which inevitably means increased rates, a burdensome outcome for the consumer. This is because lenders might need to retreat to a salary-based compensation plan in order to compensate for the incremental costs involved in implementation.

Commission-based income is the backbone of the market, and depriving the market of that dynamic, financial incentive would surely lead to depressed outcomes. Consider the economic construct: if lenders do not have the opportunity to receive points or fees from consumers, they will simply increase the rate to the consumers in order to compensate; and, importantly, if consumers do not have the opportunity to buy down the rate through discount points, they will not be able to lower their rates and their monthly payments will be higher than they would be otherwise.

Zero-Zero Alternative

Perhaps one of the most controversial of the Proposals is the Zero-Zero. As I mentioned hereinabove, the restriction against points and fees is lifted on commission-based compensation if the Zero-Zero is offered to the consumer. And, even in the event of the exemption, points and fees must result in a *bona fide* reduction in the rate.

For various reasons this poses a substantial stress to risk management strategies. Notwithstanding the fact that most lenders do not actually offer Zero-Zero pricing, the cost of funds to lenders, and secondary market limits to rate expansion, may negate the possibility of a Zero-Zero option.[26] This begs the question of how lenders are supposed to cover their costs in order to offer such an alternative loan, if the market structure itself militates against such regulatory demands.

Loan size and state mortgage programs would be adversely impacted, because the former often originates through premium pricing, which may not cover the Zero-Zero costs, and in many cases the latter do not permit fee variation by charging points. Indeed, lenders would need to cover costs through a premium interest rate that is likely to push many of them to add prepayment requirements or limit the loans that are made available, because a Zero-Zero would have higher interest payments and a greater risk of prepayment.

But how would prepayment fees be imposed if Dodd-Frank imposes limitations on prepayment fees?[27] The effect of this regulatory clash would be to drive some lenders out of the market, or, absent prepayment fees, at least make such loans economically impossible.

These limits may force lenders to forego prepayment fees, making some of these transactions infeasible, or in some cases, leave the market entirely.

If all origination costs must be factored into the rate, additional loans would not be made, because the increment would lead to originating a high-cost or a higher-priced loan.

What about the Zero-Zero's effect on the prospective Qualified Mortgage (QM) requirements? The MBA offers this sobering scenario:

"Should the Bureau include a minimum debt-to-income ratio ("DTI") in the Qualified Mortgage

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(QM) requirements, then offering a zero-zero alternative (with a higher interest rate and greater monthly payments) will significantly raise the potential that for some borrowers the increased DTI will exceed QM standards (thereby making the loan unavailable.) We cannot be certain of the shape or content of these other rules since they are not yet finalized, but there is a very real possibility that the operation of other laws may make many zero-zero alternatives unavailable."[28]

Risk management may be adversely affected by the Zero-Zero in that this alternative loan product would materially alter the risk by rate increase, concomitant mortgage payment increase, which could lead to defaults. The relationship between points and fees and risk would become distorted, since the market pricing parameters that account for risk are skewed.

Defining Proxies

In the *Clarifications and Revisions* subsection above, I provided the two steps to defining a proxy for permissible and impermissible differences in loan originator compensation, pursuant to the Proposals. Congress did not include a proxy concept in the Dodd-Frank loan originator provisions. It is clear, therefore, that Congress appears to have addressed steering concerns through provisions that expressly address steering.

These steps are more of a litmus test than actual examples encountered since April 2011, when the loan originator compensation rules went into effect. This way of defining an 'unknown' by extrapolating it into a 'known' variable is fraught with legal and regulatory compliance risk.

The MBA offers some observations of examples that should be included in the final rule,[29] in order to expand the understanding of how better to discern proxies for compensation, specifically requesting that the Proposals permit:

1. Differences in compensation based on quantifiable revenue differences to the company because of market factors. ("A loan that is brokered out of a lender company -- simply because the lender does not offer the product -- and that brings in less revenue to the company should be a basis for less compensation than a 'funded' loan.")

2. Differences in compensation based on quantifiable differences in the work it takes for a loan officer to originate a loan should be explicitly permitted. ("Board staff indicated informally that this was permissible. Written clarification would be useful.")

3. Differences in compensation to originate Community Reinvestment Act loans. (While MBA noted that "the Commentary indicates that the 'geography' is not a proxy and thus should permit differing compensation for CRA loans, it would be helpful if the rule were explicit on this point.")

4. Differences in compensation to encourage the offering of good sustainable products to meet public purposes such as state agency or other government program loans. ("Even if steering to these products was possible, the products are beneficial to consumers. Moreover, some of

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these programs restrict the amount of compensation to loan originators.")

In my view, at this time the definition of a proxy, the method for identifying a proxy, and the examples of a proxy are inadequate and require further elaboration.

Pricing Concessions

I discussed briefly in the *Bans and Refinements* subsection that the Proposals state that a loan originator may reduce compensation where there is an unanticipated increase in the closing costs attributable to non-affiliated third parties. To qualify for the exception, two conditions must be met: (1) the "unanticipated increase" must result in the actual amount of closing costs exceeding legal limits or tolerances for such costs; and, (2) the lender or loan originator must not have known or could not be reasonably expected to have known the amount of the closing costs in advance.

As in many regulatory matters, it is not what is included, but what is excluded that is of pivotal importance. For instance, it is hard to comprehend why "costs attributable to non-affiliated third parties" may be included, but costs attributed to affiliates are excluded. If a charge is truly "unexpected," what difference does it make if the charge arises from a third party that is or is not an affiliate?

An on-going problem that has caused considerable concerns for my firm's clients is that compensation is not permitted to be reduced in order to rectify an erroneous charge on the Good Faith Estimate. The lenders are forced to absorb the cost of the error, rather than being able to reduce the compensation to account for the error. Many theories have been pronounced as to why this aspect of the regulation is needed, most of which seem unconvincing to me. Errors are not abstractly invented by lenders to circumvent the Truth in Lending Act. The threat of TILA violations is a strong preventive measure.

The many reasons for removing this prohibition are trumped even more by the need to maintain an orderly market. Pricing competition is not an amorphous economic concept. It is a dynamic mechanism that actually informs all market participants of financial advantages and disadvantages. The loan originator who is able to make pricing concessions is in the position to respond promptly and assertively to market conditions, and such adjustments tend to inure to the benefit of consumers. When the consumer benefits the market improves its stability.

Defining the Loan Originator

If one does not know to which port one is sailing, no wind is favorable.
Lucius Annaeus Seneca

Although lenders and brokers have become familiar with the definition of the loan originator, as described in TILA, various governmental issuances, and staff commentary, the Proposals seek to revise the definition itself, as follows:

<u>Existing definition</u>: "a person who for compensation or other monetary gain, or in the expectation of compensation or other monetary gain, arranges, negotiates or otherwise obtains an extension of credit

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for another person."

New definition: "a person who **takes an application**, arranges, **offers**, negotiates, or otherwise obtains an extension of consumer credit for another person in the expectation of compensation or other monetary gain or for compensation or other monetary gain." (Emphasis added.)

The Commentary contains this interpretation of the new definition:

> "… a person who assists a consumer in obtaining or applying for consumer credit by advising on credit terms (including rates, fees, and other costs), preparing application packages (such as credit or pre-approval application or supporting documentation), or collecting application and supporting information on behalf of the consumer to submit to a loan originator or creditor. A loan originator includes a person who in expectation or compensation or other gain advertises or communicates to the public that such person can or will provide any of these services or activities."

In addition, the Commentary would be expanded to include "clerical" staff:

> "Managers, administrative and **clerical** staff, and similar individuals who are employed by a creditor or loan originator but do not arrange, negotiate, or otherwise obtain an extension of credit for a consumer, or whose compensation is not based on whether any particular loan is originated, are not loan originators." (Emphasis added.)

Firstly, the word "offers" is problematic. It makes an individual who is virtually unrelated to the loan origination process, *mutatis mutandi*, a part of a loan origination transaction. Would a bank teller at a retail branch be an involved party if a referral is made to a loan officer within the branch? Why would a person who has no actual involvement in the loan origination process be considered a loan originator?

Secondly, the Proposals should invoke an opportunity to clarify that loan approval functions are not deemed to be originating activities, when such loan approval functions are conducted by "managers and administrative staff" and "similar individuals." As it now stands, the Commentary states that managers, administrative staff, and similar individuals who are employed by a lender or loan originator but do not arrange, negotiate, or otherwise obtain an extension of credit for a consumer, or whose compensation is not based on whether any particular loan is originated, are not loan originators.

The term "arranges" is also problematic. It is much too broad, as witness the CFPB's own statement that it "believes that it includes any part of the process of originating a credit transaction, including advertising or communicating to the public that one can perform loan origination services and referrals of a consumer to another person who participates in the process of originating a transaction."[30]

There is no reason not to differentiate clearly and unambiguously the functions of loan approval and originating. Although managers may approve certain transactions, or have certain 'override' privileges, such approval functions do not intrinsically need to be considered core originating functions.

Thirdly, and finally, the term "clerical" is unfortunate, and it takes the definition into a much broader

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context than is pragmatically in accordance with the loan origination process. Processors prepare application packages, collect supporting documentation, and then submit the results to the lender. Essentially, then, processors should be excluded from this definition; indeed, any individual should be excluded who is an employee of a lender or loan originator and performs such processing tasks only as an employee for his or her employer.

A Word to the Wise

Beware of false knowledge; it is more dangerous than ignorance.
George Bernard Shaw

In this second part of the two part series on the Proposals, I have discussed many issues. But the topics mentioned were selected by me to provide a composite understanding. The actual Proposals are extraordinarily nuanced, complicated, deeply described and referenced, and contain many features that interact with other mortgage acts and practices.

The CFPB will issue a Final Rule that will leverage these features and likely add other non-negligible, regulatory compliance requirements. Therefore, I should like to re-affirm my opening remarks and urge you to seek a competent, risk management professional in order to obtain reliable and comprehensive guidance toward implementing the forthcoming Final Rule.

Lenders Compliance Group, Inc. is a mortgage risk management firm, providing professional guidance and support to financial institutions in all areas of residential mortgage compliance, including the following: Mortgage Compliance ● Legal and Regulatory Compliance ● Compliance Administration ● HUD Exam Readiness ● Licensing Compliance ● HMDA/CRA ● Information Technology & Security ● Portfolio Risk Management ● Quality Control Audits ● Prefunding Audits ● Retail, Wholesale, and Correspondent Lending ● Investor and Servicer Compliance ● Loss Mitigation Strategies ● Forensic Mortgage Audits ● Sarbanes-Oxley Compliance ● Due Diligence Audits ● Credit Risk Management ● Loan Analytics Audits ● Compliance Audits and Reviews ● Banking Exam Readiness ● Fannie/Freddie Applications ● Ginnie Mae Applications ● Training & Education ● CFPB Exam Readiness ● Anti-Money Laundering Exam Readiness.

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[1] Foxx, Jonathan, *Loan Originator Compensation: Past is Prologue – Part I*, National Mortgage Professional Magazine, October 2012, Volume 4, Issue 10, pp 31-49.
[2] 12 CFR Part 1026, Bureau of Consumer Financial Protection, Truth in Lending Act (Regulation Z), *Loan Originator Compensation, Proposed Rule with Request for Public Comment*, Federal Register, Volume 77, Number 174, September 7, 2012
[3] See Section 609(b) of the RFA, as amended by the Small Business Regulatory Enforcement Fairness Act of 1996 (SBREFA) and the Dodd-Frank Wall Street Reform and Consumer Protection Act.
[4] *Final Report of the Small Business Review Panel on CFPB's Proposals Under Consideration for Residential Mortgage Loan Origination Standards Rulemaking*, July 11, 2012
[5] I have discussed loan originator compensation and qualifications rather extensively. For instance, see Foxx, Jonathan, *Landmark Financial Legislation: New Rules for Mortgage Originators – Part I: Reformation and Regulations*, National Mortgage Professional Magazine, August 2010, Volume 2, Issue 8, pp 28-42; Foxx, Jonathan, *A New Era of Mortgage Reform – Part II:*

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Legislation – Reactive or Proactive, National Mortgage Professional Magazine, September 2010, Volume 2, Issue 9, pp 22-28; Foxx, Jonathan, *A New Era of Mortgage Reform – Part III: Consumer Financial Protection – Bureau and Bureaucracy*, October 2010, Volume 2, Issue 10, pp 22-40; Foxx, Jonathan, *The Birth of an Agency*, in National Mortgage Professional Magazine, September 2009, Volume 1, Issue 5, pp 24-27; and, Foxx, Jonathan, *The CFPA Controversy: Asking the Tough Questions*, in National Mortgage Professional Magazine, October 2009, Volume 1, Issue 6, pp 22-25. All Newsletters and Articles through 2011 are available at: http://Publications.LendersComplianceGroup.com. Also: Op. cit. 1.

[6] Dodd-Frank, Section 1403, includes a directive for the Federal Reserve Board to adopt regulations to implement various prohibitions against steering and related conduct. The CFPB has not yet proposed rules to implement the prohibitions; however, such prohibitions will obviously affect loan originator compensation.

[7] In developing a narrative regarding the rules, I will draw on the issuance in the Federal Register (Idem 2) as well as the CFPB's own Summary of Proposed Loan Originator Rules, issued in accordance with the aforementioned Federal Register notice.

[8] In this article I will refer to creditors as "lenders."

[9] This rule would apply to closed-end mortgage transactions.

[10] The Zero-Zero requirement would not be "triggered" by charges that are passed on to independent third parties that are not affiliated with the lender or mortgage broker.

[11] Discount points and origination fees are payable at or before consummation by the consumer to a creditor or a loan originator organization, except for: (1) Interest, including per-diem interest; (2) any *bona fide* and reasonable third-party charges not retained by the creditor or loan originator organization; and (3) seller's points and premiums for property insurance that are excluded from the finance charge under § 1026.4(c)(5), and (d)(2), respectively.

[12] On August 26, 2009, the Federal Reserve Board published a Proposed Rule in the Federal Register pertaining to closed-end credit. As part of that proposal, the FRB sought to prohibit certain compensation payments to loan originators and steering consumers to loans not in their interest because it would result in greater compensation for the loan originator. On July 21, 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) was enacted into law. Among other provisions, Title XIV of Dodd-Frank amended the Truth in Lending Act (TILA) to establish certain mortgage loan origination standards. And on July 21, 2011, pursuant to Title X of the Dodd-Frank, the Consumer Financial Protection Bureau received its exclusive rulemaking and examination authority from the Federal Reserve Board over Truth in Lending Act and its implementing regulation, Regulation Z. Due to litigation, the April 1, 2011 implementation date was temporarily stayed. The stay was dissolved. The effective compliance implementation date of the Final Rule was April 6, 2011.

[13] There were 17 SERs selected for the SBREFA process. The CFPB convened the Panel on May 9, 2012. The CFPB provided the SERs with an opportunity to submit written feedback or comments. The original due date was June 4, 2012, but at the request of several SERs, and in light of the additional calls, the deadline was extended to June 11, 2012. The CFPB received written comments from 11 of the SERs and shared these comments with the other members of the Panel. SERs were from commercial banks, credit unions, mortgage companies, mortgage brokers, and non-profit housing organizations.

[14] By "substantially," the CFPB's Proposal leaves open a precise definition, though it requests comment on whether this term is sufficiently clear and, if not, what other terms should be considered.

[15] § 1026.36(a)(3)

[16] § 1026.36(d)(1)

[17] § 1026.36(d)(1)–5

[18] Op. cit. 1

[19] § 1026.36(d)(1)–7

[20] Op.cit. 2, p 55295

[21] Safe harbor is available under § 1026.36(e)

[22] Op.cit. 2, p 55313

[23] Op.cit. 2, p 55315

[24] § 1026.24(d)

[25] *MBA Files Comment Letter on Loan Officer Compensation and Qualification*, issued to members of MBA on 10/16/12 via email from David H. Stevens, President and CEO of the Mortgage Bankers Association. The email includes an Appendix, drafted by Buckley Sandler LLP, addressed to the Mortgage Bankers Association and the American Bankers Association, entitled *CFPB's Authority to Exclude Certain Statutory Requirements From its Loan Originator Rules*.

[26] Op. cit. 1

[27] Dodd-Frank establishes a new HOEPA trigger for loans with prepayment fees applicable for more than 36 months.

[28] Op. cit. 25

[29] Ibid

[30] TILA § 103(cc)(2)(C), as enacted in Section 1401 Dodd-Frank.

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