The Strange Case of the Shrinking Mini-Correspondent: A Primer on Forensics

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WHITE PAPER

There is nothing more deceptive than an obvious fact.
The Bascombe Valley Mystery
Sir Arthur Conan Doyle

The predictable sometimes is predicted and sometimes it is not. Our biases tend to lead the way in determining a course of action based on perceived predictability. We find ways to convince ourselves that the obvious is not obvious and the necessary is really not essential. It is said that facts are stubborn things, but they are more like heat-seeking missiles if they bear ill-tidings. So, in finding the means toward a "workaround" or any method of circumventing or overcoming a problem, real or imagined, our hearty species indulges in an endless variety of obfuscations, bafflements, blinding bewilderments, miasmic confusion, discombobulating fogs of frenzy, perplexities of interests and foolish entanglements. All for the sake of avoiding ineluctable facts!

A characteristic feature of a predictable event is that it often becomes inevitable. When that happens, no manner of pleadings or remonstrations will undo the already done! It is not as if we did not know that the predictable could become the inevitable. Our biases simply refused to admit that our present plans will oneday meet their future denouement. And so it is that the strange case of the shrinking mini-correspondent took its course, gradually and inexorably, through the annals of mortgage banking to its current resting place on July 11, 2014, with the bloviatingly long title "Policy Guidance on Supervisory and Enforcement Considerations Relevant to Mortgage Brokers Transitioning to Mini-Correspondent Lenders." Published by the Consumer Financial Protection Bureau ("CFPB" or "Bureau"), the issuance is on its way to all supervised institutions as a Policy Guidance ("Guidance") relating to the Bureau's exercise of its authority to

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supervise and enforce compliance with RESPA and Regulation X and TILA and Regulation Z in certain transactions involving "mini-correspondent lenders".[1]

The billowing wave of the mini-correspondent began as a trickle, intensified as lenders established "mini-correspondent channels," and gushed into a modest torrent, its demand rising in prominence on January 10, 2014. For it was on this date that the proximate cause for the new mini-correspondent channel was given its impetus, due to the Final Rule pertaining to the Ability-to-Repay guidelines and the requirements of the Qualified Mortgage rule ("Rule"). Many brokers usually seek to charge fees between 2% and 3% per loan transaction; however, under the foregoing requirements, 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). A consequence of the Final Rule and specifically the 3% cap was to create an incentive for many brokers to morph into a new kind of loan originator, termed the "Mini-Correspondent."

In September 2013, in anticipation of the Rule's compliance effective date coming just months away, my colleague, Michael Barone,[2] and I published a White Paper and article in which we discussed the challenges facing the mini-correspondent channel. The White Paper was entitled "The Mini-Correspondent Channel: Pros and Cons."[3] In the article's penultimate section, titled "Mini-Correspondents and the CFPB," the following observation was made:

> "Before concluding please consider these final points.
>
> Has anyone given consideration as to what the CFPB might take as a position when a tremendous amount of mortgage brokers transform themselves into mini-correspondents with the primary purpose of avoiding QM's 3% points and fees cap? We surely have, and so have many others. The CFPB has not commented on this issue, but you bet they will at some point down the road.
>
> It is possible that the CFPB will take no issue with mortgage brokers becoming mini-correspondents! After all, this has been done for years, and when done correctly, it has been a valuable intermediary step for a brokerage firm that wishes to transition from broker to lender.
>
> But would it shock anyone if the CFPB took issue with the mini-correspondent channel and tried to eliminate it to the extent it is used to avoid the 3% points and fees cap? This would not be difficult. The CFPB could modify the exception to loan originators of the entity that makes the credit decision or take any number of other actions to prevent the mini-correspondent channel from growing solely for the benefit of avoiding the 3% cap. For now, we have to wait and see what their position on mini-correspondents will be."[4]

We were not soothsayers or prophets. The facts, such as they were, the experience working with applicable mortgage acts and practices, and the regulatory compliance concerns of our clients, gave us a unique purview.

Are we now finding that the mini-correspondent wave is running its course, shrinking in momentum, and undulating to its demise? Let us explore the requirements and implications of the Guidance.[5] Perhaps we will find a way to solve the mystery at the heart of the mini-

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correspondent surge and derive some insight about its potential fate.

Eliminate all other factors, and the one which remains must be the truth.
The Sign of Four
Sir Arthur Conan Doyle

Due to the Bureau becoming aware of the transitioning of mortgage brokers from their traditional roles to mini-correspondent lender roles, the CFPB has become concerned that some mortgage brokers may be shifting to the mini-correspondent model in the belief that, by identifying themselves as "mini-correspondent lenders," they automatically alter the application of important consumer protections that apply to transactions involving mortgage brokers. The specific protections that the Bureau cites include provisions in RESPA and its implementing Regulation X,[6] and TILA and its implementing Regulation Z.[7] RESPA and TILA were amended by Title XIV of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank Act).[8] On the compliance effective date of January 10, 2014, the Final Rule (issued in January 2013) required that Regulations X and Z apply certain requirements and prohibitions to compensation paid to a mortgage broker.

An outline of applicable provisions, as they concern mortgage brokers and compensation, consist of the following four factors:

1. **Disclosure of mortgage broker compensation**.
   Regulation X requires that the lender's compensation to the mortgage broker be disclosed on the Good-Faith Estimate and HUD-1 Settlement Statement.[9] However, payments received by the lender from an investor as compensation for a *bona fide* transfer of the loan in the secondary market need not be disclosed.[10]

2. **Inclusion of mortgage broker compensation in "points and fees."**
   Under Regulation Z, compensation paid to a mortgage broker by a consumer or creditor is included in points and fees for purposes of the points-and-fees cap for "qualified mortgages" and for the points-and-fees test for determining whether a mortgage is a "high-cost mortgage" under the Home Ownership and Equity Protection Act (HOEPA).[11] But, the interest paid to a creditor is excluded in points and fees. Excluded also are any points and fees compensation a creditor receives from a third party that purchases the loan.[12]

3. **Restrictions on mortgage broker compensation.**
   TILA and Regulation Z[13] prohibit certain compensation arrangements between creditors and loan originators, including mortgage brokers.[14]

   Specifically:

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- Mortgage brokers may not receive compensation from both the consumer and the creditor or any other person;[15] and,
- Mortgage brokers may not receive compensation based on loan terms.[16]

These restrictions do not apply to compensation by a third party, such as an investor, to a creditor that is not also defined as a loan originator for purposes of these compensation restrictions.

4. **Prohibition on steering to increase mortgage broker compensation.**
TILA and Regulation Z prohibit loan originators, including mortgage brokers, from ''steering'' consumers to transactions not in their interest, to increase the mortgage broker's compensation.[17]

Having taken these factors into consideration, the Bureau sets forth a generalized overview of the responsibilities of a correspondent lender. It clearly offers this overview in order to establish the differences between a mortgage broker and a correspondent lender. In doing so, the Bureau states that a correspondent lender, generally, performs the activities necessary to originate a mortgage loan (i.e., it takes on the tasks usually performed by the originating lender). Refining these activities further, the Bureau defines a correspondent lender as an entity that takes and processes applications, provides required disclosures, and often, although not always, underwrites loans and makes the final credit approval decision, but also it closes loans in its name, funds them (often through a warehouse line of credit), and sells them to an investor by prior agreement. A full correspondent lender may have such agreements with multiple investors.

One feature of a mini-correspondent channel is noted by the Bureau – the warehouse line provided to the mini-correspondent – since the Guidance states that the CFPB "understands that some entities may transition from being a mortgage broker to being a correspondent lender and, in so doing, may begin as a small correspondent with agreements with only a few investors."[18] Entities attempting to move to the role of a correspondent lender may start by obtaining a warehouse line of credit (typically from a third-party "warehouse bank"). The Bureau completes its broad definition of a correspondent by noting the requirement of the warehouse line of credit to provide the funding for the mortgage loans the entity originates and sells to a third-party investor.

There is nothing new under the sun. It has all been done before.
A Study in Scarlet
Sir Arthur Conan Doyle

Since the Bureau issued the Title XIV rules, it "understands that some mortgage brokers may be setting up arrangements with wholesale lenders in which they purport to act as mini-correspondent lenders."[19] Under such arrangements, the mortgage broker may in form appear to be the lender or creditor in each transaction by engaging in activities such as closing the loan

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in its own name, funding the loan from what is designated as a warehouse line of credit, and receiving compensation through what may nominally take the form of a premium for the sale of the loan to an investor.

However, in substance, these mortgage brokers may not have transitioned to the mini-correspondent lender role and may be continuing to serve effectively as mortgage brokers. That is, these mortgage brokers may continue to facilitate brokered loan transactions between borrowers and wholesale lenders (i.e., entities which typically provide the funding for loans in transactions involving mortgage brokers). For example, the mortgage broker may enter into an arrangement with a lender designated as an "investor," but that investor may function as the mortgage broker's wholesale lender, and not as a purchaser of loans in the secondary market. Such an "investor" may continue to perform the same origination activities it would perform as a traditional wholesale lender for the loans that it now "buys" from the mortgage broker. As well as performing these functions and agreeing to purchase the loans from the mortgage broker designated as a "mini-correspondent, the "investor" may also provide the warehouse line of credit that the "mini-correspondent" uses to fund its loans.

As discussed below, the requirements and restrictions that RESPA and TILA and their implementing regulations impose on compensation paid to mortgage brokers do not depend on the labels that parties use in their transactions. Rather, under Regulation X, whether compensation paid by the "investor" to the "lender" must be disclosed depends on determinations such as whether that compensation is part of a secondary market transaction, as opposed to a "table-funded" transaction. Likewise, under Regulation Z, whether compensation paid by the "investor" to the "creditor" must be included in the points-and-fees calculation and whether the "creditor" is subject to the compensation restrictions as a mortgage broker depends on determinations such as whether the "creditor" finances the transaction out of its own resources as opposed to relying on table-funding by the "investor."

Thus, in exercising its supervisory and enforcement authority, the Bureau intends to consider factors that evidence the true nature of the mortgage transaction – whether the parties are engaging in good faith in a secondary market transaction between a lender and a third-party investor or, in fact, a typical primary market transaction involving a mortgage broker and a wholesale lender.

Let us, then, turn our investigation toward determining the distinction between primary and the secondary market transactions. For the Bureau's position will place considerable importance to discerning the difference between the two.

Having gathered these facts, Watson, I smoked several pipes over them, trying to separate those which were crucial from others which were merely incidental.

The Crooked Man

Sir Arthur Conan Doyle

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Over many years, the difference between a primary and secondary market transaction has been the subject of numerous regulatory issuances and litigation. Now, the distinction appears as a result of the mini-correspondent phenomenon. I have no doubt that the proper discerning of the one from the other will continue in one form or another for years to come. Essentially, the mortgage broker compensation requirements imposed by RESPA do not apply to exempt *bona fide* secondary market transactions, but those requirements do apply to table-funded transactions. So, whether a transaction is deemed to be a *bona fide* secondary market sale of a loan turns on the "real source of funding" and the "real interest of the funding lender."

Regulation X defines a mortgage broker as a person, other than an employee of a lender, who renders origination services and serves as an intermediary between a borrower and lender in a federally-related mortgage loan transaction, including such a person that closes the loan in its own name in a "table-funded transaction."[20] "Table-funding" occurs when the loan is funded by a contemporaneous advance of loan funds and an assignment of the loan to the person advancing the funds.[21] In table-funding transaction, the third party who advances the loan funds and takes initial assignment of the loan at or after settlement is the lender for purposes of Regulation X, and the entity which acts as the intermediary in bringing that lender and the borrower together is the mortgage broker (even though that entity closes the loan in its own name). (A lender is otherwise generally defined as the secured creditor named on the debt obligation.) However, a "bona fide transfer of a loan obligation in the secondary-market" is not covered by Regulation X (viz., with certain immaterial exceptions).[22] The Bureau's position is now to base its scrutiny on Regulation X in order to consider the "real source of funding" for the loan and the "real interest of the funding lender" in determining what constitutes a bona fide transfer.[23] Using Regulation X as the foundational document for determining the foregoing criteria, a table-funded transaction is not a secondary-market transaction.[24]

Turning to TILA, Regulation Z provides that loan originator compensation requirements cover compensation paid to mortgage brokers in "table-funded" transactions. Under Regulation Z, a creditor is defined in relevant part as a person who regularly extends credit and to whom the obligation is initially payable on the face of the note.[25] For purposes of the loan originator compensation requirements, however, a "loan originator" is defined to include such a creditor if it engages in loan origination activity and "does not finance the transaction at consummation out of the creditor's own resources, including by drawing on a bona fide warehouse line of credit."[26] In other words, the term "loan originator," for purposes of the loan originator requirements, includes any creditor that otherwise satisfies the definition of loan originator and makes use of "table funding" by a third party.[27] A table- funded transaction is consummated with the debt obligation initially payable by its terms to one person, but another person provides the funds for the transaction at consummation and receives an immediate assignment of the note.[28]

So, we have two ways of determining a distinction:

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Regulation X recognizes that it is possible to structure transactions that take the form of the sale of a loan to an investor but where, in substance, the purchaser functions as the lender and the entity whose name is on the note is a mortgage broker, by defining mortgage brokers to include entities which close loans in their own names in table-funded transactions, and by excluding from RESPA only bona fide secondary-market transactions.

Regulation Z recognizes this as well, by defining the term loan originator to include creditors in table-funded transactions and differentiating between such transactions and those in which a creditor draws upon a *bona fide* warehouse line of credit.

Nothing clears up a case so much as stating it to another person.
Silver Blaze
Sir Arthur Conan Doyle

Having formed its analytical framework, the Bureau now moves to its observations and derives therefrom a set of questions to be used in determining whether the mini-correspondent is violating RESPA and TILA. The Bureau's observation can be summarized thus: some mortgage brokers have successfully transitioned to correspondent lenders (small or large) that do not act as mortgage brokers in covered mortgage transactions; and such correspondent lenders often perform a majority of the principal origination activities with the funds provided by a *bona fide* warehouse line of credit; and the correspondent lenders then sell the loans in secondary market transactions to third-party investors – but the Bureau also "understands that other mortgage brokers may be seeking to adopt the form of a mini-correspondent lender out of a belief that doing so avoids application of various provisions of Regulations X and Z."[29]

Therefore, the Bureau has devised a set of interrogatories that will be used to forensically determine whether any particular mini-correspondent is the "successfully transitioned" type or a sham established to "avoid" the requirements of RESPA and TILA.

It has long been an axiom of mine that the little things are infinitely the most important.
A Case of Identity
Sir Arthur Conan Doyle

The Bureau will be asking various questions relevant to understanding the "true nature" of the mortgage transaction in transactions involving mini-correspondents. I do not believe the list provided in the Guidance is meant to be comprehensive and complete. It is best to view these questions as a starting point in deliberations to determine if a mini-correspondent is viable or a sham. I have arranged the questions as a checklist, in order to ensure a means by which to self-assess a mini-correspondent's compliance with Regulation X and Z. All responses must be supported by documentation and readily available information.

Among the questions the Bureau asks are the following:

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Question	Yes	No	Other
Beyond the mortgage transaction at issue, does the mini-correspondent still act as a mortgage broker in some transactions, either brokering to the same wholesale lender that supplies the warehouse line of credit or otherwise?			
• If so, what distinguishes the mini-correspondent's "mortgage broker" transactions from its "lender" transactions?			
How many "investors" does the mini-correspondent have available to it to purchase loans?			
Is the mini-correspondent using a *bona fide* warehouse line of credit as the source to fund the loans that it originates?			
• Is the warehouse line of credit provided by a third-party warehouse bank?			
• How thorough was the process for the mini-correspondent to get approved for the warehouse line of credit?			
• Does the mini-correspondent have more than one warehouse line of credit?			
• Is the warehouse bank providing the line of credit one of, or affiliated with any of, the mini-correspondent's investors that purchase loans from the mini-correspondent?			
• If the warehouse line of credit is provided by an investor to whom the mini-correspondent will "sell" loans to, is the warehouse line a "captive" line (i.e., the mini-correspondent is required to sell the loans to the investor providing the warehouse line (or affiliates of the investor))?			
• What percentage of the mini-correspondent's total monthly originated volume is sold by the mini-correspondent to the entity providing the warehouse line of credit to the mini-correspondent, or to an investor related to the entity providing the warehouse line of credit?			
• Does the mini-correspondent's total warehouse line of credit capacity bear a reasonable relationship, consistent with correspondent lenders generally, to its size (i.e., its assets or net worth)?			
What changes has the mini-correspondent made to staff, procedures, and infrastructure to support the transition from mortgage broker to mini-correspondent?			
What training or guidance has the mini-correspondent received to understand the additional compliance risk associated with being the lender or creditor on a residential mortgage transaction?			

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Question			
Which entity (mini-correspondent, warehouse lender, or investor) is performing the majority of the principal mortgage origination activities?			
• Which entity underwrites the mortgage loan before consummation and otherwise makes the final credit decision on the loan?			
• What percentage of the principal mortgage origination activities, such as the taking of loan applications, loan processing, and pre-consummation underwriting, is being performed by the mini-correspondent, or an independent agent of the mini-correspondent?			
• If the majority of the principal mortgage origination activities are being performed by the investor, is there a plan in place to transition these activities to the mini-correspondent?			
o What conditions must be met to make this transition (e.g., number of loans, time)?			
NOTE: The above list of questions is not an exhaustive list of the Bureau's considerations relevant to the exercise of its supervisory and enforcement authorities. In addition, no single question listed above is necessarily determinative of how the Bureau may exercise its supervisory and enforcement authorities. Furthermore, the facts and circumstances of the particular mortgage transaction being reviewed are relevant to the exercise of these authorities.			

In closing, I must emphasize these words: "The Bureau will closely monitor the practices of mini-correspondents, including former mortgage brokers that have converted to this form, to ensure that the protections afforded to consumers under federal consumer financial law, including the Bureau's implementing regulations, are not being evaded. In doing so, the Bureau will use all appropriate tools to assess whether supervisory, enforcement or other actions are necessary."[30] Depending on how the Bureau views the answers to the foregoing questions, the case of the mini-correspondent will be closed, once and for all.

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[1] *Policy Guidance on Supervisory and Enforcement Considerations Relevant to Mortgage Brokers Transitioning to Mini-Correspondent Lenders*, Bureau of Consumer Financial Protection, for more information, visit the CFPB at http://www.consumerfinance.gov/newsroom/consumer-financial-protection-bureau-issues-guidance-regarding-brokers-shifting-to-mini-correspondent-model/

[2] Michael G. Barone, Director/Legal & Regulatory Compliance, Lenders Compliance Group

[3] *The Mini-Correspondent Channel: Pros and Cons*, Foxx, Jonathan and Michael Barone, National Mortgage Professional Magazine – September 2013, Volume 5, Issue 9

[4] Ibid. In this article, the citations provided will mirror the citations provided in the Guidance.

[5] The Policy Guidance is a non-binding policy guidance articulating considerations relevant to the Bureau's exercise of its supervisory and enforcement authority under Regulation X and RESPA, and Regulation Z and TILA. It is therefore exempt from the notice and comment rulemaking requirements under the Administrative Procedure Act pursuant to 5 U.S.C. 553(b).

[6] 12 U.S.C. 2601 et seq., 12 CFR part 1024

[7] 15 U.S.C. 1601 et seq., 12 CFR part 1026

[8] Public Law 111–203, 124 Stat. 1376 (2010)

[9] See 12 CFR part 1024, appendix A and appendix C. The Bureau's TILA-RESPA Integrated Disclosure Rule (78 FR 79730 (Dec. 31, 2013)) effective August 1, 2015, requires that the creditor compensation's to the mortgage broker be on the Closing Disclosure (although not on the Loan Estimate). See 12 CFR 1026.38(f)(1)

[10] 12 CFR 1024.5(b)(7). The Guidance provides this note: coverage under section 8 of RESPA [12 CFR 1024.14], "prohibiting the payment of kickbacks for the referral of settlement services, and splits of charges other than for services performed, is also implicated by whether compensation is being paid in a secondary market transaction. For example, compensation for the sale of a mortgage loan is a secondary market transaction rather than a referral fee and is 'beyond the scope of section 8.' See 12 CFR part 1024, appendix B, Illustration 5."

[11] 12 CFR 1026.32(b)(1)(ii). (This section cross references the definition of "loan originator" in 12 CFR 1026.36(a)(1).) 12 CFR 1026.36(a)(2) defines "mortgage broker" for purposes of § 1026.36, as "any loan originator that is not an employee of the creditor." See also 12 CFR 1026.32(a)(1)(ii) (threshold for points and fees for high- cost mortgages); 12 CFR 1026.43(e)(3) (limit on points and fees for qualified mortgages). See also 15 U.S.C 1602(bb)(1)(A) (definition of high-cost mortgage); 15 U.S.C 1602(bb)(4) (points and fees included for high-cost mortgages); 15 U.S.C 1639c(b)(2)(A)(vii) (limit on points and fees for qualified mortgages); and 15 U.S.C 1639c(b)(2)(C) (definition of points and fees for purposes of qualified mortgages).

[12] 12 CFR 1026.32(b)(1)(i)(A) (excluding interest from points and fees); 12 CFR 1026.32(b)(1)(ii) (generally including compensation paid directly or indirectly by a consumer or creditor to a loan originator).

[13] See *Loan Originator Compensation Requirements under the Truth in Lending Act (Regulation Z)* 78 FR 11279 (Feb. 15, 2013); see also *Amendments to 2013 Mortgage Rules Under the Equal Credit Opportunity Act (Regulation B)*, *Real Estate Settlement Procedures Act (Regulation X)*, and the *Truth in Lending Act (Regulation Z)*, 78 FR 60382 (Oct.1, 2013).

[14] The Bureau states that "in Regulation Z these prohibitions apply to compensation paid to 'loan originators' (including 'loan originator organizations')." See 12 CFR 1026.36(a)(1)(i), (iii). The Guidance defines mortgage brokers as included in the definition of "loan originator." See 12 CFR 1026.36(a)(2) and footnote 6.

[15] 12 CFR 1026.36(d)(2)

[16] 12 CFR 1026.36(d)(1)

[17] 12 CFR 1026.36(e)

[18] Op. cit. 1, p 7

[19] Op, cit. 1, p 6

[20] 12 CFR 1024.2

[21] Idem.

[22] 12 CFR 1024.5(b)(7)

[23] Idem. *See also* 12 CFR part 1024, appendix B, illustration 5

[24] Idem.

[25] 12 CFR 1026.2(a)(17)

[26] 12 CFR 1026.36(a)(1)(i)

[27] Comment 36(a)-1.i.C

[28] Comment 36(a) -1.ii

[29] Op. cit. 1, p 10

[30] Op. cit. 1, p 13

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