ABA Staff Analysis: Rules Regarding Loan Originator Compensation Policies
September 2010

Final Rule Issued: August 16, 2010

On August 2010, the Federal Reserve Board issued rules imposing restrictions regarding compensation to mortgage loan originators. These rules are meant to protect consumers in the mortgage market from unfair or abusive lending practices that can arise from certain loan originator compensation practices.

This rule is finalizing portions of a proposed rule issued in the Federal Register in August 2009, pertaining to reforms to TILA rules covering closed-end credit. (See 74 FR 43232, Aug. 26, 2009). The loan originator compensation restrictions adopted under this rule are virtually identical to compensation restrictions adopted by Congress in the Dodd-Frank Wall Street Reform and Consumer Protection Act (“DFA”).¹ The Board is adopting these compensation restrictions under authority set forth in TILA Section 129(l)(2), and not under the DFA. In various instances, the Board tailors the content of this rule to be consistent with the mandates of the DFA, but makes clear that these final rules do not implement the loan originator compensation provisions of the DFA. The Board states that it intends to implement the DFA’s mortgage loan origination standards in future rulemaking after notice and opportunity for further public comment.

Overview

The final rule contains three basic prohibitions. First, the rule prohibits a creditor or any other person from paying, directly or indirectly, compensation to a mortgage broker or any other loan originator that is based on a mortgage transaction’s terms or conditions, except the amount of credit extended. Second, the rule prohibits any person from paying compensation to a loan originator for a particular transaction if the consumer pays the loan originator’s compensation directly. Third, the rule prohibits a loan originator from steering a consumer to consummate a loan that provides the loan originator with greater compensation, as compared to other transactions the loan originator offered or could have offered to the consumer, unless the loan is in the consumer’s interest. With respect to this last option, the rule provides a safe harbor to facilitate compliance with the prohibition on steering. A loan originator is deemed to comply with the anti-steering prohibition if the consumer is presented with loan options that provide (1) the lowest interest rate, (2) no risky features, such as a prepayment penalty or negative amortization or a balloon payment in the first seven years; and (3) the lowest total dollar amount for origination points or fees and discount points.

Although this issuance is described as ending the practice of compensating loan originators on the basis of “yield spread premiums,” it is important to fully understand the nature of the Board’s restrictions expressed in this final rule, as the term “yield spread premium” has been used to identify various distinct financing methodologies. Under the current regulatory amendments, a consumer may legally continue the practice of financing upfront costs, such as third-party settlement costs, by increasing or “buying up” the interest rate. Thus, this final rule does not prohibit creditors or loan originators from using the interest rate to cover upfront closing costs, as long as “any creditor-paid compensation retained by the originator does not vary based on the transaction’s terms or conditions.” The Board’s focus in this rulemaking is on how the originator is compensated, not on how consumer costs are financed.

¹ Among other provisions, Title XIV of the Reform Act amends TILA to establish certain mortgage loan origination standards. In particular, Section 1403 of the Reform Act creates new TILA Section 129B(c), imposes restrictions on loan originator compensation and on steering by loan originators.

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Compliance

The Board has determined that compliance with this final rule shall become mandatory on April 1, 2011. The new rules would therefore apply to transactions for which the creditor receives an application on or after April 1, 2011.

The Final Rule

Coverage: The new rules apply to all persons who originate loans, including mortgage brokers and the companies that employ them, as well as mortgage loan officers employed by depository institutions and other lenders. The final rule broadens the scope of § 226.36 (containing TILA’s restrictions for practices in connection with credit secured by a dwelling) from transactions secured by the consumer’s principal dwelling to all transactions secured by real property or by a dwelling.

- The rule’s restrictions generally apply to “loan originators,” defined as 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 consumer credit for another person. The term includes an employee of a creditor or mortgage broker if the employee meets the definition.
  - A “mortgage broker” is defined as a loan originator that is not an employee of the creditor. A creditor is considered a “loan originator” only if the creditor does not provide the funds for the transaction at consummation out of the creditor’s own resources, including by drawing on a bona fide warehouse line of credit or using deposits held by the creditor.
  - The rule’s restrictions apply to all closed-end consumer credit transactions secured by a dwelling, regardless of price or lien position.
- Generally, the rule does not apply to the following—
  - Payments received by a creditor when selling the loan to a secondary market investor.
  - Payments to managers, administrative 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, and whose compensation is not based on whether any particular loan is originated.
  - Payments to loan servicers when the servicer modifies an existing loan on behalf of the current owner of the loan. This final rule does not apply if a modification of an existing obligation’s terms does not constitute a refinancing under § 226.20(a).
  - Payments to originators handling HELOCs that are subject to § 226.5b and timeshare plans, as described in the bankruptcy Code, 11 U.S.C. 101(53D).
  - Payments to originators in instances of loans secured by real property that does not include a dwelling.
- Meaning of Term “Compensation”: The term “compensation” includes salaries, commissions and any financial or similar incentive that is tied to the transaction’s terms or conditions, including annual or periodic bonuses, or awards of merchandise or other prizes.
  - For purposes of § 226.36(d) and (e), the term “compensation” includes amounts retained by the loan originator, but does not include amounts that the loan originator receives as payment for bona fide and reasonable third-party charges, such as title insurance or appraisals.
  - The Board recognizes that often, loan originators receive payment for third-party charges that may exceed the actual charge because originators may not be able to determine with full accuracy what the charge for the third-party service will be. In such instances, the originator may retain the difference, and such amount retained will not be deemed compensation if the third-party charge imposed on the consumer is bona fide.
  - If, however, a loan originator marks up a fee and retains the amount over the actual fee, the excess is compensation.

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Prohibiting Compensation Based on Loan Terms: In § 226.36(d)(1), the final rule prohibits any person from compensating a loan originator, directly or indirectly, based on the terms or conditions of a loan transaction secured by real property or a dwelling.

- Comment 36(d)(1)-2, provides examples of loan originator compensation that are deemed to be
  based on transaction “terms or conditions,” such as compensation that is based on the interest rate, annual percentage rate, or the existence of a prepayment penalty.
  - This general rule would also restrict decreases in loan originator compensation where the originator offers loan concessions to the consumer. In the preamble, the Board clarifies that permitting creditors to decrease loan originator compensation because of a change in terms favorable to the consumer would result in loopholes and permit evasion of the final rule.
  - CRA Loans: The Board, through the rule’s preamble, articulates the opinion that “allowing compensation to vary with loan type, such as loans eligible for consideration under the Community Reinvestment Act, would permit unfair compensation practices to persist in loan programs offered to consumers who may be more vulnerable to such practices.”
- Comment 36(d)(1)-2 and (d)(1)-3 explicitly detail various compensation calculations or formulas that would not be considered to be based on transaction “terms or conditions.” The following constitutes a non-exhaustive list of acceptable considerations in the compensation of loan originators—
  - The rule permits originators to be compensated based on “loan amount.” The “amount of credit extended” is explicitly defined as not being a transaction “term or condition” for purposes of § 226.36(d)(1). Thus, compensation payments to loan originators that are based on a fixed percentage of the amount of credit are permissible.
  - The final rule explicitly permits creditors to establish minimum or maximum dollar amounts for loan originator compensation (so long as such minimum or maximum amount do not vary with each credit transaction).
  - The loan originator’s overall loan volume (i.e., total dollar amount of credit extended or total number of loans originated), delivered to the creditor.
  - The long-term performance of the originator’s loans.
  - An hourly rate of pay to compensate the originator for the actual number of hours worked.
  - Whether the consumer is an existing customer of the creditor or a new customer.
  - A payment that is fixed in advance for every loan the originator arranges for the creditor (e.g., $600 for every loan arranged for the creditor, or $1,000 for the first 1000 loans arranged and $500 for each additional loan arranged).
  - The percentage of applications submitted by the loan originator to the creditor that result in consummated transactions.
  - The quality of the loan originator’s loan files (e.g., accuracy and completeness of the loan documentation) submitted to the creditor.
  - A legitimate business expense, such as fixed overhead costs.
  - The Board clarifies, in Comment 36(d)(1)-2, that risk-based pricing is still allowed, so long as the originator’s compensation does not vary on the basis of such factors.
- The rule preamble clarifies that creditors may compensate their own loan officers differently than mortgage brokers. For instance, to account for the fact that mortgage brokers relieve creditors of certain fixed overhead costs associated with loan originations, a creditor may pay mortgage brokers more than its own retail loan officers.
- The rule preamble clarifies that a creditor may pay one loan officer more than it pays another loan officer, so long as each loan originator receives compensation that is not based on the terms or conditions of the transactions delivered to the creditor. For example, a creditor may pay loan officer A an amount equal to 1 percent of the amount of credit extended for each loan, and loan officer B an amount equal to 1.25 percent of the amount of credit extended for each loan.

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Prohibiting Certain “Dual” Compensations: In § 226.36(d)(1), the final rule, the rule prohibits a mortgage broker or loan officer from receiving payments directly from a consumer while also receiving compensation from the creditor or another person. Under this rule, if the loan originator receives compensation directly or indirectly from a consumer in the transaction, then—(1) the originator may not receive compensation, directly or indirectly, from any person other than the consumer in connection with the transaction, and (2) no person (other than the consumer) who knows or has reason to know of the consumer-paid compensation to the loan originator may pay any compensation to a loan originator, directly or indirectly, in connection with the transaction.

- Comment 36(d)(2)-1 explains that payment of a salary or hourly wage to a loan originator does not violate the prohibition in § 226.36(d)(2) even if the loan originator also receives direct compensation from a consumer in connection with that consumer’s transaction.
- Additional clarifications: Payments to an originator that are derived by subtracting the amounts from the loan proceeds are considered compensation received directly from the consumer. Payments derived from an increased interest rate, however, would not be considered compensation received directly from the consumer. If the consumer pays any points on a loan, these are not considered payments received directly from the consumer. The Board clarifies that if the consumer pays any origination points to the creditor and the creditor then compensates the loan originator, the loan originator may not receive compensation directly from the consumer.
- The rule, under Section 226.36(d)(3), clarifies that affiliates must be treated as a single “person” for purposes of § 226.36(d), in order to prevent circumvention of the final rule. A parent company may not, therefore, avoid these rules by allowing a loan originator to choose one affiliate over another in order to collect more compensation for loans with different loan terms.

Prohibiting Steering to Products Not In Consumer’s Best Interest: In § 226.36(e), the final rule sets forth the prohibition that a loan originator may not steer a consumer to consummate a dwelling-secured loan based on the fact that the originator will be provided with greater compensation, as compared to other transactions the loan originator offered or could have offered to the consumer, unless the loan is in the consumer’s interest.

- This provision appears to be inapplicable to traditional arrangements where the loan officer is a bank employee and is originating loans for the employer. In instances where the loan originator is an employee of the creditor bank, the employee is prohibited under the prohibitions on “term-based compensation” set forth under § 226.36(d)(1) from receiving fees that are based on the terms or conditions of the loan. Thus, when a loan officer originates loans for the employer-creditor, the originator may not steer the consumer to a particular loan offered by the employer to increase compensation. Accordingly, the Board clarifies that in these cases, compliance with §226.36(d)(1) is deemed to satisfy the requirements of §226.36(e)(1).
  - At the same time, the Board recognizes that a creditor’s employee may occasionally act as a broker by forwarding a consumer’s application to a creditor other than the loan originator’s employer, such as when the employer does not offer any loan products for which the consumer would qualify. According to the rule, if the loan originator is compensated for arranging the loan with the other creditor, the originator is not an employee of the creditor in that transaction and is subject to §226.36(e)(1). See comment 36(e)(1)-2.ii.
- The Board states that there is no uniform method to determine which loans may be in the consumer’s interest.
- **Safe Harbor:** The rule provides a safe harbor to facilitate compliance with the prohibition on steering. See §226.36(e)(2)-(e)(3). A loan originator is deemed to comply with the anti-steering prohibition if the consumer satisfies three requirements—
  - First, for each type of transaction in which the consumer expressed an interest (i.e., a fixed-rate, adjustable-rate, or a reverse mortgage), the consumer is presented with, and able to choose from, loan options that include a loan with the lowest interest rate, a loan with the lowest total dollar amount for origination points or fees and discount points, and

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a loan with the lowest rate with no risky features, such as a prepayment penalty or negative amortization.

- The loan originator need only evaluate loan offers that are available from creditors with whom the loan originator regularly does business.
- Loan originators can present fewer than three loans and satisfy §226.36(e)(2) and (e)(3)(i) if the loans presented meet the criteria of the options set forth in § 226.36(e)(3).
- Under §226.36(e)(3)(iii), if a loan originator presents more than three loans to the consumer for each type of transaction in which the consumer expresses an interest, the loan originator must highlight the three loans that satisfy the criteria of the safe harbor, as discussed above.
  - Second, the loan options presented to the consumer are obtained by the loan originator from a significant number of the creditors with whom the loan originator regularly does business.
  - Third, the loan originator believes in good faith that the consumer likely qualifies for the loan options presented to the consumer.

**Record Retention:** Commentaries to Section 226.25(a) clarify that a creditor must retain, for two years, at least two types of records to demonstrate compliance with § 226.36(d)(1): a record of the compensation agreement with the loan originator that was in effect on the date the transaction’s rate was set, and a record of the actual amount of compensation it paid to a loan originator in connection with each covered transaction. The commentaries explain that for loans involving mortgage brokers, the creditor may retain a disclosure or agreement required by applicable state law.

Questions? Contact **Rod Alba** for more information.