Are You in Compliance with the Compensation & Steering Requirements?

It seems some are still navigating through the new compensation rules that went into effect on April 1st and continue to have questions with the final rules amending Regulation Z. Read on for clarification…

The amendments were drafted to protect consumers in the mortgage market from unfair and abusive lending practices caused by compensation paid to loan originators and brokers and the practice of steering consumers to products providing the best compensation for them, but that may not be in the interest of the consumer. Compensation to loan originators and brokers can no longer be paid based on the terms and conditions of a loan transaction. Compensation can, however, be paid based on the amount of credit extended in a loan transaction. Moreover, if a loan originator's compensation is paid directly by the consumer, no other party to the transaction may compensate the loan originator on the same loan. Also, loan originators cannot steer consumers to a credit product that will earn them higher compensation unless the transaction is in the interest of the consumer. It sounds pretty straightforward on the surface, but once you start to dig a little deeper, you will find that it is not so clear. And by the way, these amendments took effect on April 1st for mortgage loan applications received by creditors from that point forward. So hopefully by now, you have it all sorted out and your loan originator compensation program is in compliance. But if not, this article should shed some light into the nuances of these new requirements.

You should know that these new provisions do not impact a creditor's ability to offer various loan pricing deals to borrowers, as long as there is no impact on the loan originator's compensation. Additionally, when a borrower negotiates a lower interest rate or reduction in points or fees from the creditor, the creditor cannot offset the reduction by reducing the loan originator's compensation.

Who is covered?

Let's look at who is covered by these new compensation rules. By definition, anyone who arranges, negotiates, or obtains a mortgage loan for a consumer in return for compensation or other monetary gain is covered by these new rules. A mortgage brokerage company or a creditor that closes loans in its own name, but funds transactions through third-parties, is considered a loan originator. On the other hand, a creditor that funds transactions out of its own resources (such as, drawing on a bona fide warehouse line of credit, or out of its deposits) is not considered a loan originator. But, employees of creditors are considered to be loan originators, as are employees of mortgage brokers.

Anyone who arranges, negotiates, or obtains a mortgage loan for a consumer in return for compensation or other monetary gain is covered by these new rules.

Who is not covered?

Loan servicers are not loan originators even if they modify existing loans on behalf of the owner of a loan, as long as a modification is not considered to be a refinancing under §226.20(a) of Regulation Z. Moreover, managers and administrative staff who are employed by a creditor or loan originator are not considered loan originators, as long as they do not arrange, negotiate, or obtain extensions of credit for consumers, and their compensation is not based on whether or not a loan is originated.

What types of loans are covered/ not covered?

These new rules apply to closed-end loans secured by first or subordinate liens on a consumer's dwelling, including mobile homes, trailers, houseboats, etc. Also included are reverse mortgages that are not lines of credit, home equity loans, loans for second homes subject to Regulation Z and RESPA, and construction loans. Since Home Equity Lines of Credit (HELOCs) are open-end loans, they are not coved by these new rules. Additionally, time shares have been excluded, as are investment or rental properties that are not subject to Regulation Z or RESPA.

Compensation

Compensation includes salaries, commissions, bonuses (annual or periodic), and awards of merchandise, services, trips, or other prizes. It should be noted that fees retained by a loan originator are considered to be compensation regardless of the fee name; consequently, a processing fee retained by a loan originator is considered compensation. Compensation to a loan originator can no longer be based on the terms or conditions of consumer credit transactions (i.e., "features").

Compensation can be based on the amount of the loan as long as it is a fixed percentage of the amount of the credit extended. Because smaller loans would yield a smaller compensation, a minimum dollar amount of compensation can be set. Moreover, since larger loans would yield a larger compensation, a maximum dollar amount of

compensation can be set. If minimum and maximum dollar amounts are set, they cannot vary with each credit transaction. Compensation can also be based on hourly rates, which would help to compensate for those loans that may take longer to originate. Further, compensation can be based on the number of loans originated during a particular time period. Additionally, compensation can be based on whether the consumer is an existing customer of the creditor or a new customer.

It is also possible to pay compensation based on loan volume, long-term performance of an originator's loans, or the time spent to originate a loan. Compensation that is fixed in advance and that accounts for a loan originator's fixed overhead costs is permissible. Compensation can also be paid based on a percentage of applications that result in consummation or the quality of a loan originator's files.

When compensation is based on loan volume, it can be based on the total dollar amount of credit extended or the total number of loans originated over a particular period of time. However, these methods should not provide incentives to originate loans that are inconsistent with the safety and soundness of the institution.

It is permissible for a loan originator to receive a salary or hourly wage and to also be paid compensation directly from the consumer as long as no other entity or person receives compensation from the consumer on a particular loan.

It should be noted that payments made to loan originators by creditors are not payments made directly by the consumer, regardless of how they may be disclosed on the GFE or HUD-1. Moreover, a Yield Spread Premium between a creditor and a loan originator that appears as credit on the GFE and HUD-1 to the consumer to reduce the consumer's upfront costs is not considered compensation to the loan originator.

Compensation can vary from one loan originator to another. A creditor may vary the compensation it pays its own loan originators from one to another. A creditor may also vary the compensation it pays its own loan originators with that which it pays its mortgage brokers. Compensation cannot, however, be based on any terms or conditions of the credit extended (other than the amount of a loan).

Types of compensation not permissible

Compensation to a loan originator cannot be based on the interest rate, annual percentage rate, or the existence of a prepayment penalty. Moreover a proxy that is based on terms or conditions cannot be used to base a loan originator's compensation. For instance, credit scores, when used in risk-based pricing, would provide a loan originator with different levels of compensation that are ultimately based on the interest rate. The same holds true where debt-to-income (DTI) and loan-to-value (LTV) ratios are used to set interest rates or the existence of a prepayment penalty. Therefore, setting a loan originator's compensation based on a credit score, DTI, or LTV where the interest rate varies would not be a permissible method of paying compensation.

Compensation cannot vary based on geographic location unless the difference is based on the cost of overhead and not on the terms and conditions of loans. Similarly, compensation cannot be based on a loan type or loan program (for example, small loans, loans to low- or moderate-income borrowers, first-time homebuyers, Community Reinvestment Act loans, or other special loan programs). Furthermore, Point Banks are most likely not permitted since the underlying premise of the Point Bank is based on negotiated loan terms.

Tiering compensation based on the amount of credit extended is also not permitted. In other words, it is not permissible to structure compensation payments where a loan originator is paid 1% for loans up to $300,000, 2% for loans $300,000 up to $500,000, and 3% for loans $500,000 or more.

Finally, a loan originator cannot receive compensation from two sources relative to a single transaction. For example, a loan originator cannot receive compensation from the consumer and then be paid again by the creditor. If the consumer pays the loan originator compensation, the consumer can, however, pay the loan originator in cash or from the proceeds of the loan. Similarly, if the creditor pays the loan originator compensation, the creditor can use funds from the points paid by the consumer, an increased interest rate, or some other source of the creditor. Keep in mind that any fee paid to a loan originator by the consumer is considered to be compensation and that a creditor can, in a table-funded transaction, become the loan originator.

Changes in compensation

Loan originator compensation can prospectively be revised by the creditor based on loan performance, loan volume, and current market conditions for compensation. Revisions to compensation cannot be based on terms and conditions of loans and cannot be applied retroactively to loan transactions.

Affiliated Entities

Affiliated entities are treated as one person for purposes of this compensation rule. Therefore, affiliate A and affiliate B cannot pay a loan originator different compensation structures for the same loan. This prevents a loan originator from presenting the loan to the highest compensator.

What has not changed?

Borrowers can still finance upfront costs by increasing the interest rate regardless of who pays the loan originator as long as the originator's compensation is not based on terms or conditions of the transaction. Amounts paid to the loan originator to pay bona fide and reasonable third-party fees (e.g., pass through fees for the services of third parties) are not considered to be compensation, for example appraisals or credit reports. If the loan originator charges a fee that exceeds the third-party fee because he or she can't determine what the exact fee will be, the excess over the third-party fee is not considered to be compensation. However, if the loan originator intentionally marks-up (up-charging) an amount over the third-party fee, the excess amount would be

considered compensation. It should be noted that this particular practice, up-charging in relationship to third-party charges, is prohibited by RESPA, according to Statements of Policy issued by HUD in 1991 and 2001.

Creditors can still charge different consumers different rates based on the credit risk of the consumer, whether or not upfront fees are financed, and the costs associated with the loan, including the compensation that will be paid to the loan originator. Consumers can still negotiate the terms of their loans. Just keep in mind that a loan originator's compensation cannot be based on the terms and conditions of the loan. Therefore, when savvy consumers negotiate a good rate for themselves, the loan originator's compensation cannot be revised to compensate for the negotiated rate.

Steering

A loan originator is prohibited from steering (advising, counseling, or influencing) a consumer to consummate a credit transaction that will yield the loan originator higher compensation unless the transaction is in the consumer's interest. A loan originator can avoid a steering violation and fall within the safe harbor by providing a consumer with a significant number of other options for the type of transaction (fixed-rate, adjustable-rate, or reverse mortgage) for which the consumer applies. A significant number of other options are satisfied by providing three options from creditors with which the originator regularly does business. The loan options must be ones for which the consumer will likely qualify and must meet the following criteria in order to avail the safe harbor:

1. The loan with the lowest interest rate
    a. Loans with fixed rate for at least five years (use note rate),
    b. Loans where rate is not fixed during first five years (use fully indexed rate),
    c. Loans with a step-rate (use highest rate that could apply during first five years);
2. The loan with the lowest interest rate and no risky features such as prepayment penalties, negative amortization, interest only payments, a balloon payment within the first seven years, a demand feature, shared equity, or share appreciation; or in the case of a reverse mortgage, a prepayment penalty, shared equity, or shared appreciation; and
3. The loan with the lowest total dollar amount for origination points or fees and discount points.

Best practice would be to provide no more than three loan options since providing more will require the loan originator to highlight the three best options to the consumer. By the way, in order for a steering violation to take place, the loan in question must actually be consummated. In other words, you can't have a steering violation if the loan did not close.

If a loan originator who is an employee of a creditor is not paid compensation based on the terms and conditions of a loan and the loan originator offers the consumer a product

of the creditor, compliance with the anti-steering provisions are met without needing to supply the consumer with additional options of the creditor, and the safe harbor is met. This is especially important for those institutions that only offer their own loan products and employ their own loan originators. But keep in mind that if the loan originator offers credit products from sources other than its employer, satisfaction of the above options will be necessary to obtain the safe harbor. By the way, simply completing the trade-off table on a Good Faith Estimate does not satisfy the criteria listed above to invoke the safe harbor.

Record retention

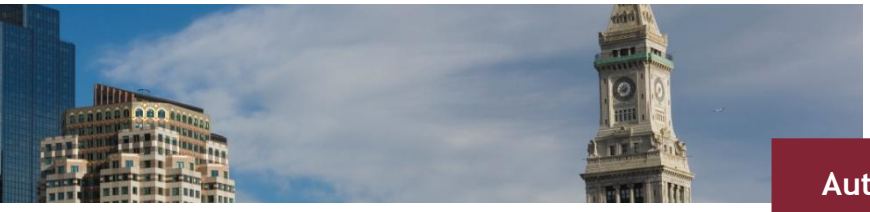
To comply with the record retention rules of Regulation Z, all records pertaining to compensation must be retained by the creditor, who pays the loan originator's compensation, for two years after a mortgage loan is consummated. For creditors, the records to maintain would be the compensation agreement with the loan originator in effect on the date the interest rate is set for the loan transaction and a record of the compensation actually paid to the loan originator. For mortgage brokers, a disclosure of compensation or other broker agreement that is required by applicable state law that complies with the requirements of §226.25 would satisfy the record retention requirements.

Final check

Has your institution altered it business practices and revised its business model to comply with these new compensation and steering rules? Have appropriate employees been trained on these new rules? Have system changes and procedures been implemented to comply with the new rules?

Dodd-Frank revisions

We can expect these new compensation and steering rules to be revised sometime in the future due to the Dodd-Frank Act. Once that happens, there are sure to be more questions that will need answers. Hopefully for now, this article has answered some of your questions on the rules in place at this time.



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