Mortgage Rule Modifications under CFPB Consideration

Executive Summary

The Bureau of Consumer Financial Protection ("CFPB") has announced that it intends to promulgate rules to modify the regulations governing mortgage points and fees as well as qualifications for mortgage loan originators ("MLOs"). Proposed rules are expected to be released in the summer of 2012 and finalized by January 21, 2013. The CFPB's announcement outlines the regulatory modifications it is currently considering, including, among others, proposals to:

- Require any discount point to be "bona fide" (where consumers would be required to receive at least a certain minimum reduction of the interest rate in return for paying the point).
- Require all creditors to offer a loan without discounts or fees.
- Prohibit brokerage firms and creditors from charging origination fees based on the size of a loan.
- Implement standards for mortgage loan originators regarding:
  - Character, fitness and financial responsibility;
  - Felony conviction screenings; and
  - Training.
- Reaffirm the Federal Reserve Board ("Fed") rule that prohibits the practice of varying loan originator compensation based on interest rates or certain other loan terms.

Prior to the release of any proposed rules the CFPB intends to convene a Small Business Review Panel that will meet with a group of representatives of the small financial services providers that would be directly affected by the proposals under consideration. Separately, consumers and interested parties are encouraged to provide feedback to the CFPB in advance of the release of a proposed rulemaking.

Background

The CFPB's proposals would implement requirements of the *Dodd-Frank Wall Street Reform and Consumer Protection Act* (the "Dodd-Frank Act") relating to MLO compensation and qualification that will, absent a final rulemaking, automatically take effect on January 21, 2013. The proposals under consideration are generally intended to address issues such as steering, where the consumer is directed toward a loan that is more costly but offers the MLO greater compensation, and confusion, where the consumer isn't clear what fees are actually paid to the MLO. The Dodd-Frank Act defines MLOs to include mortgage brokers, loan officers, and the brokerages or creditors that employ them, in certain cases. In contrast, the definition of an MLO under the *Secure and Fair Enforcement for Mortgage Licensing Act of 2008* (the "SAFE Act") includes individuals who take a residential mortgage loan application and offer or negotiate terms of a residential mortgage loan for compensation or gain.

In September 2010, the Fed issued regulations pursuant to the *Truth in Lending Act* ("TILA") and as implemented by Regulation Z, which prohibit certain practices related to MLO compensation (the "Loan Originator Rule"). These final rules became effective in April 2011 and generally:

- Prohibit payments to MLOs that are based on a loan's terms and conditions (except for payments that consumers make directly to MLOs); and
- Prohibit the MLO from also receiving compensation from any other party in connection with a transaction when the consumer directly pays the MLO.

General rulemaking authority for the TILA was transferred to the CFPB in July 2011.

The MLO compensation requirements imposed by the Dodd-Frank Act vary in certain respects from the Fed's Loan Originator Rule. Similarly, the Dodd-Frank Act imposes somewhat different MLO qualification requirements than the SAFE Act. The CFPB's consideration of MLO compensation and qualification proposals is intended to address these differences prior to the effective date of the Dodd-Frank Act requirements and absent other final rulemakings by the CFPB.

Description

The CFPB is considering proposals to implement requirements of the Dodd-Frank Act in the areas of:

- Dual compensation and the payment of upfront points and fees;
- Compensation that varies based on loan terms; and
- MLO qualifications and screening requirements.

Ban on Dual Compensation

Both the Dodd-Frank Act and the Loan Originator Rule generally prohibit dual compensation to an MLO. The MLO can be paid compensation by a person other than the consumer (*e.g.*, a creditor or brokerage firm) only if the MLO is not paid by the consumer. The prohibition on dual compensation generally applies to commissions and other payments tied to the loan transactions that are made to individual brokers, individual loan officers and brokerages, and generally does not include salaries or hourly wages.

Creditor-Paid Compensation

The CFPB is considering using its exemption authority to issue a partial exemption to permit consumers to pay certain upfront points and fees in retail and wholesale loan originations when the creditor compensates an MLO, subject to these conditions:

- Consumers may pay discount points when the discount points are bona fide and the creditor also offers the option of a no discount point loan.
- Consumers may pay upfront origination fees (but not to the MLO) that are "flat" and do not vary with the loan size.
- Consumers may pay upfront fees to affiliates of the MLO or the creditor provided they are "flat" and do not vary with the loan size, except for title insurance.

The CFPB is also considering two additional conditions:

- The creditor must offer a no-fee loan, and the difference between the higher interest rate on the no-fee loan and the interest rate on the loan with upfront fees must be reasonably related to the amount of upfront fees.
- The creditor must offer a no point, no fee loan.

Brokerage-Paid Compensation

Again using its exemption authority, the CFPB is considering a proposal that would permit consumers to pay discount points and origination fees to brokers provided the discount points are bona fide and the origination fees are "flat" and do not vary with the size of the loan. This construct would impose the same conditions on brokerage-paid compensation structures as is being considered for creditor-paid structures.

MLO Compensation that Varies with Loan Terms

Under the Dodd-Frank Act, MLOs may not receive (and no person may pay to MLOs), directly or indirectly, compensation that varies based on the terms of the loan (other than the amount of principal).

The CFPB would propose rules that implement the statute to prohibit consumers, creditors and brokers from compensating MLOs, directly or indirectly, on the basis of loan terms, except for the principal amount.

The Bureau is also considering certain changes to the Loan Originator Rule that would clarify or address interpretive and compliance issues relating to the prohibition that have arisen since that rule went into effect (April 2011). These include issues associated with: compensation payments derived from the MLOs mortgage business (such as bonuses and payments to qualified plans); pricing concession restrictions; point banks; proxies; and records retention requirements. Each is outlined below.

Compensation Payments Derived from MLOs Mortgage Business

The proposals under consideration would allow MLO compensation to be paid from mortgage business profits when the compensation is substantially deferred in time or other safeguards are in place to sufficiently mitigate steering incentives. The proposal would not allow an employer to compensate individual MLOs differently depending on the profitability of the loans he or she originates. At present, the CFPB is considering three separate proposals that would:

- Permit employers to make contributions to MLO employees' qualified retirement plans, qualified profit-sharing plans, and qualified stock ownership plans even if contributions to a particular plan are made from profits derived from the company's mortgage business.
- Permit employers to pay MLO employees bonuses or to make contributions to non-qualified profit-sharing or similar non-qualified plans from profits derived from the company's mortgage business, provided that mortgage-related revenue does not contribute more than a set percentage of the company's total revenue. The CFPB is considering setting that percentage at a fixed percentage between 20 percent and 50 percent of total revenue.
- Permit employers to make contributions to MLO employees' qualified or non-qualified plans and to pay MLO employees bonuses from profits derived from the company's mortgage business provided: (1) the number of loans originated by the MLO is below a set small number; and/or (2) the MLO has originated a small proportion of the total loans originated by the company.

Pricing Concession Restrictions

The Dodd-Frank Act prohibition on compensation paid to an MLO based on loan terms would prevent an MLO from renegotiating compensation for an origination where the loan terms change. The CFPB is considering a proposal that would allow MLOs to make certain types of pricing concessions to cover unanticipated increases in third-party settlement charges, where those settlement charges are not controlled by the MLO, the creditor, or their affiliates and exceed or are in addition to the amounts disclosed on the Good Faith Estimate disclosure required by the *Real Estate Settlement Procedures Act*. The CFPB is also considering whether to further limit any exception allowing MLOs to make pricing concessions (such as limits on the dollar amount or volume of concessions made by a particular MLO) or whether pricing concessions should be allowed in other situations.

Point Banks

The CFPB is considering proposing language that would clarify MLO point banks fall within the definition of "compensation" and also providing guidance on the award of points to MLOs that would not violate the Dodd-Frank Act's prohibition against compensation that varies based on loan terms. In particular, the Bureau would clarify:

- Point banks funded based on the difference between a loan term required by the creditor for a given consumer and the actual term the MLO sells the consumer would not be permissible because the contributions to the point bank would vary based on the terms of the mortgage transaction; and
- Point banks funded by a creditor are permissible provided:
  - The creditor does not base the amount of the contribution to an MLO's point bank for a given transaction on the terms and conditions of the transaction;
  - The creditor does not change its contributions to the point bank over time based on terms or conditions of the MLO's transactions, or on whether the MLO overdraws the MLO's point bank; and
  - The creditor does not reduce the MLO's commission on a transaction when the MLO overdraws the point bank.

Proxies

The CFPB indicates that it has received numerous inquiries highlighting uncertainty with regard to the scope of the prohibition on receiving compensation based on a proxy for a loan term or condition (for example, a credit score or debt-to-income ratio). The Bureau is considering proposing the following test to determine whether a factor is a proxy for a loan term:

- A factor would be a proxy if:
  - It substantially correlates with a loan term; and
  - The MLO has discretion to use the factor to present a loan to the consumer with more costly or less advantageous term(s) than term(s) of another loan available through the MLO for which the consumer likely qualifies.

Records Retention for MLOs

The CFPB is considering requiring brokerages (in addition to creditors) to maintain: (1) records of MLO compensation arrangements and agreements; and (2) records of compensation provided to MLOs by a consumer or a person other than the consumer.

MLO Qualification and Screening Requirements

The Dodd-Frank Act amends TILA to impose a duty on MLOs to be "qualified" and, where applicable, registered or licensed as a mortgage originator under state law and the Federal SAFE Act. This requirement is applicable to entities (creditors and brokerages) and individuals (brokers and loan officers). It also requires MLOs to provide their identifying numbers under the Nationwide Mortgage Licensing System and Registry ("NMLSR") on all loan documents.

The CFPB is considering proposals to require entities that employ or retain the services of MLOs to be "qualified." In particular, the proposals would:

- Obligate MLO entities to ensure that MLO individuals who work for them are licensed or registered, to the extent those individuals are already required to be licensed or registered under the SAFE Act and its implementing regulations.
- Require entities whose employee MLOs are not subject to SAFE Act licensing (*i.e.*, depositories and bona fide non-profit MLO entities) to:
  - Ensure that their MLO employees meet character and fitness and criminal background standards equivalent to the licensing standards that the SAFE Act applies to employees of non-bank MLOs; and
  - Provide appropriate training to their MLO employees commensurate with the size and mortgage lending activities of the entity.
- Require all MLO entities (banks, non-banks, and non-profit organizations) to comply with applicable state law requirements for legal existence and foreign qualification.
- Clarify that only disclosure and closing documents that include loan terms must include the required unique identifiers and the names of individual MLOs, and, for those cases in which multiple individuals (or entities) meet the Dodd-Frank Act definition of mortgage originator, clarify which MLOs must include their unique identifiers and names on the documents.

Commentary

The CFPB notes that it is taking a cautious approach to the rule proposals being considered in recognition of current and widespread industry practices, the weakened state of the mortgage market, and the potential for unpredictable results for both consumers and the industry arising from changes to the pricing structure of mortgage transactions the Dodd-Frank Act rules would generate. Nevertheless, the proposals as outlined would have both direct and indirect implications for financial services providers depending on the extent of their relationships with MLOs.

Although the imposition of flat fees is aimed at trying to address the CFPB's stated purpose of increased transparency, it could also increase the likelihood that certain small dollar loan consumers would realize a greater relative cost than under percentage-based fees.

From a business perspective, the implications of the contemplated changes might include:

- Reduced leverage to reward high performers based on loan economics, except in the case of loan principal.

- Potential skewing of MLO interest in high balance loans since the reward structure will likely be more heavily weighted toward loan principal.
- An opportunity to compensate MLOs under the loan profitability and deferred compensation provisions based on long term customer loan performance behaviors, such as credit risk and prepayments.
- The need for MLO management to revise the control structures in regard to implementing compensation structures and ongoing testing. This will include the need for additional compliance oversight and the inclusion of Human Resources, Legal, and Compliance in the build of the compensation structures.

On May 24, 2012, the U.S. Supreme Court released a unanimous decision upholding the findings of a lower Circuit Court (*Freeman v. Quicken Loans, Inc.*, No. 10-1042), which permit lenders and other service providers to accept "unearned fees" provided the fees are not split with a third party. More specifically, the Supreme Court said that to establish a violation of Section 8(b) of the *Real Estate Settlement Procedures Act* ("RESPA"), "a plaintiff must demonstrate that a charge for settlement services was divided between two or more persons." RESPA section 8(b) provides:

> "No person shall give and no person shall accept any portion, split, or percentage of any charge made or received for the rendering of a real estate settlement service in connection with a transaction involving a federally related mortgage loan other than for services actually performed." 12 USC 2607(b)

The Petitioners in the case had alleged that the respondent had violated Section 8(b) by charging fees at closing for which no services were provided. The fees included "loan discount fees," "processing fees" and "loan origination fees." The Court did not address whether "loan discount fees" fall outside the scope of Section 8(b) because they are not fees for "settlement service[s]," but are generally considered part of the pricing of a loan.

Press reports suggest that this decision will result in an increase in flat rate "administrative fees" or "mark-ups" being charged and retained by lenders and other service providers. Some suggest Congress may seek to modify the RESPA provisions to prohibit unearned fees or the CFPB may address the issue through actions or rulemakings related to its unfair, deceptive or abusive acts or practices authority.

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