



Issue Date: RESPA News Monthly
September 2010, Posted On: 9/3/2010
In-Depth Reports

Attorney tackles Fed's LO compensation rule

Musings from the Fool on the Hill

A column by Howard A. Lax

I am going to switch gears from my usual diatribe about the vagaries of RESPA reform, and the Department of Housing and Urban Development's (HUD) sometimes baffling advice on how to get back to "Kansas," to talk about the latest rule to rock the mortgage industry — the Federal Reserve Board's (FRB) loan originator compensation rule. The purpose of the rule, "to protect consumers in the mortgage market from unfair or abusive lending practices that can arise from certain loan originator compensation practices, while preserving responsible lending and sustainable homeownership" is misleading in some respects. I know what the rule is supposed to do, but I am not quite sure what the result will be.

The initial reaction to the rule by loan officers is best characterized as confusion and misconception. We are not experiencing chaos yet — that will happen about a month before the effective date of April 1, 2011. Based on what we saw as July 30, 2009, approached (the effective date for the Mortgage Disclosure Improvement Act rule changes), most loan originators will panic.

Do not be distressed by the self flagellation in net branches as the effective date approaches. This is merely a ritual, similar to the running of the bulls in Pamplona, Spain. This rule will not mean the end of loan officer commissions, and it will not be the nail in the coffin of mortgage brokers (this presumes that mortgage brokers are still in business after Full Eagle investors impose heightened originator standards for FHA-insured third-party origination loans). For each homeowner left breathing, there will still be three offers of brokered mortgage loans.



The FRB gave us a blessing and a curse

Like Snopes.com, I will attempt to dispel the urban legends arising before the ink in the Federal Register is dry, and explain the method behind the FRB's rule. First, the rule requires adherence to three basic commandments:

1. Thou shall not receive income both from the consumer and the lender. The FRB's goal is to stop the perceived "double fee" that brokers were charging to originate a loan. Some brokers were not getting half of their income from the borrower and half from the lender. They were receiving a double measure. Note that certain affiliates are lumped in with "thou" in this rule (sort of like a married couple) to prevent mortgage brokers from circumventing the rule by having an affiliate receive a fee. The rule tying affiliates together is not airtight, as I will discuss in greater detail below.

2. Thou shall not receive income based directly or indirectly on any loan term other than the loan amount. Income or commissions cannot vary based upon credit risk, interest rate, whether it is an ARM or fixed rate loan, whether there is an escrow account or prepayment fee or not, etc. The rule has a list of features that may factor into income, such as overall default rate, loan quality, volume (but remember that RESPA does not permit volume-based compensation for brokers), overall profitability of the company, hours worked, etc. Furthermore, you cannot get around the rule by marking up your “regular” fee and then giving the consumer a discount. This commandment does not limit creditor compensation, but it does limit the compensation of loan officers of creditors, as discussed below.

3. Thou shall offer the loan terms to the consumer that are in the consumer’s interest. A loan originator cannot steer a consumer to a product that pays higher compensation to the originator, unless the product is in the consumer’s interest. For example, if the consumer’s credit qualifies him for loans from many investors, and investor A offers lower interest rates than investor B (all other loan terms being equal), the consumer must be offered the lower interest rate loan. This is a no brainer, since the mortgage broker and the loan officer earn the same base fee and commission from each investor. The rule presumes that (i) if all loan options pay the same originator compensation, then steering is not occurring, and (ii) a loan is in the best interests of the consumer if the loan originator receives the lowest level of compensation of any competing option. The rule allows the loan originator to show the consumer the three best offers for each loan product (e.g. the best three plain Jane fixed rate loans, the best three fixed rate loans that have bells and whistles, and the best three ARM loans) from among all investors available to the loan originator, so that the consumer may choose his or her poison.

Second, it is self-evident that all loan officers are created equal, that they are endowed by wage and hour laws with certain unalienable rights, and that among these are the right to earn commissions through the pursuit of hapless and undereducated homeowners. You might think that this rule puts mortgage brokers at a disadvantage compared to creditors, or vice versa, but that is not so. All loan officers, regardless of who they work for, are subject to the three commandments outlined above. If loan officers cannot earn more for up-selling the interest rate or tacking on a prepayment fee, then their employer is not going to originate higher yielding loans. *Quod Erat Demonstrandum.*

Third, an opportunity is presented by the rule to devise business strategies to (i) attract and keep high performing loan officers, (ii) improve consumer disclosure compliance, and (iii) satisfy banking regulators. Mortgage companies and banks may vary commissions based on adherence to rules and performance of the loans. There will be significant differences in the commission rate per loan for someone who originates four loans a month and someone who originates 10 loans per month. Commission floors and caps coupled with higher commission scales for loan volume may incentivize loan officers to seek out moderate income borrowers and assist their bank to meet Community Reinvestment Act goals.

The pull of the Dark Side is strong

Of course every rule has its dark side. First, the rule distinguishes true creditors that use a “*bona fide* warehouse line of credit” to fund loans, from mortgage brokers who rely on table funding. The first two commandments above do not apply to origination fees and loan sale income (SRP) earned by true creditors. The term “*bona fide* warehouse line of credit” will not be further clarified. HUD has struggled for a long time, trying to decide how to define a true interest in a loan. The FRB is not going to trouble its conscience with the issue of where to draw the line between *Kosher* and *unclean* lines of credit. The FRB staff will know a *bona fide* warehouse line when they see one. That answer is less than satisfactory to the attorney who is asked to render a legal opinion, and the investor that wants to avoid litigation. You have to consider whether any of the following conditions make the warehouse line of credit a *non-bona fide* warehouse line of credit:

- The line of credit is used to fund loans sold to other institutions. Some warehouse lines of credit can only be used to fund loans sold to the warehouse line of credit lender.
- The cost to fund a loan using a warehouse line of credit is less if the loan is sold to the lender providing the warehouse line of credit.
- A warehouse line of credit is provided by an affiliate of the institution purchasing the loan.
- The warehouse line of credit lender retains a security interest in the loan until the loan is sold and the warehouse line of credit lender is repaid.
- Instead of the investor providing a warehouse line of credit, the investor and the loan originator

enter into a mandatory repurchase agreement that requires the loan originator to repurchase any loan within 90 days of closing upon demand of the investor.

- o The loan is purchased less than 48 hours after it is funded with the warehouse line of credit, *i.e.*, before the loan can be packaged for sale.

This issue impacts banks when the bank provides a warehouse line of credit to an operating subsidiary mortgage company, which then sells the loans back to the bank. This issue impacts mortgage brokers that do business with investors that use a warehouse line of credit to entice the mortgage brokers to send a significant portion of their production to the investor.

Second, the first commandment above does not capture fees paid to many affiliates. Section 36 refers us back to Section 32 for the definition of "affiliate." Section 32 refers to FRB Regulation Y for this definition. Regulation Y generally considers two companies to be affiliates if they are in a holding company structure, *i.e.*, there is 5 percent common ownership plus control, or 25 percent common ownership. However, common ownership of two companies by an individual (or by certain grantor trusts) is exempted from creating affiliates. Under Section 32, the premiums charged by a title agency affiliated with a creditor must be included in the "points and fees" test for high cost and higher cost loans. Hence, mortgage companies and title companies created joint venture title agencies owned by the individuals who owned the mortgage companies in order to avoid creating "affiliates."

Banks, on the other hand, usually create affiliated title agencies and appraisal management companies in a holding company structure. As a result, a bank violates the first commandment if the bank brokers a loan or originates a table funded loan (*i.e.* the bank is a "loan originator" rather than a "creditor") in which (i) the bank receives compensation from the investor, and (2) an affiliated title agency or an appraisal management company receives a closing fee or an appraisal fee from the consumer. A mortgage company would not violate the first commandment if there is no holding company owning the loan originator and the joint venture. Big banks that have mortgage reinsurance companies and other affiliates hidden from public view should evaluate their business plan to determine whether the first commandment puts the kibosh on brokered transactions. It may not be feasible under the rule for big banks to broker out loans that do not meet creditor guidelines.

Third, the second commandment will prevent mortgage brokers from originating FHA streamline refinance loans and other no-fee loans. The rule prohibits loan originators from charging different fees for the same loan terms. In a no-fee loan, the loan originator will grant a credit to the borrower to pay closing costs. The credit granted by a loan originator cannot vary based on any loan factor other than the loan amount. Unfortunately, closing costs do not vary on a dollar-by-dollar basis with the loan amount. Here, true creditors that offer no-fee loans have the advantage over mortgage brokers since the second commandment does not apply to true creditors.

Fourth, the "safe harbor" permitting a loan originator to show multiple offerings of products to a consumer, to allow the consumer to choose loan terms, may not be much of a "safe harbor." Borrowers in default will second guess whether the offerings shown to them were really the best available to the loan originator. The loan originator has the burden of proving that no better offers were available and/or other offers would pay higher compensation to the loan originator. Given the near impossible task of proving the non-existence of better loan terms, we expect that this "safe harbor" will be used by few loan originators.

Finally, the second commandment could put a loan originator in a no win situation if RESPA fee tolerances are violated. Providing a credit to correct a fee tolerance creates an indirect imbalance in loan fees charged from loan to loan. A creditor cannot deduct the tolerance refund from the mortgage broker's fee since this would vary the broker's loan income based on loan terms and, thus, violate the second commandment. Mortgage brokers who cannot properly complete a Good Faith Estimate (GFE) to save their lives should strongly consider investing in remedial GFE education, or find another line of work before Easter.

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