



Mortgage Originator Compensation Rules

We can expect a number of significant regulatory changes during 2011, particularly with respect to regulations governing transactions related to a consumer's principal dwelling. One of the first significant regulatory challenges of this type will be the implementation of the Federal Reserve's revisions to Section 36 of Regulation Z. These amendments will implement new restrictions on mortgage loan originator compensation, as well as other requirements related to loan "steering". Although these requirements will be effective April 1, 2011, we can also expect further revisions to these rules due to the inclusion of similar, yet more expansive, requirements in the Dodd-Frank Act.

An Outline of the New Restrictions

In broad terms, the final rules published by the Federal Reserve will place significant compensation restrictions on individual loan officers, mortgage brokers, and mortgage companies that do not close transactions with their own funds (i.e. rely on table funding or some other agency relationship). Under the present rules published by the Federal Reserve, most traditional community banks will be directly exempted from these rules as an entity; however, the employees of these banks will generally still be covered by these restrictions. Upon enactment, the final rules will prohibit payments to loan originators based on a transaction's interest rate or any other terms, including loan-to-value, credit score, and debt-to-income characteristics. The rules will also restrict "steering" of consumers into loans with less favorable terms than would otherwise be available in order to increase the loan originator's compensation. The final rules also provide a defined "safe harbor" for satisfying the anti-steering restrictions contained within this new amendment to Regulation Z.

Acceptable Compensation Practices

Although the revisions to Section 36 primarily focus upon prohibited practices in relation to mortgage loan originator compensation, the Official Staff Commentary provided by the Federal Reserve does outline a number of compensation practices that are formally considered to be unrelated to loan terms and conditions. These "acceptable" compensation practices include payments based on loan origination volume, long-term performance of an officer's loan portfolio, a flat or fixed dollar amount for each loan originated, a percentage value for each loan originated (i.e. 1% of the gross loan amount), and the actual cost and time spent in the origination process, as well as several other methodologies. At the present time, the Federal Reserve has not provided any formal commentary regarding compensation to loan originators based on overall bank profitability or the profitability of a particular business unit. Based on the Federal

Reserve's broad prohibition of compensation based on loan terms, it is not unreasonable to expect that compensation based on aggregated performance metrics, such as ROA or ROE, may not pass regulatory scrutiny with respect to payments made to covered loan originators. This restriction could potentially create compensation plans that reward the personnel of unprofitable loan origination departments or business units since profitability, as a metric for determining originator compensation, may be prohibited under these rules.

Loan Steering

One of the most problematic requirements for many community banks will likely be found within the steering restrictions contained within this revision. In effect, these steering requirements will likely create a de facto standard for many banks to begin formally providing each covered consumer with a "menu" or formal listing of options that include loan products with the lowest interest rate, lowest origination fees, and lowest "risk" features, such as the presence of fixed rates or the absence of characteristics such as prepayment penalties or negative amortization.

As many bank's experienced in relation to HUD's recent revisions to the RESPA, in which the Good Faith Estimate was partially converted into a loan "shopping" disclosure that included a comparison table to assist the customer in evaluating loan options, the Federal Reserve has also apparently adopted a perspective that it is now the responsibility of loan originators to assist customers in shopping for the most advantageous loan products available. Although it is apparent that many consumers do not traditionally "shop" for loan products, at least to the extent envisioned by the regulatory agencies, the Federal Reserve has apparently adopted the industry trend of placing community banks in the position of both lender and financial advisor through loan steering requirements that place the burden of providing the most suitable product available to the customer directly upon bank personnel.

In response to these new loan steering requirements, many banks will be faced with the increased necessity of expanding or formalizing policies regarding the terms and features of in-house loan products, including the standardization of interest rates, origination fees, and other features throughout the lending environment. This process will not only allow a bank to establish an improved compliance posture with respect to these new anti-steering provisions, but will also reduce fair lending risks that arise from variance with product features. Bank management will also be required to dedicate significant attention to underwriting practices, particularly for in-house loan products, to ensure that loan officers are evaluating consumer creditworthiness in a consistent manner and are presenting similar loan options to consumers with similar credit characteristics and circumstances.

Future Revisions

To the chagrin of those responsible for ensuring compliance with these new compensation and steering restrictions, the industry will soon be faced with additional revisions to these requirements that arise from Title XIV of the Dodd-Frank Act (also known as the Mortgage Reform and Anti-Predatory Lending Act or MRAPLA). Not only does MRAPLA include the same requirements established under the Federal Reserve's revisions to Section 36 of Regulation Z, but it also introduces broader prohibitions related to the offering of loans without direct consideration of a consumer's ability to repay, practices that result in disparities between products offered to protected and non-protected classes (i.e. prohibited basis consumers), and steering of customers into products that do not meet the definition of "qualified residential mortgages" when they might otherwise qualify for these products. Qualified residential mortgages, or QRMs, are likely to be a topic of significant debate after the formation of the Consumer Financial Protection Bureau and the implementation of MRAPLA. As a brief summary, QRMs are generally defined within the MRAPLA as loan's that meet certain underwriting and structure requirements, including the following: the presence of no balloon payments that are greater than twice the average of earlier, regularly scheduled payments, full amortization of a loan's principal balance over a given loan's term, the inclusion of an escrow account for taxes and insurance, verified and documented income and financial resources, total fees and points that do not exceed three percent of the total loan amount, as well as several other restrictions that have yet to be fully defined by the Bureau.

In order to meet the compliance requirements of these recent revisions to Section 36 of Regulation Z, as well as prepare for the forthcoming requirements mandated under the Dodd-Frank Act, bank management must proactively assess compensation policies and loan product presentation practices for mortgage loan originators. Management should also consider how the bank's portfolio of loan products can be structured in order to provide consistency and uniformity across the enterprise in order to decrease fair lending risks and ensure that compliance with future requirements of the Dodd-Frank Act is reasonably achievable. Finally, management will be required to begin evaluating current loan terms and features in contrast with the features outlined within QRMs, which are likely to be a central element of the "plain vanilla" products advocated by the Consumer Financial Protection Bureau.

Mr. Reaves is the Chief Financial Officer and Director of Compliance Services of Superior Consulting, LLC, a bank consulting firm based in Springfield, Missouri. Mr. Reaves is a licensed Certified Public Accountant, a Certified Fraud Examiner, and a Certified Regulatory Compliance Manager. In addition to these designations, he also holds six other information technology and risk management certifications. Mr. Reaves may be contacted at 417-276-8452 or breaves@superiorconsultingllc.com