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Recently Issued Federal Reserve Rules Restrict Mortgage Compensation and Steering Practices

On August 16, 2010, the Board of Governors of the Federal Reserve System (Board) published final rules (Final Rules) creating new restrictions on the compensation practices applicable to the mortgage industry. The Final Rules prohibit, as unfair practices, payments to mortgage brokers and loan officers of mortgage lenders that are based on any terms or conditions of the mortgage other than the amount of credit extended. The Final Rules also prohibit mortgage brokers and loan officers of mortgage lenders from steering consumers to loans that will yield greater compensation, but are not in the consumers' interests. The Final Rules will apply to mortgages where the creditor receives the mortgage application on or after April 1, 2011.

The Final Rules amend Regulation Z, which implements the Truth in Lending Act (TILA) and the Home Ownership and Equity Protection Act (HOEPA). The Final Rules are also consistent with the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), which was enacted on July 21, 2010. Title XIV of the Dodd-Frank Act amends TILA to establish mortgage loan origination standards that were modeled after the Final Rules' initial proposed form, but are somewhat different than what is contained in the Final Rules. The preamble to the Final Rules notes that those Title XIV provisions that are not addressed in the Final Rules will be handled in a future rulemaking with opportunity for public comment.

Basis for the Final Rules

The Board originally proposed rules restricting mortgage compensation and steering in August 2009 (Proposed Rules).[1] The Proposed Rules proposed a complete prohibition against mortgage compensation that is based on the terms and conditions of a mortgage loan. In the Final Rules, however, the Board is permitting the amount, but no other terms or conditions, of the mortgage loan to be used as a factor in determining permissible compensation amounts. In addition, the Final Rules adopt the anti-steering rule and the

1 For a summary of the proposed rules, please refer to Part II of our previous August 2009 Advisory, "Proposed Amendments to Regulation Z Relating to Closed-End Mortgages and Home-Equity Lines of Credit," *available at* http://www.arnoldporter.com/public_document.cfm?id=14611&key=28B3.

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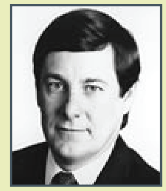

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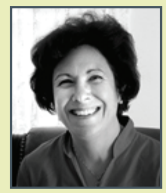

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safe harbor of the Proposed Rules, but modify the options that a loan originator must present to the consumer to qualify for the safe harbor.

Under TILA, the Board has the authority to prohibit practices such as those addressed in the Final Rules in connection with mortgage loans that it finds to be unfair. The Board relies on standards set forth in Section 5(a) of the Federal Trade Commission Act (FTC Act) in determining whether these mortgage practices are unfair under TILA. Under the FTC Act's standards, an act or practice is unfair if it "causes or is likely to cause substantial injury to consumers that is not reasonably avoidable by consumers themselves and not outweighed by countervailing benefits to consumers or to competition."[2] In view of this unfairness standard, the Final Rules state that the Board concluded that both compensation payments to loan originators based on the terms or conditions of the loan (other than the amount of credit extended), and the steering of consumers to loans that are not in their best interest in order to maximize loan originator compensation, are prohibited practices. The Board believes that the practices cause substantial economic injury to consumers, that consumers cannot reasonably avoid these practices due to a lack of awareness, and that this lack of awareness prevents consumers from gaining any benefits from the practices that could outweigh their economic injuries. Thus, as mentioned, the Final Rules expressly prohibit these practices.

Scope of the Final Rules

The Final Rules apply to both mortgage brokers and loan officers of mortgage lenders. The term "loan originator" is used expansively to include not only mortgage brokers, but individual employees of mortgage brokers, individual employees of creditors, and even creditors themselves when providing loans that at consummation are not funded by the creditor's own resources (i.e., table-funding). Creditors, besides those who use table-funding, are generally excluded from the definition of loan originator. Thus, depository institution lenders and non-depository mortgage companies are not loan originators under the Final Rules, but their loan officer employees are covered. Also, managers and administrative staff of both mortgage brokers and creditors are not loan originators if they:

- Do not arrange, negotiate, or otherwise obtain an extension of credit for a consumer; and
- Are not compensated by the mortgage broker or creditor on the basis of whether any particular loan is originated.

Servicers are not considered "loan originators" when modifying an existing loan on behalf of a consumer, because the Final Rules only apply to extensions of credit, and not loan modifications.

Despite the broad definition of the term "loan originators," the Final Rules cover a relatively limited scope of transactions secured by real estate. Closed-end consumer loans secured by first or subordinate liens are covered by the Final Rules. Home equity lines of credit (HELOCs) and loans secured by a consumer's interest in a timeshare plan are not covered, while reverse mortgages are only covered if they are not HELOCs.

Prohibition on Certain Loan Originator Payments

The Final Rules prohibit loan originators from receiving compensation that is based on any of the mortgage transaction's terms or conditions, other than the amount of credit extended. Furthermore, if any loan originator receives compensation directly from a consumer in a mortgage transaction, then that loan originator may not receive compensation for the transaction from any other person.

Mortgage Compensation Received by a Loan Originator

Under these prohibitions, mortgage compensation includes:

- Salaries, commissions, and any financial or similar incentive;
- Annual or periodic bonuses;
- Awards of merchandise, services, trips, or similar prizes; and

2 15 U.S.C. § 45(a).

- Amounts that a loan originator retains, regardless of whether it is labeled as a “fee,” “expense,” or any other name.

Mortgage compensation would not include amounts that the loan originator receives as payment for *bona fide* and reasonable third-party charges for services, including charges for title insurance and appraisals. Furthermore, when the amounts that a loan originator receives exceed the actual charge for a third-party service, then the surplus amounts retained by the loan originator would not be considered compensation if the loan originator could not accurately determine the actual charge prior to the consummation of the mortgage transaction.

Compensation Based on a Mortgage Transaction’s Terms or Conditions

Under the Final Rules, the only term of a covered mortgage transaction that the Final Rules permit to be a factor in determining a loan originator’s compensation is the amount of credit extended. A loan originator may not be compensated based on any other terms or conditions of a mortgage transaction, including the following:

- Interest rate;
- Annual percentage rate;
- Loan-to-value ratio;
- Existence of a prepayment penalty; and
- Factors that are proxies for determining a transaction’s terms or conditions such as a consumer’s:
  — Credit score
  — Annual income
  — Debt-to-income ratio.

According to the Official Staff Commentary accompanying the Final Rules, a loan originator’s mortgage compensation will not be considered to be based on a transaction’s terms or conditions, if the compensation is based on any of the following factors:

- Loan originator’s overall loan volume delivered to a creditor;
- Long-term performance of the loan originator’s loan volume;
- Hourly rate of pay for the actual number of hours worked by a loan originator;
- Status of the consumer as an existing customer of the creditor or new customer;
- Percentage of applications submitted by the loan originator to the creditor, resulting in consummated transactions;
- Accuracy and completeness of the loan documentation submitted by the loan originator to the creditor; and
- Legitimate business expenses such as overhead costs.

Notwithstanding that the foregoing factors are permitted under the Final Rules, creditors should ensure that their method of paying loan originator compensation is also in compliance with Section 8 of the Real Estate Settlement Procedures Act[3] (RESPA). For example, while the Final Rules may permit compensation to be based on overall loan volumes, RESPA prohibits payments to a third party loan originator that are not for services actually performed. Accordingly, payment based on loan volume may be inconsistent with this prohibition. We note that the RESPA prohibition, however, does not apply to payments that a creditor makes to its employees for generating business for the creditor. Thus, the above permissible factors likely would be compliant with RESPA if they were used by a creditor to pay its loan originator employees, because the payments would reflect compensation for generating business for the creditor.

Effect of Compensation Received Directly from the Consumer

Under the Final Rules, if any loan originator receives compensation directly from a consumer in a mortgage transaction, then that loan originator may not receive additional compensation for the transaction from any other person. This restriction treats both a company and its employee as the same loan originator. Thus, if an employee of a mortgage broker company receives mortgage compensation directly from a consumer, neither the employee, nor the mortgage broker company may receive any additional compensation from a creditor for the particular mortgage transaction.

3 31 U.S.C. § 2607.

Prohibition on Steering

In addition to the restrictions on compensation, the Final Rules prohibit a loan originator from steering a consumer to a mortgage loan because the originator will receive greater creditor-paid compensation for that loan, compared with the creditor-paid compensation that the originator would have received for another loan that the originator offered or could have offered to the consumer. This prohibition does not apply if the loan resulting in the originator's receiving greater creditor-paid compensation is in the consumer's interest. A loan originator does not violate the prohibition unless the consumer actually receives the loan to which he or she is steered.

A loan originator working as an employee of a creditor and originating loans only for that creditor will not violate the prohibition on steering if the originator does not receive compensation that is based on the loan terms (other than principal amount), in compliance with those requirements of the Final Rules discussed above. However, if a loan originator works with more than one creditor, the originator's creditor-paid compensation is subject to the prohibition on steering. Such an originator could be a mortgage broker, or an originator who is an employee of a creditor but acts as a broker in certain circumstances by forwarding a consumer's application to other creditors (such as when the originator's employer does not offer any loan products for which the consumer would qualify).

Determining Whether a Violation Exists

In determining whether a loan originator engages in the prohibited practice of steering, the mortgage that the consumer actually obtains must be compared to any other possible loan offer available through that loan originator. With respect to any consumer, a mortgage is considered a possible offer available through the loan originator if:

- It could be obtained from a creditor with which the loan originator regularly does business; and
- Such a creditor would extend the loan to the consumer upon receiving an application from the consumer, based on the creditor's current credit standards and its current rate sheets or other similar documents showing the creditor's current pricing and the required minimum credit score or other eligibility criteria.

Obviously, these are not bright-line standards for determining what options are possibly available through the loan originator to a particular consumer. The loan originator is required to make a good faith determination, but there is an element of uncertainty as to what qualifies as a good faith determination in this case.

Under the Final Rules, a loan originator may advise a consumer to take a mortgage that could result in greater creditor-paid compensation to the loan originator compared with other available mortgage options, if the former is in the consumer's interest. The Official Staff Commentary accompanying the Final Rules explicitly states that the Final Rules do not require a loan originator to direct a consumer to a mortgage that will result in the least creditor-paid compensation to the loan originator. However, if a loan originator advises a consumer to take a mortgage that does not result in the least creditor-paid compensation to the loan originator, it may not be easy for the loan originator to justify the advice on the basis that the mortgage is in the consumer's interest. The Official Staff Commentary gives an example of a consumer who likely qualifies for a mortgage from Creditor A with a fixed interest rate of 7 percent, and also for a mortgage from Creditor B with a fixed interest rate of 7.5 percent. According to the official staff commentary, the loan originator does not necessarily violate the steering prohibition by advising the consumer to take the 7.5 percent interest mortgage if the 7 percent interest loan has a prepayment penalty or requires upfront payments that the consumer is unwilling or unable to make. In other words, the loan with the higher interest rate may be better for the customer due to unattractive features that may be associated with a lower-rate alternative loan. Nevertheless, in light of the wide variety of mortgage terms and conditions available, some of which are not readily quantifiable, when a loan originator advises a consumer to take a certain mortgage where there is another mortgage option that would result in lower creditor-paid compensation to the loan originator, the originator may be taking a risk.

Safe Harbor

The Final Rules do provide a safe harbor from the steering prohibition for loan originators to which this part of the Final Rules may apply. To fall within the safe harbor, the loan originator must obtain mortgage options from a significant number of the creditors with which the loan originator regularly does business, and must present the consumer with the required mortgage options, as discussed below. The loan originator must do so for each "type of transaction" in which the consumer expressed an interest. For purposes of the safe harbor, there are three types of transactions: (i) a fixed-rate loan; (ii) a loan with an annual percentage rate that may increase after consummation; and (iii) a reverse mortgage loan. For example, if a consumer indicated that she was looking for a mortgage loan and would be interested in either a fixed-rate loan or an adjustable-rate loan, the loan originator would need to present the consumer with loan options both for fixed-rate loans and for adjustable-rate loans, and the options for each type must meet the requirements discussed below.

The loan options that the loan originator must present to the consumer must include the following three loan options—all of which must be ones for which the loan originator has a good faith belief that the consumer likely qualifies:

- The loan with the lowest interest rate;
- The loan with the lowest interest rate, and without any of the following features: a prepayment penalty, shared equity, or shared appreciation with respect to a reverse mortgage, plus negative amortization, interest-only payments, a balloon payment in the first seven years of the life of the loan, or a demand feature with respect to all other mortgages; and
- The loan with the lowest total dollar amount for origination points or fees and discount points.

A loan originator obtains loan options from a significant number of the creditors with which the loan originator regularly does business if the loan originator obtains loan options from three or more of those creditors. If the loan originator regularly does business with fewer than three creditors, the loan originator meets the requirement by obtaining loan options from the one or two creditors with which it regularly does business. A loan originator regularly does business with a creditor if (i) there is a written agreement between the loan originator and the creditor governing the loan originator's submission of mortgage loan applications to the creditor; (ii) the creditor has made at least one consumer loan secured by a dwelling during the current or previous calendar month based on applications submitted by the loan originator; or iii) the creditor has made at least 25 consumer loans secured by a dwelling during the previous twelve calendar months (excluding the month in which the originator accepts the consumer's application) based on applications submitted by the originator.

For the purpose of determining which loan among the available loan options has the lowest interest rates, the following rules apply:

- If a loan has an interest rate that remains fixed for at least the first five years, the interest rate of the loan is its initial interest rate;
- If the interest on a loan changes from one fixed rate to another during the first five years, the interest rate of the loan is the highest rate that applies during the first five years; and
- If a loan has a floating interest rate that varies on the basis of an index, the interest rate of the loan is the fully-indexed rate that would be in effect at consummation.

To fall within the safe harbor, if the loan originator presents more than three loans to the consumer, the loan originator must highlight the three loan options listed above. The loan originator may present fewer than three loans to the consumer if the loans presented cover all the three loan options. For example, if a loan is the loan with the lowest interest rate, the loan with the lowest interest rate and without any of the specified features, and the loan with the lowest dollar amount for points or fees, then it is all three loan options rolled into one. This would mean the loan originator may present this loan option only to meet the requirements of the safe harbor, assuming the loan originator has a good faith belief that the consumer qualifies for the loan.

If a loan originator does not meet the requirements of the safe harbor, the originator does not have the protection of the safe harbor, but it does not necessarily follow that the originator violates the prohibition on steering. Nevertheless, a loan originator who advises a consumer to take a loan that results in higher creditor-paid compensation compared with other available options but does not have the protection of the safe harbor would be subject to second-guessing as to whether the loan obtained was in the consumer's interest.

The Final Rules represent an important change to the regulatory regimes applicable to mortgage participants, and will certainly alter mortgage practices once implemented. Further changes are anticipated as the various provisions of the Dodd Frank Act applicable to the mortgage industry go into effect. Participants in the industry would be advised to keep abreast of these developments, and work on easy to understand compliance processes and procedures. Alternatives to the existing fee structure for loans also may need to be considered, as the costs of implementation will certainly affect the cost of offering mortgage products going forward.

Arnold & Porter LLP is available to respond to questions raised by the Final Rules. We can assist you in determining how the Final Rule and other mortgage-related regulations may affect your business and industry. For further information, please contact your Arnold & Porter attorney or:

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