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CFPB Finalizes Rule on Mortgage Loan Originator Compensation and Qualifications

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Here, the authors discuss a final rule issued by the Consumer Financial Protection Bureau that implements a number of statutory requirements that build upon the existing regulation of mortgage loan originators' compensation and business practices. They also explain that the final rule will impact the operations of creditors, loan originator organizations, and individual loan originators in a variety of ways, including training, registration, licensing, the structuring of compensation and benefit plans, as well as other aspects of the loan origination process, such as recordkeeping.

The Consumer Financial Protection Bureau ("CFPB") has issued its final rule (the "Final Rule") regarding mortgage loan originator compensation and qualification requirements[1] under the Truth-in-Lending Act ("TILA"), as amended by the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). The Final Rule modifies existing compensation and qualification requirements under Regulation

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Z.[2] It prohibits a creditor from compensating a loan originator based on a term of a transaction or a "proxy" for a term of a transaction. It also codifies the existing ban on "dual compensation," in which a loan originator receives compensation from the consumer and an additional party other than the originator's organization, but creates an exception allowing a loan originator organization to pay its employees or contractors a commission provided that the commission is not based on a term of a loan. The Final Rule provides a complete exemption from the statutory ban on a consumer's payment of upfront points and fees. The Final Rule also includes requirements regarding loan originator qualifications, licensing, and recordkeeping, and implements statutory provisions regarding mandatory dispute resolution and the financing of credit insurance in connection with a residential mortgage loan.

The Final Rule is designed to protect consumers, who generally rely on the services of mortgage brokers or loan officers to secure a mortgage loan, from being "steered" to loans with unnecessarily high interest rates or other "unfavorable" terms. Individual loan originators are most commonly compensated by commission, which is correlated to the amount of the loan.[3] Prior to 2010, and particularly during the rapid expansion of the mortgage market in the early-to-mid 2000s, commissions paid to loan originators varied considerably and were often higher in the case of high-interest loans.[4] Accordingly, due to the presence of financial incentives, the practice of steering consumers to loans with high interest rates and/or significant upfront fees and charges became increasingly common. The Final Rule is the latest in a series of actions taken by lawmakers and regulators to address this practice and further regulate the qualifications of loan originators and the services they provide to consumers.[5]

STATUTORY FRAMEWORK AND PRIOR RULEMAKING ACTIVITY

The Dodd-Frank Act granted the CFPB jurisdiction over the "consumer financial protection functions" previously vested in other federal agencies, including the authority to issue regulations under TILA. Prior to the transfer of TILA jurisdiction to the CFPB, the Board of Governors of the Federal Reserve System (the "Board") issued a number of regulations pertaining to loan originator compensation practices under its then-existing TILA authority.[6] The CFPB's Final Rule was necessary to implement a number of TILA amendments enacted through the Dodd-Frank Act[7] and provide additional official interpretations of these regulations. The Final Rule contains select modifications to the rule as originally proposed by the CFPB[8] and provides additional analysis in response to comments submitted by the public. The majority of the Final Rule becomes effective January 10, 2014. However, the rule's prohibition on mandatory arbitration clauses and waivers of certain consumer rights became effective on June 1, 2013. The rule's ban on the financing of single-premium credit insurance in connection with a consumer credit transaction secured by a dwelling was originally intended to also take effect on June 1, 2013, but recent CFPB amendments have delayed its effective date until January 10, 2014.[9]

ANALYSIS OF THE FINAL RULE

Definitions and Scope

The Final Rule clarifies or redefines a number of important terms that serve to establish the Final Rule's reach. Most notably, the Final Rule adopts a broad definition of "loan originator" in order to establish consistency with the definition of "mortgage originator" under TILA, as amended by the Dodd-Frank Act. The CFPB's stated objective in aligning the meaning of these terms is to ensure consistent regulation of any person who, early in the loan origination process, may have financial incentives to steer consumers to loans with particular terms.

Accordingly, the Final Rule defines a "loan originator" as a "person who takes an application, offers, arranges, assists a consumer in obtaining or applying to obtain, negotiates, or otherwise obtains or makes an extension of consumer credit for another person."[10] Therefore, under the Final Rule, "loan originators" include not only individual loan originators, loan originator organizations, mortgage brokers, and many creditors,[11] but also those engaging in certain referral actions, certain seller financers,[12] and those assisting with several aspects of a credit transaction.[13] The definition of a "loan originator," however, expressly excludes certain persons and functions, including those who perform purely administrative or clerical tasks or real estate brokerage activities.

The CFPB's approach to establishing the scope of covered transactions mirrored its approach to determining covered persons and entities. Rather than exclude specific credit products from the rule,[14] the CFPB adopted a broad definition of covered transactions, which includes any "closed-end consumer credit transaction secured by a consumer's principal dwelling."[15] The Final Rule noted that no underlying statute provided for different treatment based on transaction type, and therefore the CFPB declined to do so in its rulemaking.

Prohibition on Compensation Based on a Term of a Transaction

The Board's 2010 rule amended Regulation Z to generally prohibit compensation based on a transaction's terms. The CFPB's Final Rule further amends Regulation Z by implementing Section 1403 of the Dodd-Frank Act, which created Section 129B(c) of TILA.[16] This new provision produces an important distinction between the two rules: under the CFPB's Final Rule, compensation restrictions apply to *all* residential mortgage loans, whereas under the Board's 2010 rule the restrictions apply only to compensation arising from transactions in which any person other than the consumer pays the loan originator. The CFPB's Final Rule, unlike the Board's rule, provides no exception for loan originators when receiving compensation directly from the consumer. Additionally, the CFPB has further clarified the components of the ban, including the method for determining its application to compensation based on a "proxy" for a term of the transaction.

A "term" of a transaction is defined as "any right or obligation of the parties to a credit transaction."[17] Several methods of compensation are, however, deemed not to be based on a transaction's terms and are therefore permissible. For example, compensation paid directly to a loan originator by a consumer is not barred simply because that compensation is itself a term of the transaction. Additionally, compensation in the form of a fixed percentage of the amount of credit extended is permitted, as is compensation based on a loan originator's overall dollar volume across a number of credit transactions. The Final Rule also clarifies what constitutes a "proxy" for a term or factor of a transaction by providing a two-prong methodology. A term or factor will be a "proxy" if (1) it consistently varies with a factor or term over a significant number of transactions, and (2) the loan originator has the ability to manipulate (*e.g.*, add, remove, or change) the factor.

The CFPB provided a number of additional clarifications regarding the application of these prohibitions after receiving significant inquiry from commenters.

First, as briefly mentioned above, the Final Rule sets out a number of illustrative examples of compensation that is not based on the terms of a transaction and is also not subject to proxy analysis.[18]

Second, the CFPB noted that the Final Rule applies to compensation that is directly or indirectly based on the terms of a single transaction from a single loan originator, the terms of multiple transactions from a single loan originator, and the terms of multiple transactions from multiple loan originators. Thus, with certain exceptions, compensation based on profits derived from mortgage-related business would be subject to the Final Rule. For example, the Final Rule permits contributions paid to, and benefits derived from, designated tax-advantaged plans, provided that such contributions are not based on the terms of the individual loan originator's transactions.[19] Additionally, compensation under a non-deferred profits-based compensation plan is permitted if the compensation paid does not exceed 10 percent of the loan originator's "total compensation" *or* if the loan originator served in that role for ten or fewer transactions during the twelve-month period preceding the date in which compensation is determined.[20]

Third, the Final Rule extends Regulation Z's prohibition on compensation in connection with a pricing concession, which is generally a reduction in compensation based on a change in a transaction's terms, out of a concern that the practice could lead to increased originator compensation in connection with higher interest-rate loans. The Final Rule, however, provides an exception for circumstances in which a pricing concession is offered to defray unexpected increases in settlement costs.

Prohibition Against Dual Compensation

Regulation Z contains a prohibition on "dual compensation." Specifically, it bars loan originators from receiving compensation in connection with a transaction from both the consumer and another person, typically a creditor. The Final Rule generally preserves this prohibition.[21] However, under current regulations, if a loan originator receives direct payment from a consumer, that person is prohibited from receiving any form of payment from another person, such as a commission from a creditor. Commenters contended this prohibition was economically infeasible because of the practical challenges associated with paying individual loan originators a salary or an hourly wage. In an effort to create flexibility for both loan originators and consumers, the CFPB responded in the Final Rule by permitting a loan originator organization to compensate an individual loan originator (*e.g.*, offer a commission) provided that neither party's compensation is based on the terms of the underlying transaction. In addition, the Final Rule contains guidance on circumstances in which payments by a consumer are not deemed to be "compensation received directly from a consumer" for purposes of the rule.[22]

Waiver of Prohibition on Consumer Payment of Upfront Points and Fees

A component of the TILA provision underlying the ban on dual compensation permits a loan originator to receive "an origination fee or charge" from a person other than the consumer on the condition that the loan originator does not receive any compensation directly from the consumer and the consumer does not make an upfront payment of discount points, origination points, or fees.[23] However, TILA, as amended by the Dodd-Frank Act, also authorizes the CFPB to waive or create exceptions from the statutory prohibition on the payment of upfront points and fees when doing so "is in the interest of consumers and in the public interest."[24] Under this authority, and in response to a wide variety of criticism from commenters, the CFPB decided in its Final Rule to adopt a complete exemption to the statutory ban on consumer payment of upfront points and fees.

The CFPB initially proposed a partial exemption to the above statutory prohibition[25] out of concern that implementation of the ban would (a) produce higher mortgage interest rates as a result of creditors' inability to recover significant origination costs through consumer payment of points and fees, and (b) limit the range of pricing options available to consumers, ultimately curtailing access to credit. The CFPB determined, however, that its proposed alternative to the statutory ban suffered from design flaws and its operation and effectiveness was uncertain. Accordingly, the Final Rule notes that the CFPB intends to further study the issue and conduct consumer testing to determine the full effect of the complete exemption and whether additional action might be warranted.[26]

Prohibition on Steering; Loan Originator Qualification and Identifier Requirements

Regulation Z currently prohibits loan originators from "steering," or directing a consumer to execute a transaction based on the fact that doing so will result in higher compensation for the originator as paid by the creditor. Current regulations also provide a safe harbor for the loan originator if certain "loan options" are presented to the consumer. The Final Rule provides additional guidance on a loan originator's qualification for the safe harbor. Specifically, for each type of transaction in which the consumer has expressed interest, the loan originator must present the consumer with loan options for which the loan originator has a good faith belief that the consumer is likely to qualify. Those options include:

(1) the loan with the lowest interest rate;

(2) the loan with the lowest interest rate without negative amortization, a prepayment penalty, interest-only payments, a balloon payment in the first seven years of the life of the loan, a demand feature, shared equity, or shared appreciation; and

(3) the loan with the lowest total dollar amount of discount points or origination points or fees.

The Final Rule also contains a number of non-compensation-oriented requirements pursuant to the Dodd-Frank Act[27] that require mortgage originators to be "qualified" and appropriately licensed and registered.[28] Accordingly, under the Final Rule, loan originator organizations must comply with existing state and federal law, particularly with respect to requirements for legal existence and those that authorize the organization to transact business in a state. Additionally, loan originator organizations and all those employed by the organization (including independent contractors) must comply with the licensing, registration, and other regulatory provisions of the Secure and Fair Enforcement for Mortgage Licensing Act ("SAFE Act").[29] For employees not required to be licensed and registered under the SAFE Act or associated state implementing laws,[30] the Final Rule requires employing loan originator organizations to obtain a state and national criminal background check, a credit report, and information from the National Mortgage Licensing System and Registry ("NMLSR") regarding any administrative, civil, or criminal findings by any government agency involving those employees. Furthermore, the Final Rule establishes standards for review of the information obtained by loan originators for purposes of determining whether an employee is qualified in the same manner as a SAFE Act-compliant loan originator. These standards are generally consistent with those that apply when SAFE Act-covered employees apply for a license. The Final Rule also requires periodic training to ensure that non-SAFE Act employees possess sufficient knowledge and skill, as well as an understanding of the legal requirements that apply to the individual's loan origination activities.

Finally, loan originators that are primarily responsible for the origination of a loan are required under the Final Rule to include both their NMLSR identification numbers and their names on all loan documents to facilitate consumers in their evaluation of the risks associated with transacting with the loan originator.

Prohibition on Mandatory Arbitration Clauses and Single Premium Credit Insurance

The Dodd-Frank Act amended TILA to add Section 129C(e)(1), which prohibits consumer credit transactions secured by a dwelling from containing terms that mandate arbitration as the prescribed method of dispute resolution, and further provides that no agreement related to the transaction may be applied to bar a consumer from seeking judicial relief in connection with a violation of federal law.[31] The Final Rule implements this statutory prohibition. The CFPB was careful to note that neither the statute nor the rule is interpreted to ban all settlement agreements. Rather, a consumer and a creditor are permitted to agree to settle a dispute or claim, provided that the settlement agreement does not bar the consumer from pursuing a judicial remedy for any subsequent disputes that arise if he or she chooses to do so.

Under Section 129C(d) of TILA, created pursuant to Section 1414 of the Dodd-Frank Act, creditors are prohibited from financing any premiums or fees for credit insurance in connection with a closed-end consumer credit transaction secured by a dwelling. This prohibition does not apply to credit insurance[32] for which premiums are calculated and paid in full on a monthly basis. As stated above, the prohibition on mandatory arbitration clauses became effective June 1, 2013. The CFPB originally intended for restrictions on the financing of credit insurance premiums to become effective on the same date, but it delayed the effective date of this provision to January 10, 2014 to further consider its applicability to transactions other than those in which a lump-sum premium is added to a loan amount at closing and to provide the mortgage industry with sufficient time to comply with any clarifications.

Recordkeeping and Miscellaneous Provisions

Regulation Z currently requires that creditors maintain evidence of compliance with the regulation and sets out standards for doing so. However, certain provisions of the Dodd-Frank Act imposed statutory changes[33] that prompted the CFPB to expand upon these recordkeeping requirements in its Final Rule for purposes of achieving consistency with the statutory law. Therefore, the Final Rule extends the length of the recordkeeping requirement under Regulation Z and mandates that creditors and loan originators maintain evidence of compliance for three years after the date of payment. The Final Rule applies to both creditors and loan originator organizations, while individual loan originators are excluded from compliance. The Final Rule also provides guidance on the substantive elements of its recordkeeping requirements.[34]

CONCLUSION

The CFPB's Final Rule implements a number of statutory requirements that build upon the existing regulation of mortgage loan originators' compensation and business practices. The Final Rule will impact the operations of creditors, loan originator organizations, and individual loan originators in a variety of ways, including training, registration, licensing, the structuring of compensation and benefit plans, as well as other aspects of the loan origination process, such as recordkeeping. Creditors, individual loan originators, loan originator organizations, and those employed by or under contract with loan originator organizations should carefully review the Final Rule's requirements and, when applicable, its exceptions, and should start making the necessary modifications to policies, procedures, and systems to implement appropriate changes.

NOTES

[1] Loan Originator Compensation Requirements Under the Truth-in-Lending Act (Regulation Z), Final Rule, 78 Fed. Reg. 11,280 (Feb. 15, 2013) (to be codified at 12 C.F.R. Part 1026).

[2] 12 C.F.R. § 1026, *et seq.* (2013).

[3] As noted by the CFPB, a number of other compensation structures also exist. For example, some loan officers are paid a salary plus a bonus, which is based on overall loan volume. *See* Final Rule at 11,286.

[4] This form of compensation is commonly referred to as a "yield spread premium" (YSP). While interpretations and use of the YSP vary, a YSP loan's interest rate is traditionally greater than the market rate that the consumer could otherwise obtain. The difference between interest payments is then either shared with the consumer to defray a portion of his or her closing costs or retained by the loan originator as additional compensation.

[5] The CFPB has recently implemented other mortgage-related provisions of Title XIV of the Dodd-Frank Act by finalizing rules that impose new requirements on lenders (when assessing a consumer's ability to repay a mortgage loan) and on mortgage servicers (when providing information to consumers about their loans).

[6] Truth in Lending, Final Rule, 75 Fed. Reg. 58,509 (Sep. 24, 2010) (codified at 12 C.F.R. Part 226) (subsequently transferred to the CFPB's jurisdiction and codified at 12 C.F.R. Part 1026). The Board also issued a series of disclosure regulations aimed at informing consumers about loan originator compensation practices under authority granted by the Real Estate Settlement Procedures Act of 1974, 12 U.S.C. § 2601, *et seq.* (2012).

[7] Dodd-Frank Act §§ 1401-03, 1414; 15 U.S.C. § 1602, *et seq.* (2012).

[8] Truth-in-Lending Act (Regulation Z), Loan Originator Compensation, Proposed Rule, 77 Fed. Reg. 55,272 (Sep. 7, 2012) (Proposed Rule).

[9] 12 C.F.R. § 1026.36(i) (2013). On May 29, 2013, the CFPB issued an amendment to the Final Rule which finalized the new effective date of the provision as January 10, 2014. The CFPB has indicated that the delay will provide time to further consider the application of the provision and for covered individuals and entities to comply

with any clarifications.

[10] Final Rule at 11,298.

[11] Creditors are generally excluded from the term "mortgage originator" under Section 103(cc)(2)(F) of TILA (amended by Section 1401 of the Dodd-Frank Act). However, the exclusion does not apply to creditors that make use of "table funding," which occurs when a creditor does not supply the funds for the credit transaction out of its own resources, but rather from an existing line of credit or from deposits. *See id.* at 11,415 (comment 36(a)-1.ii). Moreover, under the Final Rule, all creditors that engage in loan origination activities will be defined as "loan originators," which reflects the broader definition of the term in the Final Rule as compared to the statutory definition of "mortgage originator."

[12] Seller financers have not traditionally been defined as "creditors" under Regulation Z. Congress, under Section 1401 of the Dodd-Frank Act, and the CFPB, under its Final Rule, generally preserve this definition, but with conditions. A seller financer is excluded from the definition of "loan originator" if the person finances three or fewer properties in any twelve month period, does not construct a residence on the property, and provides fully amortizing financing based on a good faith determination that the consumer has a reasonable ability to repay the loan. *See* 12 C.F.R. § 1026.36(a)(4) (2013). Similar conditions for seller financers of a single property are set forth in 12 C.F.R. § 1026.36(a)(5) (2013).

[13] For example, collecting certain information from the consumer for submission to a creditor would fall within the scope of activities of a covered "loan originator."

[14] Commenters suggested, for example, that the CFPB exclude prime, traditional, and government credit products as well as those developed by housing finance agencies from the scope of the regulations.

[15] 12 C.F.R. § 1026.36(b) (2013).

[16] Under Section 129B(c)(1) of TILA, "[f]or any residential mortgage loan, no mortgage originator shall receive from any person and no person shall pay to a mortgage originator, directly or indirectly, compensation that varies based on the terms of the loan (other than the amount of the principal)." Dodd-Frank Act § 1403, 15 U.S.C. § 1639b(c)(1) (2012).

[17] 12 C.F.R. § 1026.36(d)(1)(ii) (2013). The CFPB noted that it believes that Congress intended the term "credit transaction" to fall within the statutory definition of "residential mortgage loan" under TILA, as amended. *See* Final Rule at 11,322.

[18] Permissible methods of compensation include, for example, an hourly wage paid for actual hours worked and compensation based on the long-term performance of the originator's loans.

[19] These conditions may vary in practice. For example, contributions to a defined contribution plan or benefits from a defined benefit plan are permitted *even if* such

contributions are directly or indirectly based on the terms of *multiple* transactions from *multiple* loan originators.

[20] Commenters expressed concern over the methods proposed by the CFPB for determining circumstances in which a profits-based compensation plan creates a substantial risk of "steering." The CFPB proposed doing so through a "revenue test" and subsequently considered a "profitability test" before rejecting those methods and adopting a "total compensation" test in the Final Rule. "Total compensation" includes the sum of all reportable wages and tips and all contributions to accounts in designated tax-advantaged plans. *See id.* at 11,420-21 (comment 36(d)(1)-3.v.A).

[21] "No loan originator shall receive compensation, directly or indirectly, from any person other than the consumer in connection with the transaction; and [n]o person who knows or has reason to know of the consumer-paid compensation…shall pay any compensation to the loan originator…." 12 C.F.R. § 1026.36(d)(2)(i)(A)(1)-(2) (2013).

[22] For example, payments received by a loan originator resulting from increased interest rates are not considered to be compensation received directly from the consumer.

[23] Discount points are payments made by the consumer to the loan originator for the purpose of obtaining a lower interest rate. Origination points or fees are typically presented to the consumer as charges associated with applying for a loan and can come in a variety of forms.

[24] Dodd-Frank Act § 1100A, 15 U.S.C. § 1601, *et seq.* (2012).

[25] Proposed Section 1026.36(d)(2)(ii) would have required that before a creditor or loan originator could impose upfront points or fees on a consumer, the creditor must have made available to the consumer a comparable alternative loan with no upfront points and fees.

[26] Specifically, the CFPB stated in the preamble to the Final Rule that it is concerned about consumers' understanding of the trade-off between the payment of upfront points and fees and the interest rate associated with the transaction.

[27] *See* Dodd-Frank Act § 1402(a)(2), 15 U.S.C. § 1639b (2012).

[28] In addition to expressly imposing registration and licensing requirements, TILA § 129B(b)(1)(A) authorizes the CFPB to issue regulations that help ensure that mortgage originators are "qualified," which is a term of art to be interpreted by the CFPB.

[29] Pub. L. No. 110-289, 122 Stat. 2810 (codified at 12 U.S.C. § 1501, *et seq.* (2012)).

[30] For example, SAFE Act requirements do not apply to loan originators who are employees of "*bona fide*" non-profit organizations.

[31] *See* Dodd-Frank Act § 1414, 15 U.S.C. § 1639 (2012).

[32] "Credit insurance" includes credit life, credit disability, credit unemployment,

or credit property insurance as well as other payments used for debt cancellation, suspension agreements, or for contract purposes. *See* 12 C.F.R. § 1026.36(i)(2)(i) (2013).

[33] *See* Dodd-Frank Act § 1416(b), 15 U.S.C. § 1640(e) (2012) (providing for a three-year limitations period for civil actions arising under TILA).

[34] For example, records are sufficient if they demonstrate "the nature and amount of the compensation; that the compensation was paid, and by whom; that the compensation was received, and by whom; and when the payment and receipt of compensation occurred." Final Rule at 11,414 (comment 25(c)(2)-1.i).