

FEDERAL RESERVE AMENDS RULES REGARDING ORIGINATOR COMPENSATION

The Federal Reserve has adopted regulations which prohibit payment to loan originators based on the terms or conditions of the transaction, other than the amount of credit extended. 12 C.F.R. 226.36(d)(1). The rules apply to closed-end consumer credit transactions secured by a dwelling, regardless of price or lien position. For purposes of this regulation, a loan originator is defined by 12 CFR 226.36(a) as “a person, who for compensation or other monetary gain, or in the expectation of compensation or other monetary gain, arranges, negotiates, or otherwise obtains an extension of consumer credit for another person.” This includes an employee of a creditor, such as a depository or a mortgage banker, an employee of a broker, and a mortgage brokerage company. It also includes lenders who table fund in a particular transaction.

A. Loan Originator Compensation

The rule prohibits compensation to a loan originator for a transaction based on the interest rate, annual percentage rate, loan to value ratio, or the existence of a prepayment penalty. Similarly, if a creditor pays a loan originator more for a loan originated to a borrower with a lower fico score and a higher interest rate, than to a second borrower with a higher fico score and a lower interest rate, this will also be prohibited by the regulation. Such compensation is prohibited, whether it be as a commission, bonus, or in any other form.

However, compensation based on the amount of credit extended or on the following factors is permissible:

1. The loan originator’s overall loan volume, whether it be dollar amount of credit extended or total number of loans originated;
2. The long term performance of the loans originated;
3. Whether the customer is an existing customer or a new customer;
4. A fixed payment for each loan originated;
5. The percentage of applications that result in consummated transactions;
6. The quality of the loan originator’s loan files submitted to the creditor; and
7. A legitimate business expense, such as fixed overhead costs.

The regulation does not prevent a creditor from offering a higher interest rate in a transaction as a means for the consumer to finance the loan originator’s compensation, or based on the creditor’s assessment of the credit and other risks involved.

The regulation also provides that, if a loan originator receives compensation directly from a consumer in a consumer credit transaction secured by a dwelling, (a) the loan originator may not receive compensation from any person other than the consumer in that transaction; and (b) no person who has reason to know of the consumer paid compensation to the loan originator shall pay any compensation to the loan originator. 12 C.F.R. 226.36(d)(2).

Therefore, if the borrower pays points to the lender and the lender compensates the broker, the broker may not also receive compensation directly from the consumer. Compensation includes amounts retained by the broker, but does not include the amounts the broker receives as payment for bona fide and reasonable third charges, such as title insurance or appraisals. It appears from the Commentary that application fees paid to the broker, as permitted in states such as New Jersey, to reimburse the broker for the cost of third party charges, are not deemed to be compensation paid directly from the consumer so long as the application fee is a bona fide estimate of the third party charges. Accordingly, a broker could receive an application fee to reimburse the broker for third party charges, and also receive a fee from the lender.

B. Prohibition Against Steering.

The regulation also provides that a loan originator may not direct or “steer” a consumer to a particular loan based on the fact that the originator will receive greater compensation from the creditor in that transaction than in other transactions the originator offered or could have offered to the consumer, unless it is in the consumer’s interest. The rule once again applies to consumer credit transactions secured by a dwelling, regardless of the lien position. 12 C.F.R. 226.36(e)(1). A transaction is not in violation if the consumer is presented with loan options for each type of transaction in which the consumer has expressed an interest. By “type of transaction,” the rule is referring to (i) a fixed rate loan; (ii) a variable rate loan; and (iii) a reverse mortgage loan.

To satisfy this safe harbor, the loan originator must obtain loan options from a significant number of the creditors (usually three or more) with which the originator regularly does business. For each type of transaction in which the consumer expressed an interest, the loan originator must present the consumer with loan options that include (a) the loan with the lowest interest rate; (b) 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 loan, a demand feature, shared equity or appreciation or, in the case of a reverse mortgage loan, a loan without a prepayment penalty or shared equity or appreciation; and (c) the loan with the lowest total dollar amount for origination points or fees and discount points.

The regulations become effective on April 1, 2011. Prior to such effective date, virtually all mortgage lenders and brokers will need to amend their loan officer employment agreements, and all wholesale lenders will need to amend their brokerage agreements consistent with these new rules.