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MEMORANDUM

TO: Clients and Friends of the Firm

FROM: J. Alton Alsup

DATE: September 24, 2010

SUBJECT: New Fed Rule Adopted to Regulate Compensation Practices of Mortgage Brokers and Other Home Loan Originators, including the Payment by Creditors of "Yield Spread Premiums," Effective April 1, 2011.

The Federal Reserve Board has amended Regulation Z §226.36 (Truth in Lending) to regulate compensation paid to mortgage brokers, loan officers and other loan originators for the stated purpose of protecting consumers from unfair or abusive compensation practices, including the common industry practice of paying so-called "yield spread premiums" to mortgage brokers based on the loan's interest rate. The Fed's Interim Final Rule was published in the Federal Register on September 24, 2010 and can be found at 75 F.R. 55809 – 58538. This memorandum outlines the new rule in what is hoped to be an easily understood Q & A format.

Q. When is the new rule effective?

A. The new rule applies to covered loans for which the creditor receives an application on or after April 1, 2011.

Q. What loans are covered by the new rule?

A. The rule applies to all closed-end, first- and subordinate-lien transactions secured by a dwelling (including closed-end reverse mortgages) that are subject to the Truth in Lending Act, which would include all traditional home mortgages. The rule does not apply to open-end home equity lines of credit (HELOCs) or time share loan transactions.

Q. Who is subject to the new rule?

A. The new rule applies to all *loan originators* of home mortgage loans covered by the rule, which term is defined to include mortgage brokers and loan officers employed by mortgage brokers, mortgage bankers, and financial institutions who for compensation arrange, negotiate, or otherwise obtain a consumer loan for another person. Managers, administrative staff, and other employees of such loan originators who do not engage in these activities (and whose compensation is not based on whether any particular loan is originated) are not considered loan originators. *Mortgage broker* for purposes of the rule means any loan originator that is not an employee of the creditor.

The rule also applies to creditors who close transactions that are *table funded* (i.e., closings where the creditor named as payee on the promissory note does not actually fund the loan from its own resources or a bona fide warehouse line of credit for which it is obligated, but instead obtains funding by another party who is immediately assigned the loan.) However, creditors that originate loans closed in their own names and with their own source of funds are not loan originators subject to the rule. Loan servicers are not loan originators subject to the rule when modifying an existing loan on behalf of the current holder of the loan (so long as the modification does not constitute a *refinancing* in which the original obligation is satisfied or extinguished and replaced by a new obligation).

Q. In a nutshell, what does the new rule cover?

A. The new rule essentially prohibits three compensation practices:

- *Compensation Based on Loan Terms.* The new rule prohibits paying compensation to loan originators based on any terms and conditions of the loan transaction *other than the loan amount*. This has the effect of prohibiting creditors from paying so-called *yield-spread premiums* (YSP) to mortgage brokers (i.e., compensation based on the interest rate) although paying a fee based upon a fixed percentage of the loan amount is authorized. C*ompensation* for purposes of the rule includes all amounts paid to and retained by the mortgage broker or other loan originator from salaries, commissions, annual or periodic bonuses, incentive compensation, and awards of merchandise, services, trips, or similar prizes.

- *Receiving Compensation from Both the Creditor and Consumer.* The rule further prohibits a mortgage broker or other loan originator from directly receiving compensation from both the creditor (or any other person) and the consumer in the same loan transaction. That is to say, if any loan originator receives compensation directly from a consumer in a loan transaction, neither the creditor nor any other person may provide any compensation to the loan originator, directly or indirectly, in connection with that same loan transaction. (This would prohibit, for example, a mortgage broker from collecting a 1% origination fee from the borrower at closing and additionally receiving any compensation from the creditor that funds the loan.)

- *Steering Consumer to Loan Not in Consumer's Interest for Greater Compensation.* The new rule prohibits loan originators from *steering* consumers to consummate a loan *not in their interest* when the loan originator will receive greater compensation from the creditor for the loan than for other loan transactions that the loan originator offered or could have offered the consumer. (But a "safe harbor" procedure is set out in the rule that loan originators can rely upon to avoid a violation of the anti-steering prohibition.)

Q. If mortgage brokers can no longer base compensation for their services on the loan's interest rate, on what basis may mortgage brokers charge compensation under the rule?

A. Mortgage brokers may base their total compensation for origination services on a fixed percentage of the loan amount (which percentage must be fixed and must not be stepped or otherwise vary with the amount of credit extended). Although the percentage must be fixed, percentage compensation may be made subject to a minimum and/or a maximum dollar amount (as long as the minimum and maximum dollar amounts do not vary with each loan transaction).

For example, a mortgage broker could fix compensation at 2.5% of the principal loan amount, but not less than $1,500 nor more than $5,000. Under this example, for a $100,000 loan, compensation would be fixed at $2,500. For a $50,000 loan, compensation would be fixed at the minimum $1,500 fee. For a $250,000 loan, compensation would be fixed at the maximum $5,000 fee. However, the rule does not limit the dollar amount of compensation a mortgage broker may charge or require that the mortgage broker's compensation be made subject to a minimum or maximum dollar amount.

Examples of other permissible bases for creditor compensation to mortgage brokers include flat fees expressed as a dollar amount for every loan arranged for the creditor, a flat fee that varies based on the total volume of loans delivered to the creditor, the quality of loan files (e.g., file accuracy and completeness of loan documentation), the quality of loans (based upon their long-term performance), the percentage of loan applications registered with the creditor that result in consummated loans, and an hourly rate to compensate the loan originator for actual hours worked. (Caution: Volume-based compensation may be considered by HUD to be a violation of RESPA, Section 8, prohibiting referral fees and kick-backs, to the extent that such compensation exceeds the reasonable value of services actually performed.)

Q. Does the new rule prohibiting payment of compensation to mortgage brokers based on the interest rate mean the end of financing the payment of mortgage brokers' compensation through the charging of a higher interest rate?

A. No, the rule does not limit the creditor's ability to offer the consumer a higher interest rate in a loan transaction as a means for the consumer to finance the payment of mortgage broker compensation and other transaction costs that the consumer would otherwise be required to pay directly. In such 'no cost' or 'low cost' loans, the creditor may agree to pay any such costs for which the consumer is otherwise obligated to pay in exchange for the consumer agreeing to pay a higher interest rate that allows the creditor to recoup those costs over time. If a consumer is cash-strapped and can only pay one-half of the transaction costs directly at closing, the creditor, for example, may quote a 6% annual interest rate (i.e., 'low cost'), but if the consumer elects to pay none of the transaction costs (i.e., 'no cost') the creditor may charge a 6 ½ % rate. Payments to a mortgage broker and other settlement service providers derived from an increased interest rate in this fashion is not regarded as compensation received *directly* from the consumer. (Note, however, that when mortgage broker fees and charges are rolled into the principal loan amount and disbursed from loan proceeds at closing, the disbursements are considered to be broker compensation received *directly* from the consumer.)

Q. Does the new rule prohibiting both the creditor and the consumer from directly paying compensation to a mortgage broker in the same loan transaction mean that mortgage brokers may no longer charge consumers a loan application fee to cover the front-end costs of an appraisal and a credit report?

A. No, mortgage brokers may still charge fees to the consumer that are passed through to third-party service providers without precluding payment of compensation by the creditor. *Compensation* for purposes of the rule is defined to mean amounts that the mortgage broker actually *retains* (regardless of the name or label given a fee or charge), and does not include amounts the mortgage broker receives and passes through as payment for *bona fide* and reasonable third-party charges. For example, if the mortgage broker charges a $400 application fee and uses that amount to pay $350 for a property appraisal and $50 for a credit report, the application fee does not count as compensation directly paid to the mortgage broker for purposes of the rule. However, if the mortgage broker deliberately marks-up such a third-party fee and retains the difference, the amount retained does count as direct compensation under the rule. (Caution: Marking up third-party fees, sometimes called "up-charging," may be considered by HUD to be violation of RESPA, Section 8, if no additional, necessary, and non-duplicative service has been performed to justify the additional charge.) However, if the mortgage broker is uncertain of the cost of what a third-party charge will be at the time the $400 application fee is charged, such as when the mortgage broker may choose from a list of appraisers that usually charge in a range of $300 – $400 for a typical appraisal, and later the appraisal fee is determined to come in at $300 (i.e., $50 less than expected), the mortgage broker in that case may retain the $50 without it being deemed direct compensation paid by the consumer for purposes of the rule.

Q. What is the new anti-steering rule and how can a loan originator avoid violating it?

A. The anti-steering rule prohibits a mortgage broker or other loan originator from directing or *steering* a consumer to consummate a particular home mortgage loan in order to receive greater compensation from the creditor than the loan originator would have received for other loans that the loan originator offered or could have offered to the consumer unless the consummated loan is *in the consumer's interest*. "Steering" for this purpose means advising, counseling, or otherwise influencing a consumer to accept and consummate a particular loan transaction. To constitute steering, the consumer must actually consummate the loan transaction.

However, a *safe harbor* procedure is set out in the rule, which if followed protects the mortgage broker from a claim of violation of the anti-steering rule for any consummated loan transaction if the loan originator has first presented the consumer with certain other loan options to choose from for each type of transaction (i.e., fixed-rate, ARM, or reverse mortgage) in which the consumer has expressed an interest. However, no presumption of a violation arises simply if a mortgage broker fails to follow the safe harbor procedures.

To satisfy the safe harbor requirements, the loan originator must obtain loan options from a *significant number* of the creditors with which the loan originator regularly does business, and must present the consumer with loan options for each type of loan in which the consumer has expressed an interest (and for which the loan originator in good faith believes the consumer likely would qualify). A *significant number* for this purpose means three, or more, but if the loan originator regularly does business with fewer than three creditors, the loan originator is deemed to comply with this requirement by presenting loan options from *all* the creditors with which it regularly does business if the loan options otherwise satisfy the safe harbor criteria. The loan originator is not required to establish any new business relationships with creditors to satisfy this condition. If the loan originator presents four or more loan options to the consumer, the loans that satisfy the safe harbor criteria must be highlighted.

For each type of loan transaction in which the consumer has expressed interest, the loan originator must present the consumer with options that include the following:

- the loan with the lowest interest rate available;

- the loan with the lowest interest rate without risky features such as negative amortization, a prepayment penalty, interest-only payments, a balloon payment in the first seven years of the loan term, a demand feature, shared equity or shared appreciation features; or, in the case of a reverse mortgage, a loan without a prepayment penalty or shared equity or shared appreciation; and
- the loan with the lowest total dollar amount charged for origination points or fees and discount points.

To determine whether a consummated transaction is *in the consumer's interest*, the consummated transaction must be compared to other possible loan offers for which the consumer likely would qualify that are available through the creditors with which the loan originator regularly does business. The loan options do not have to be offers actually extended by the creditors; they need only be offers the creditor would likely extend upon duly receiving an application from the consumer based on the creditors' current credit standards and current rate sheet. The loan originator is not required to inform the consumer about any loan options for which the loan originator has in good faith determined the consumer is unlikely to qualify. ◊