LBA
Legal Bulletin

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Mortgage Loan Originator Compensation Limitations a Problem for Many Banks

The Federal Reserve, during the past year, amended the regulation addressing mortgage loan originator ("MLO") compensation. This was discussed at the recent FDIC-sponsored Directors Conference held earlier this month in Lafayette, and I thought it would be helpful to share this information for the benefit of those who did not attend the Conference. In addition, it is the time of year when bonuses and 401k profit sharing distributions are paid and this regulation impacts how a bank is able to pay bonuses and profit-sharing to MLO's. The applicable regulation amended was Regulation Z, 12 CFR 226.36, which addresses how a bank may compensate its MLO's. Section 226.36(d)(1)(i) provides that, "[i]n connection with a consumer credit transaction secured by a dwelling, no loan originator shall receive and no person shall pay to a loan originator, directly or indirectly, compensation in an amount that is based on any of the transaction's terms or conditions." The regulation goes on to clarify that the amount of credit extended is not deemed to be a transaction term or condition, provided compensation received by or paid to a loan originator, directly or indirectly, is based on a fixed percentage of the amount of credit extended; however, such compensation may be subject to a minimum or maximum dollar amount. 12 CFR 226.36(d)(1)(ii). According to the corresponding Staff Commentary, 36(d)(1)-1, the term "compensation" includes salaries, commissions, and any financial or similar incentive provided to a loan originator that is based on any of the terms or conditions of the loan originator's transactions. Examples given for what the term "compensation" includes are given in the Staff Commentary as well. The examples given are: an annual or other periodic bonus; or awards of merchandise, services, trips, or similar prizes.

The regulation seems to focus on restricting MLO compensation based on a transaction's "terms or conditions." The Staff Commentary gives examples of compensation that is based on transaction terms or conditions, which would be prohibited. Specifically, Staff Commentary 36(d)(1)-2, explains that the rule prohibits compensation to a MLO for a transaction based on that transaction's interest rate, annual percentage rate, loan-to-value ratio, or the existence of a prepayment penalty. It is further explained that the rule prohibits compensation based on a factor that is a proxy for a transaction's terms or conditions. An example given is as follows: If the creditor pays the loan originator $1,500 in compensation for consumer A's loan and $1,000 in compensation for consumer B's loan because the creditor varies compensation payments in whole or in part with a consumer's credit score, the originator's compensation would be based on the transactions' terms or conditions.

The question that many lenders are asking is, "What is an example of compensation that is not based on transaction terms or conditions," which would be permissible. Staff Commentary provides some illustrative examples, and points out that the list is not an exhaustive list. Compensation is not based on the transaction's terms or conditions if it is based on, for example: the loan originator's overall loan volume delivered to the creditor; the long-term performance of the originator's loans; an hourly rate of pay to compensate the originator for the actual number of hours worked; whether the consumer is an existing customer of the creditor or a new customer; a payment that is fixed in advance for every loan the originator arranges for the creditor; the percentage of applications submitted by the loan originator to the creditor that result in

consummated transactions; the quality of the loan originator's loan files submitted to the creditor; a legitimate business expense, such as fixed overhead costs; or compensation that is based on the amount of credit extended, as permitted by Section 226.36(d)(1)(ii).

The list of examples of permitted MLO compensation may not cover all situations contemplated by lenders. As we approach the end of the year many banks are preparing to pay bonuses and to distribute 401k profit sharing to employees and are searching for answers on how they are able to pay MLO's. The rule and the Staff Commentary don't clearly address these issues. One bank has asked whether it can pay bonuses to all of its employees, including its MLO's, where the bonuses would be based on a percentage of the each employee's salary and where the bonus is because of the overall profitability of the bank for the year. This scenario does not seem to be clearly covered by the Staff Commentary examples. FDIC staff attending the recent Directors Conference indicated that they would seek guidance from their Washington, D.C. office.

The LBA is working to obtain clarification on the issues of MLO compensation restrictions as it applies to bonuses and 401k profit sharing. We have communicated with FDIC representatives, with mortgage loan experts with the ABA and ICBA, and with Washington, D.C. legal counsel. Regional representatives of the FDIC have offered to provide us with a contact in their Washington, D.C. office so that we may be able to speak directly with FDIC staff who is working on guidance. While the FDIC is the primary regulator for many banks in Louisiana and will determine how it will interpret the rule as to the banks it regulates, the July 2011 transfer date under the Dodd-Frank Act caused Regulation Z, including Section 226.36, to be transferred from the authority of the Federal Reserve to the Consumer Financial Protection Bureau. The CFPB may have their own views on how the regulation should be interpreted, and accordingly, their interpretations could influence other regulators, including the FDIC.

We have asked ICBA's regulatory counsel, Elizabeth Eurgubian to inquire with her contacts at the CFPB about this issue. Ms. Eurgubian was able to discuss the issue with Catherine Henderson with the CFPB. Ms. Henderson provided some informal feedback relative to the MLO compensation rule. Ms. Henderson explained that a bank can pay a loan originator a bonus, but the bonus cannot in any way be based on profitability made from the bank's residential mortgage business. She further explained that, however, a bank could carve out what portion of the bonus pool is based on profitability from consumer mortgages, and give the loan originator the portion of the bonus not based on mortgage profitability. For example, Bob is a loan originator. His bank has a bonus pool, and 2% of this bonus pool is based on mortgage profits and 98% is based on non-mortgage-related profits. They can pay Bob his entire bonus minus funds from the 2%. So, Bob is eligible for 98% of his bonus. The bank, of course, would have to show and document that any bonus received was not based on consumer mortgage profitability, but other profitability of the bank. See the email by Elizabeth Eurgubian, ICBA VP and Regulatory Counsel, explaining her conversation with Ms. Henderson. We will continue to work on this issue and will report any new developments.

While the MLO compensation issue is giving many bankers heartburn, there are additional pending mortgage lending regulations that could potentially lead to greater difficulty for the industry. There are two pending regulations that have the potential to harm the industry. One of the proposed regulations is referred to QRM or Qualified Residential Mortgages regulation, which seeks to impose risk retention requirements on certain mortgage loans originated. The QRM regulation is a joint bank regulatory proposal. The second threat to mortgage lending is the proposed QM regulation, which could impose additional underwriting standards on residential mortgage lending. It is being promulgated by the CFPB. The proposed QM regulation may potentially require that lenders document the ability of a borrower to repay a loan and only offer a safe harbor if the loan product is a standard loan product, such as a thirty-year fixed mortgage. Our national banking associations are working diligently to try to shape these proposed regulations so that they do not harm our industry. We will continue to follow the status of these pending regulations and report any news on them to the industry. Let us all hope that such regulations such as these do not result in making it more difficult for Louisiana banks to make residential mortgage loans.

Note: The information contained in this LBA Legal Bulletin is not intended to constitute, and

should not be received as, legal advice. Please consult with your counsel for more detailed information applicable to your institution.

Louisiana Bankers Association / 5555 Bankers Avenue / Baton Rouge, LA 70808
(225) 387-3282 tel / (225) 343-3159 fax / info@lba.org