TILA's LO Compensation Rule:

A State Regulator Focused Discussion with Attorney Brian Levy

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AARMR Annual Meeting Breakout Session:

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3:45 pm-4:45 pm

LO COMP RULE PRESENTATION OUTLINE

- **Steering into subprime and NINA loans fuels “meltdown”**
- **Culture shock & confusion-2011 Rule**
- **DFA & CFPB’s 2014 Rule**
  - **“Safe” forms of compensation**
  - **What’s a “Proxy”?**
- **Proxy Rule applied to common issues**
  - **Refi vs. Purchase**
  - **Business Channel based variation**
  - **Discounts at point of sale and Adjustments due to LO error**
  - **Reductions for State Housing and CRA loans**
- **Common State Law Issues**
- **Q&A/Other common LO Comp issues**

WHY DO WE HAVE AN LO COMP RULE?

- Mortgage “meltdown” (2008) lead to banking crisis
- Politicians and public find blame everywhere leading to Dodd Frank Act (DFA) in 2010
- DFA key concerns:
  - Banks offering subprime, stated income and neg. am. products to borrowers without regard to ability to repay (leads to QM/ATR Rule);
  - Secondary market with no skin in the game (leads to QRM Rule);
  - Mtg. broker and loan officer incentives to “steer” consumers to more profitable loans, esp. subprime and other “risky” loans (LO Comp); and
  - Housing bubble-Unsustainable desire to increase US homeownership (fate of GSE’s still unknown)
- Even prior to DFA, however, Fed was accused of inaction on stemming steering concerns.

2011 FEDERAL RESERVE LO COMP RULE

- Prior to CFPB opening in July 2011, the Federal Reserve enforced TILA.
- Fed faced criticism for not acting sooner on many issues, but really only had limited authority on the steering concerns.
- Fed issued rulemaking (under TILA) effective spring of 2011 on LO Comp prohibiting compensation to mortgage originators based on terms of loans or "proxies" for such terms.
- Fed's Rule prohibited compensation based on profitability or overages, but left many questions on interpretation.
  - Exception made for loan volume-based commission
- DFA required additional LO Comp rulemaking under TILA by CFPB

CULTURE SHOCK & CONFUSION FOR MORTGAGE INDUSTRY

- Fed Rule was contrary to the sales culture in the mortgage business:
  - Actually, culture shock to be unable to pay based on profitability
  - LO's had been sharing in "overages" similar to auto sales
  - Yet, paying more for subprime was clearly "a bridge too far" when the massive defaults hit
    - Disproportionately impacted minorities and low mod income earners
    - Rule also serves fair lending goals
  - Still, I have said it "wildly swings an axe when a scalpel might have been more effective".
- Industry sought to find ways around Rule.
  - Point Banks (no averaging)
  - Paying for "workload"
- Lack of clarity around concept of "Proxy"
  - Type of loan? E.g., Bond loan or Jumbo
  - Does amount of work matter?
- Industry frustration with ability of salespeople to discount commissions at the point of sale-even for consumer friendly reasons

2014 CFPB LOAN ORIGINATOR COMPENSATION RULE

CFPB issued its own LO Comp rule under TILA effective 1/1/14, clarifying many of the questions left open in the Fed Rule and shutting the door on many of the ways used to work around it:

- Rejected the idea that you could pay based on the amount of "work" (still confuses some due to prior Fed Rule treatment);
- Flatly outlawed "point banks" (fair lending concerns predominate)
- Made record-keeping violations equal to substantive violations;
- Defined who is subject to the Rule, (i.e., who is an LO?) and leveled the playing field on LO training and qualifications with bank employees; *Note, LO Comp's definition of who is an LO is doesn't follow the SAFE Act and covers more activities than virtually any state licensing definition* (includes);
  - Anyone who gets paid referral fees for a loan* (if legal under RESPA);
  - Producing Managers (>10 loans/year)

**Some state regulators consider anyone who gets a referral fee subject to licensing in that state. Check statutes/regs to confirm interpretations*

2014 CFPB LOAN ORIGINATOR COMPENSATION RULE (cont.)

- Offered a clearer definition of what a "proxy" for a loan term is:
  - ***"Proxy" is something which varies with the terms and conditions of a loan, <u>and</u>***
  - ***The LO has the ability to influence that something;***
- Identified permissible forms of compensation and permitted some limited profit-based compensation (up to 10% of total comp);
- Expressly rejected some key industry concerns such as permitting variations in comp for (i) consumer discounts at the point of sale, (ii) state housing authority and similar CRA loans, and (iii) LO errors. (All subject of recent industry letter)

"SAFE" FORMS OF COMP IDENTIFIED IN CFPB LO COMP RULE

NON-EXCLUSIVE LIST OF "SAFE" FORMS OF LO COMP:

- Percentage based on loan amount-(Loan amount is not considered a "term of the loan")
- Fixed minimum and maximum comp.
- LO's overall unit or dollar volume (including tiered % based on volume)
- Long-term performance of LO's loans
- Hourly rate of pay for hours actually worked
- Existing v. new customer
- Payments fixed in advance
- Pull-through rate
- Quality of LO's loan files submitted to creditor

"SAFE" FORMS OF COMP IDENTIFIED IN CFPB LO COMP RULE (cont.)

- **Profit based comp through defined contribution plans and designated tax advantage plans**
  - Unlimited by LO Comp, but highly limited by Tax Code.
- **Up to 10% of total annual comp in the form profit based incentive (company wide or branch) so long as comp is not based on terms of individual LO's transactions and either**:
  - Comp does not, in the aggregate, exceed 10% of the individual LO's total comp (incl 10% bonus) for such time period.
- **Profit based payments to Non-Producing Managers.**
  - LO was a loan originator for 10 or fewer transactions during the 12-month period preceding the date comp is determined (FYI, that's the Non Producing Manager definition).

OTHER LO COMP VARIATIONS PERMITTED BY CFPB's 2014 Rule

- **Open End Loans like HELOCS**
  - Open end Reverse Mortgages
  - But, no "structuring" loans as open-end to get around LO Comp rule (or ATR)
- **Commercial/Investor Loans**
  - In particular, NOO-business purpose loans are not covered by TILA even if secured by residential property, e.g., NOO fix & flip buyers
- **Short term loans (<12 months)**
  - Construction loans
  - Bridge loans
- **Unsecured Loans**
- **Not a "Proxy"** e.g., geographic region-next slides

THE CFPB's "PROXY" RULE

A "proxy" is something which varies with the terms and conditions of a loan ***and***

The LO has the ability to influence that something

Next few slides we walk through the CFPB's proxy definition applied to specific examples

THE PROXY* RULE APPLIED

*A "proxy" is something which (i) varies with the terms and conditions of a loan and (ii) the LO has the ability to influence that something.

Refinance vs. Purchase?

A. Reasons why company might want to encourage/discourage refi's with LO incentives
B. Varies with terms-Yes (variation in commission will enable variation in rates/fees)
C. But, is it really possible to influence a consumer to buy vs. refi or vice-versa?
D. CFPB has verbally changed their position on this one-no official guidance
E. My conclusion **NOT A PROXY**

THE PROXY* RULE APPLIED

*A "proxy" is something which (i) varies with the terms and conditions of a loan and (ii) the LO has the ability to influence that something.

Company Generated vs. LO's Efforts?

A. Consumer direct/internet/unique business sources ("Business channel" variations)
B. Common to see lower commission rates for loans coming through a "house channel"
C. Big pricing variation between consumer direct/call center models (low touch) and LO on the "street" (high touch).
D. But, LO does not cause the loan to "come in the door" if handed to them by the Company
E. My conclusion **NOT A PROXY** (with proper recordkeeping)

THE PROXY* RULE APPLIED

*A "proxy" is something which (i) varies with the terms and conditions of a loan and (ii) the LO has the ability to influence that something.

Lowering commissions to cover Consumer Discounts or LO Errors

A. Example of real head scratcher caused by Proxy Rule
   1. Variation in terms to provide a discount is clearly controlled by LO
      i. They can't lower their own commission to lower cost to consumer
      ii. Company may discount, but not the salesperson
   2. Rule says the LO may only discount commission for *unforeseen/unforeseeable* errors (like a TRID C of C)
      i. If you should have seen it coming, you can't lower your commission to cover your mistake (e.g. extension fees)
      ii. Seems that is exactly when LO should be able to

B. PROXY (unless unforeseeable)

C. Industry Letter to CFPB asking for relief

THE PROXY* RULE APPLIED

*A "proxy" is something which (i) varies with the terms and conditions of a loan and (ii) the LO has the ability to influence that something.

State Housing Finance/Bond/CRA Loans

A. Typically revenues are capped at 1%
   1. LO commission % can exceed revenues earned
   2. Losing money on each deal disincents companies from offering these products
   3. Compare vs. FHA/VA

B. CFPB *assumes* LO influences product selection
   a. No variation in commission is permitted based on product-even if "steering" benefits consumer
   b. Some argue product selection can be out of the LO's control if the borrower only qualifies for a certain kind of loan (e.g., low downpayment requirements), only one available so can't steer?
   c. Comes up over and over, but no cure is available

C. PROXY

D. Industry Letter to CFPB asking for relief

COMMON STATE LAW ISSUES RELATED TO LO COMP

- Internal Referrals
  - Out of state loans transferred to other branch/originator licensed in state home is located
  - No RESPA issue if compensation paid by employer
  - Can be ok to vary LO Comp based on geographic region (e.g. out of market loans are paid at a flat rate)/Receiving LO gets a "house channel" loan
  - But, is there a licensing obligation simply for getting fee related to out of state loan? Some states take that position
- Deductions for uncollected fees on applications that don't close
  - Lenders may seek to reduce LO comp for uncollected fees (e.g. appraisal, credit reports)
  - Raises state employment law questions
  - Interesting question whether TILA to compensation adjustment unrelated to a closed loan.

OTHER COMMON LO COMP TOPICS FOR Q&A

- POINT BANKS
- BROKERED LOANS
- JUMBO'S & PORTFOLIO LOANS
- PRODUCING AND NON PRODUCING MANAGER COMPENSATION
  - LO was a loan originator for 10 or fewer transactions during the 12-month period preceding the date comp is determined (FYI, that's the Non Producing Manager definition
- USE OF THE 10% PROFIT BASED COMPENSATION CARVE OUT
- OTHER DEDUCTIONS SUCH AS FOR EPO OR EPD

THE PROXY* RULE APPLIED

*A "proxy" is something which (i) varies with the terms and conditions of a loan and (ii) the LO has the ability to influence that something.

Point Banks

A. Quintessential Proxy
B. Essentially company tracks the LO's pricing to consumers against par rates to give credits (or debits) for the LO to use in discounting or as compensation.
   i. Nothing wrong with tracking LO Profitability
   ii. Problem if you compensate based on profits
C. A "point bank" arises from how LO's price loans-
   i. Pricing is what the whole rule is about and definitely in LO's control to quote rates & fees
   ii. Also raises fair lending red flags
D. Common to all CFPB LO Comp enforcement actions:
   i. All 4 CFPB LO Comp Consent Orders were about "point banks". Many without records to demonstrate "true" reason for compensation adjustments
   ii. Recordkeeping violation is just as bad as the substantive violation

Q & A ON LO COMP

Brian S. Levy-Bio

AARMR Conference, August 6-9, 2019, San Diego CA

Brian S. Levy, Of Counsel with Katten & Temple, LLP in Chicago, provides practical and creative compliance, transactional and regulatory guidance for mortgage lenders and related providers to the mortgage industry. Brian has unique sales and in-house experience enabling him to offer actionable guidance and effective training on matters such as RESPA (MSA's, lead sharing, joint marketing, desk leases, AfBA's, etc.), LO compensation, mortgage repurchase defense, loan sale agreements, and other regulatory and enforcement issues.

Brian is a frequent conference speaker and is also a member of the American College of Consumer Financial Services Lawyers and the American College of Mortgage Attorneys. Among other articles and publications, Mortgage Banking Magazine featured two of his articles: *Buybacks-They're Not Going Away* (September 2013) and *CFPB's Enforcement-First Approach,* regarding the CFPB's enforcement-based method of providing compliance guidance (April 2016).

Brian was General Counsel for a mid-sized midwestern bank (and its 3 mortgage banking subsidiaries) from 1994-2009 and prior to that worked for 5 years handling primarily commercial real estate matters at a large firm in Chicago. Brian graduated from the University of Illinois at Urbana-Champaign, (A.B., 1986, Summa Cum Laude) and Harvard Law School (J.D., 1989). Brian can be reached at 262/241-7977 or blevy@kattentemple.com and can be followed on Linkedin and Twitter @BrianSLevy.

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