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Pay Attention: Final Rules on Loan Originator Compensation

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January, 2013, was a watershed month for mortgage standards after the **Consumer Financial Protection Bureau** released the long-awaited final rules on ability to repay, qualified mortgages, mortgage servicing, and appraisal requirements. Each of these rules promises to keep compliance gurus busy throughout this year and into 2014. January also heralded another Dodd-Frank final rule of great interest to senior management, boards of directors, and certainly to the frontline, revenue producing, mortgage loan personnel – the mortgage loan originator compensation requirements.

The new compensation rules are potential bottom line changers both for mortgage loan officers/originators and financial institutions themselves—making it imperative that financial institution management and boards of directors move this topic to the top of their to-do lists.

In the aftermath of the mortgage market meltdown, politicians and pundits, and the federal regulators who answer to them, became increasingly focused on the role that loan officers and originators play in the consumer mortgage loan process. Prior to the meltdown, training and qualification standards for loan originators varied widely within the industry. Furthermore, compensation programs evolved to incentivize loan officers and originators to lead consumers into more expensive loans. With Title XIV of the Dodd-Frank Act and the compensation final rules, the consumer protectors set out to end these practices.

What's Not OK

The rules on compensation prohibit a loan officer/originator from being compensated based on any “term of the transaction” or any proxy for a term of the transaction. This is not new; this prohibition has been part of Regulation Z since 2011. The final rule now defines “term of the transaction” but leaves some uncertainty. A term of the transaction is “any right or obligation of the parties to the credit transaction.” What does this mean? The commentary to the final rule answers that question by including descriptions of items the CFPB believes are “terms of the transaction.” Those items include (see final rule commentary for full list):

- interest rate
- prepayment penalty

- whether a product or service is purchased (e.g., lender's title policy)
- fees or charges requiring a good faith estimate and/or HUD-1 disclosure statement (and future Truth-in-Lending Act/Real Estate Settlement Procedures Act combined disclosure)
- points, discount points
- document fees; origination fees

What's OK

CFPB acknowledges the compensation restrictions could create uncertainty for regulated institutions. To allay this uncertainty, the final rule commentary provides a list of examples of permissible compensation mechanisms, which includes (see final rule commentary for full list):

- originator's overall loan volume
- loan performance over time
- whether the customer is existing or new
- quality/condition of loan files
- percentage of applications resulting in closed loans

Under the final rules, financial institutions are permitted to continue paying mortgage loan officers/originators bonus compensation. However, bonuses will be subject to some restrictions. Bonuses may not be based on the terms of the individual loan officer/originator's transactions, and bonus compensation cannot exceed 10 percent of the individual loan officer/originator's total compensation for the relevant period.

Looking Forward: Best Practices

The new compensation rules and the other residential mortgage related rules go into effect in January, 2014. Examination teams, armed with new exam procedures, will be descending on banks to test for compliance. Below are a few best practice steps bank managers and boards of directors may take to be prepared.

1. Ensure consumer compliance teams are trained on the new rules. Modify consumer compliance audit/review procedures to ensure new rules are appropriately tested.
2. Ensure mortgage lending management teams and loan officers/originators are trained on the new rules.
3. Review existing loan officer/originator compensation programs, policies and practices to determine level of compliance; adjust programs and practices accordingly.
4. Review existing employment, service, and management agreements and other documents

relating to residential mortgage lending to determine if problematic provisions exist; amend agreements as necessary.

5. Assign appropriate personnel to monitor release of guidance from CFPB and other federal regulatory agencies; review new examination procedures when available.

6. Have management report to board of directors, or appropriate committee, on progress toward compliance.

There is Still More

The compensation final rules address several other important topics, including dual compensation, payment of upfront points/fees, loan originator qualifications, and mandatory arbitration provisions. These topics are important for all participants in the mortgage lending arena, and you are encouraged to review them.

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