Consumer Financial Protection Bureau Adopts Loan Originator Compensation and Qualification Rules

February 4, 2013

On Thursday, January 18, 2013, the Consumer Financial Protection Bureau (CFPB) released its Final Rule (the Rule) incorporating Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (Dodd-Frank) provisions into the Regulation Z rules, which regulate certain loan originator compensation practices. In addition, the rule requires: (1) employers of loan originators to ensure that the originators are licensed under the Secure and Fair Enforcement for Mortgage Licensing Act of 2008 (SAFE Act) and applicable state law, and (2) employers whose employees do not have to be so licensed (such as bank employees who originate mortgages) to ensure that such employees meet character and fitness standards and receive proper training. Furthermore, the Rule prohibits the inclusion of mandatory arbitration clauses in home loan or home equity loans.

The Rule does not address the Dodd-Frank provisions that require the CFPB to adopt regulations prohibiting steering and various related types of conduct. The CFPB will address these regulations in the future.

The Rule's loan originator compensation and qualification provisions will take effect on January 10, 2014, while the prohibition against the use of mandatory arbitration clauses will become effective on June 1, 2013.

Loan Originator Compensation

Prohibition Against "Transaction Term and Condition" Based Compensation

An existing Regulation Z provision prohibits loan originator compensation from being based upon the transaction terms and conditions of a mortgage loan. Compensation may be based on a fixed percentage of the transaction amount; in addition, the compensation may be subject to a minimum and/or maximum dollar amount. The Rule continues this prohibition and these exceptions.

The CFPB's Rule replaces "transaction term and condition" with the phrase "a term of a transaction." This phrase is defined to include any right or obligation of the parties to a credit transaction. The Rule prohibits loan originator compensation from being based on such things as the interest rate of a loan. Moreover, loan originator compensation may not be based upon the inclusion of additional fees or charges for products or services provided by other parties to the credit or loan transaction. For example, a loan originator's compensation may not be based, in whole or in part, on the fact that the originator directed a borrower to purchase required title insurance from an affiliate of the broker.

The CFPB has indicated that the following fees or charges are a term of the transaction, if the fees or charges must be disclosed in the Good Faith Estimate or Settlement Statement (GFESS) under the Real Estate Settlement Procedures Act (RESPA) (or in any integrated disclosure adopted in the future by the CFPB):

- Loan originator or creditor fees or charges for the credit or for a product or service provided by the loan originator or creditor that is related to the extension of credit; and

- Fees or charges of other parties for any product or service required to be provided as a condition of the extension of credit.

It should be noted, however, that the disclosure of a fee or charge in a GFESS, by itself, does not make the fee or charge a term of the loan transaction.

The Rule generally prohibits loan originator compensation from being reduced in response to a change in the transaction terms. However, in limited circumstances, the compensation may be reduced to offset unexpected increases to estimated settlement costs.

Subject to certain limited exceptions, a loan originator may not receive compensation based on multiple transactions of a single loan originator or multiple transactions of multiple loan originators (including compensation based on profits).

Mortgage related business profits can be used to make contributions to tax advantaged retirement plans (*e.g.,* a 401(k)). A contribution to a defined contribution plan, however, may not be based on the terms of the individual loan originator's transactions.

A loan originator may receive payments under nondeferred profit-based compensation plans (*e.g.,* bonus pools, bonus plans, profit-sharing plans). Such payments can be made provided that: (1) the compensation is not directly or indirectly based on the terms of the individual loan originator's transactions; and (2) either: (a) the compensation under the plan does not exceed 10 percent of the loan originator's total compensation for the applicable period, or (b) the loan originator was an originator for no more than 10 transactions during the preceding 12 months. When calculating such payments, bonuses, awards of merchandise, trips or similar prizes may have to be considered.

Prohibition Against "Proxy" Based Compensation

The Rule also provides that loan originator compensation may not be dependent upon a factor that is a "proxy" for what would otherwise be considered a term of a loan transaction. A factor is a term of a loan transaction "proxy" if: (1) it varies with a transaction term over a significant number of transactions; and (2) the loan originator, directly or indirectly, has the ability to add, reduce or change the factor when originating the loan or credit.

Prohibition Against Dual Compensation

The Rule continues the prohibition against dual compensation payment restrictions previously contained in Regulation Z. Thus, a loan originator may not be compensated by both the creditor and the consumer. Mortgage brokers are permitted to pay commissions to their employees and contract agents, provided that these commissions are not based upon the terms of the loans that they originate.

Compensation for Nonloan Origination Activities

Amounts received by a loan originator organization (a company that acts as a mortgage broker in a transaction) or its affiliates for nonloan origination activities are not compensation for purposes of the Rule. Under the Rule, compensation does not include a payment received:

- By a loan originator organization or an affiliate for bona fide and reasonable charges for services it performs that are not loan origination activities; and
- By a loan originator organization for bona fide and reasonable charges for services that are not loan origination activities when those amounts are not retained by the loan originator but are paid to the lender, its affiliate, or the affiliate of the loan originator organization.

Allowing Payment of Up-Front Points and Fees

Section 1403 of Dodd-Frank prohibited the payment by a consumer of upfront points and fees on transactions where the loan originator is to be paid compensation by a person or entity other than the consumer. However, a corollary provision also gave the CFPB the authority to establish either an exemption, or to waive the upfront points and fee prohibition entirely, if it determined that application of the prohibition would ultimately not be in the public interest.

The CFPB's initial proposed rule, issued for public comment in August 2012, set forth an exemption for the upfront points and fee prohibition. To do this, the lender had to offer qualified borrowers an alternative loan without upfront points or fees (the "zero-zero alternative").

Following the receipt of considerable lender opposition to the zero-zero alternative, the CFPB adopted a complete exemption under which a creditor may impose points and fees on a consumer in cases in which the creditor will pay compensation to a loan originator, as long as the consumer does not also pay a loan originator.

Significantly, the CFPB has cautioned that this complete waiver of the upfront points and fee prohibition in the Rule may be further altered or amended after additional research has been completed.

Mandatory Loan Originator Qualification Standards

As required by Dodd-Frank, all loan originator organizations must make certain that their loan originator employees and agents are either appropriately licensed or registered in accordance with the SAFE Act and applicable state law.

Certain loan originators (those employed by banks and certain nonprofit entities) are exempt from the SAFE Act registration requirements and applicable state licensing requirements. The Rule instructs employers of these originators to take measures to ensure that these originators meet character and background standards essentially similar to those established under the SAFE Act. As such, nonlicensed loan originators will be subject to the same rules regarding criminal background, credit reporting and Nationwide Mortgage Licensing System and Registry (NMLSR) checks as licensed loan originators. Furthermore, the employer must ensure that the nonlicensed loan originator receives training covering federal and state law requirements that apply to the loan originator's loan origination activities.

Provisions have been included in the Rule addressing when: (1) a criminal conviction will disqualify an individual from serving as a loan originator; and (2) a criminal background or credit check is required.

The Rule requires the inclusion of loan originator's name and NMLSR identification number on the credit application, note, or loan contract, and security instrument.

The Rule does not require that the NMLSR identification number be included on the GFESS, or early or final Truth in Lending Act disclosure statements. The CFPB will address this in the future when it adopts an integrated disclosure rule.

Mandatory Loan Originator Arbitration Clause Prohibition

The Rule prohibits any loan contract or other agreement related to a consumer residential mortgage or home equity transaction from including or requiring mandatory arbitration of disputes. It does not prevent the parties from agreeing to arbitration once a dispute arises.

The Rule also prohibits:

- contract or loan agreement provisions that would operate to bar or limit a consumer from seeking relief in court for any claimed violation of federal law; and
- interpretations of provisions of loan documents which would bar a consumer from bringing a claim in court in connection with any alleged violation of federal law.

The Rule does not prevent the parties from agreeing to arbitration once a dispute arises.

These provisions will become effective on June 1, 2013.

Single Premium Insurance

Premiums or fees for credit insurance (such as credit life insurance) may not be financed in connection with a consumer credit transaction secured by a dwelling. Credit insurance may be paid for on a monthly basis.

Record Retention Requirements

Lastly, lenders and mortgage brokers are directed to maintain records related to loan originator compensation for a period of at least three years after the date of payment; such documentation would include, but not be limited to, compensation agreements with loan originators, and all payments made to the loan originators.

For further information, please contact Michael D. Morehead, Tim Sullivan or your regular Hinshaw attorney.
