BARACK FERRAZZANO
Compensation and Employment Group

CLIENT ACTION ALERT

THE FEDERAL RESERVE BOARD'S
FINAL RULE ON LOAN ORIGINATOR COMPENSATION AND STEERING

Just a year ago the Department of Labor said it was likely that your mortgage loan originators are entitled to overtime pay. Then in July, 2010 Congress passed the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") which tells you how you may and may not pay your mortgage loan originators. But well before the Dodd-Frank prohibitions are effective (sometime in 2012 most likely), you need to comply with the Federal Reserve Board's Final Rule on Loan Originator Compensation and Steering, promulgated under its Truth in Lending (Reg. Z) regulatory authority (the "Final Rule"). The Final Rule was effective April 1, 2011. The Final Rule was challenged in court by the National Association of Mortgage Brokers and the National Association of Independent Housing Professionals. On March 30, 2011, the Associations were successful in obtaining an 11th hour emergency administrative stay of the Final Rule. However, only days later on April 5, 2011, the Circuit Court of Appeals dissolved the stay and the Final Rule became effective immediately. Although the Associations have stated their intentions to continue the litigation, if you have not yet revised your commission programs to comply with the Final Rule, now is the time to turn to this important compliance issue.

OVERVIEW OF FINAL RULE

The Final Rule prohibits certain compensation and steering practices that the Federal Reserve believes are unfair, abusive or deceptive to consumers. The Final Rule applies to closed-end consumer loans secured by a dwelling or real property that includes a dwelling. Therefore, the Final Rule does not apply to:

(1) Open-end home equity lines of credit (HELOCs);

(2) Time share transactions; or

(3) Loans secured by real property if the property does not include a dwelling.

MORTGAGE ORIGINATOR'S COMPENSATION CANNOT BE BASED ON LOAN TERMS AND CONDITIONS

- The Final Rule prohibits a creditor or any other person from paying, directly or indirectly, compensation to a mortgage loan originator or broker that is based on a mortgage loan's terms or conditions other than the amount of the credit extended.

- The amount of the credit extended will not be considered a term or condition of the loan if the compensation to the originator is based on a fixed percentage of the amount of the credit extended.

- For smaller loans, the Final Rule permits the creditor to pay the originator on an hourly rate or based on the number of loans originated in a given period of time.

- The Final Rule permits the creditor to pay a minimum or maximum amount, which may be another way to address small loans.

An originator may increase a borrower's interest rate to generate a larger yield spread premium to pay third-party closing costs (reducing the up-front costs to the borrower), but that increase in interest rate

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may not impact the amount of compensation the originator receives. Similarly, if a loan originator receives compensation directly or indirectly from the borrower, no other person may compensate, directly or indirectly, the originator in connection with the same transaction.

PERMISSIBLE COMPENSATION

Although a mortgage originator's compensation cannot be based on loan terms and conditions, the Final Rule permits compensation to be based on other terms:

- Overall loan volume (*i.e.,* total dollar amount of credit extended or total number of loans originated);
- The long term performance (any reasonable period of time over which the overall performance of an originator's loans can be measured) of the originator's loans;
- An hourly rate;
- Whether the borrower is a new or existing customer;
- A fixed amount set in advance for every loan originated;
- The quality of the loan originator's loan files; and
- A legitimate business expense such as fixed overhead costs.

CAUTION

One of the significant issues that arose as the effective date for compliance was approaching was whether compensation could vary based on the type of loan, such as whether the loan is a purchase money loan or refinancing, FHA, VA or CRA loan, or a portfolio or non-portfolio loan. In non-binding responses to questions posed by the Mortgage Bankers Association, the legal staff at the Federal Reserve stated that differences in compensation and terms and conditions are permissible so long as these differences are not correlated to or a proxy for differing compensation based on the terms and conditions of the loans. If a correlation between loan terms or conditions and compensation exists (such as a differing compensation for those loans that take less time or expense than others), the burden will shift to the creditor to show that the compensation differences are based on valid factors that are not loan terms or conditions or proxies thereof. In informal conversations with the Federal Reserve, staff members were unwilling to provide any guidance on what type of showing will be required to meet this burden. Please note that even with this burden shifting approach, this permissible differing of compensation likely will not apply to CRA loans because the fact that a loan is made in a specific area, such as a low income area, is not a permissible factor (geography was a permissible factor when the rule was proposed but was removed in the Final Rule).

The Final Rule also includes an anti-steering provision that prohibits a mortgage originator from steering a consumer to a lender that offers less favorable terms in order to increase the originator's compensation. Although the anti-steering rules include a safe harbor, for banks that employ mortgage originators the safe harbor is met not by the safe harbor rules themselves but by compliance with the compensation rules discussed above.

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Note: As noted above, Dodd-Frank includes similar requirements and prohibitions. Therefore, it is reasonable to expect that when the regulations under Dodd-Frank are published, finalized and effective (which will be some time prior to two-and-a-half years after July 21, 2011, which is the date that regulatory authority is transferred to the new Consumer Financial Protection Bureau), they will require yet more changes to how you compensate your mortgage loan originators.

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