

REGULATION Z: LOAN ORIGINATOR COMPENSATION AND STEERING 12 CFR 226

federalreserve.gov | Jan 26th 2011

This guide was prepared by the staff of the Board of Governors of the Federal Reserve System as a "small entity compliance guide" under Section 212 of the Small Business Regulatory Enforcement Fairness Act of 1996, as amended. The guide summarizes and explains rules adopted by the Board but is not a substitute for any rule itself. Only the rule itself can provide complete and definitive information regarding its requirements. The complete rule, including the Official Staff Commentary, which is published as Supplement I to Regulation Z, is available on the Government Printing Office web site.

The Truth in Lending Act

The Truth in Lending Act (TILA) is implemented by the Board's Regulation Z (12 CFR Part 226). A principal purpose of TILA is to promote the informed use of consumer credit by requiring disclosures about its terms and cost. TILA also includes substantive protections. For example, the act and regulation give consumers the right to cancel certain credit transactions that involve a lien on a consumer's principal. Regulation Z also prohibits specific acts and practices in connection with an extension of credit secured by a consumer's dwelling.

Prohibitions related to mortgage originator compensation and steering

Regulation Z prohibits certain practices relating to payments made to compensate mortgage brokers and other loan originators. The goal of the amendments is to protect consumers in the mortgage market from unfair practices involving compensation paid to loan originators.

The prohibitions related to mortgage originator compensation and steering apply to closed-end consumer loans secured by a dwelling or real property that includes a dwelling. The rule does not apply to open-end home equity lines of credit (HELOCs) or time-share transactions. It also does not apply to loans secured by real property if the property does not include a dwelling.

For purposes of these rules, loan originators are defined to include mortgage brokers, who may be natural persons or mortgage broker companies. This includes companies that close loans in their own names but use table-funding from a third party. The term loan originator also includes employees of creditors and employees of mortgage brokers that originate loans (i.e., loan officers).

Creditors are excluded from the definition of a loan originator when they do not use table funding, whether they are a depository institution or a non-depository mortgage company, but employees of such entities are loan originators.

The rule prohibits a creditor or any other person from paying, directly or indirectly, compensation to a mortgage broker or any other loan originator that is based on a mortgage transaction's terms or conditions, except the amount of credit extended. The rule also prohibits any person from paying compensation to a loan originator for a particular transaction if the consumer pays the loan originator's compensation directly.

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The rule also prohibits a loan originator from steering a consumer to consummate a loan that provides the loan originator with greater compensation, as compared to other transactions the loan originator offered or could have offered to the consumer, unless the loan is in the consumer's interest. The rule provides a safe harbor to facilitate compliance with the prohibition on steering.

Creditors who compensate loan originators must retain records to evidence compliance with Regulation Z for at least two years after a mortgage transaction is consummated.

Compliance with these rules is mandatory beginning on April 1, 2011. Accordingly, the rules on originator compensation apply to transactions for which the creditor receives an application on or after April 1, 2011.

Section-by-Section

Section 226.25 Record retention.

(a) General rule.

Requires, for each transaction subject to the loan originator compensation provisions in § 226.36(d)(1), that the creditor maintain records of the compensation it provided to the loan originator for the transaction as well as the compensation agreement in effect on the date the interest rate was set for the transaction.

Section 226.36 Prohibited acts or practices in connection with credit secured by a dwelling.

(a) Loan originator and mortgage broker defined.

States that the regulation applies to all persons who originate loans, including mortgage brokers and their employees, as well as mortgage loan officers employed by depository institutions and other lenders.

The rule does not apply to payments received by a creditor when selling the loan to a secondary market investor. When a mortgage brokerage firm originates a loan, it is not exempt under the final rule unless it is also a creditor that funds the loan from its own resources, such as its own line of credit.

(d) Prohibited payments to loan originators.

For purposes of § 226.36(d)(1) and (d)(2), affiliates are treated as a single "person."

(d)(1) Payments based on transaction terms or conditions.

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

A loan originator's compensation can neither be increased nor decreased based on the loan terms or conditions. When the creditor offers to extend a loan with specified terms and conditions (such as rate and points), the amount of the originator's compensation for that transaction is not subject to change, based on either an increase or a

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decrease in the consumer's loan cost or any other change in the loan terms. Thus, if a consumer's request for a lower interest rate is accepted by the creditor, the creditor is not permitted to reduce the amount it pays to the loan originator based on the change in loan terms. Similarly, any reduction in origination points paid by the consumer must be a cost borne by the creditor.

Under the rule, the amount of credit extended is deemed not to be a transaction term or condition of the loan for purposes of the prohibition, provided the compensation payments to loan originators are based on a fixed percentage of the amount of credit extended. However, such compensation may be subject to a minimum or maximum dollar amount. The minimum or maximum amount may not vary with each credit transaction.

Creditors may use other compensation methods to provide adequate compensation for smaller loans, such as basing compensation on an hourly rate, or on the number of loans originated in a given time period.

Example: A creditor may not pay a loan originator 1 percent of the amount of credit extended for amounts greater than \$300,000, and 2 percent of the amount of credit extended for amounts that fall between \$200,000 and \$300,000. However, a creditor could choose to pay a loan originator 1 percent of the amount of credit extended for each loan, but no less than \$1,000 and no more than \$5,000. In this case, the originator is guaranteed payment of a minimum amount for each loan, regardless of the amount of credit extended to the consumer. Using this example, the creditor would pay a loan originator \$3,000 on a \$300,000 loan (i.e., 1 percent of the amount of credit extended), \$1,000 on a \$50,000 loan, and \$5,000 on a \$900,000 loan.

An originator that increases the consumer's interest rate to generate a larger yield spread premium can apply the excess creditor payment to third-party closing costs and thereby reduce the amount of consumer funds needed to cover upfront fees. Thus, the rule does not prohibit creditors or loan originators from using the interest rate to cover upfront closing costs, as long as any creditor-paid compensation retained by the originator does not vary based on the transaction's terms or conditions.

For example, suppose that for a loan with a 5 percent interest rate, the originator will receive a payment of \$1,000 from the creditor as compensation, and for a loan with a 6 percent interest rate, a yield spread premium of \$3,000 will be generated. The originator must apply the additional \$2,000 to cover the consumer's other closing costs.

(d)(2) Payments by persons other than consumer.

If any loan originator receives compensation directly from a consumer in a transaction, no other person may provide any compensation to a loan originator, directly or indirectly, in connection with that particular credit transaction. Thus, no person who knows or has reason to know of the consumer-paid compensation to the loan originator (other than the consumer) may pay any compensation to a loan originator, directly or indirectly, in connection with the transaction.

For purposes of this rule, payments made by creditors to loan originators are not payments made directly by the consumer, regardless of how they might be disclosed under HUD's Regulation X, which implements the Real Estate Settlement Procedures Act (RESPA).

(e) Prohibition on steering.

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Prohibits a loan originator from "steering" a consumer to a lender offering less favorable terms in order to increase the loan originator's compensation.

Provides a safe harbor to facilitate compliance. The safe harbor is met if the consumer is presented with loan offers for each type of transaction in which the consumer expresses an interest (that is, a fixed rate loan, adjustable rate loan, or a reverse mortgage); and the loan options presented to the consumer include:

- * (A) the loan with the lowest interest rate for which the consumer qualifies;
- * (B) the loan with the lowest total dollar amount for origination points or fees, and discount points, and
- * (C) the loan with the lowest rate for which the consumer qualifies for a loan without negative amortization, a prepayment penalty, interest-only payments, a balloon payment in the first 7 years of the life of the loan, a demand feature, shared equity, or shared appreciation; or, in the case of a reverse mortgage, a loan without a prepayment penalty, or shared equity or shared appreciation.

To be within the safe harbor, the loan originator must obtain loan options from a significant number of the creditors with which the originator regularly does business. The loan originator can present fewer than three loans and satisfy the safe harbor, if the loan(s) presented to the consumer otherwise meet the criteria in the rule.

The loan originator must have a good faith belief that the options presented to the consumer are loans for which the consumer likely qualifies. For each type of transaction, if the originator presents to the consumer more than three loans, the originator must highlight the loans that satisfy the criteria specified in the rule.

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