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First They Came For The Mortgage Brokers!

COMMENTARY: by JONATHAN FOXX
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It is now one week since the U. S. Court of Appeals lifted the stay on the loan originator compensation amendment to TILA. Are we at the end or the beginning? Whether the stay of the TILA loan originator compensation rule (Rule) was lifted or remained, one thing is clear: virtually the entire mortgage industry has coalesced against it.

The battle that I characterized as one between David and Goliath has been joined, with most market participants lining up behind David, and few behind Goliath.

Let's step back from the fray and give some thought to the broader implications.

Where We Are Now

After nearly an entire industry has written letters, lobbied, and received support from virtually all industry trade associations; after certain U. S. Senators and a majority of the House Financial Services Committee asked the FRB for a delay in the Rule; after two major industry organizations, the NAMB and NAIHP, were constrained to file costly motions for a temporary restraining order and preliminary injunction; and after the U. S. District Court - DC denied that motion, thereby causing the NAMB and NAIHP to seek relief in the U. S Court of Appeals - DC, which granted a stay and then dissolved it just a few days later; finally, the mortgage industry's participants, at huge financial cost in preparation, moved forward April 6, 2011 in complying with the Rule's requirements.

The lawsuits continue in the Appeals Court, but some actors in the industry, particularly mortgage brokers, are now bracing for what they see as their economic ruin.

A Framework

On August 16, 2010, the FRB issued a final rule to amend Regulation Z. This is the Rule that restricts loan originator compensation and steering practices, ostensibly to protect consumers in the mortgage market from unfair, abusive and deceptive lending practices. Subsequently, the FRB set forth interpretive guidance in its rulemaking capacity, in order to implement Title XIV of the Dodd-Frank Act, titled the Mortgage Reform and Anti-Predatory Lending Act (Mortgage Act).

Many provisions of the new TILA mortgage originator compensation provision imposed by the Mortgage Act are similar to the Rule. The definition of loan originator in Regulation Z covers mortgage brokers, employees of creditors and mortgage brokers obtaining an extension of consumer credit for the mortgage lender, and applies to creditors making use of "table funding" by a third party. With some exceptions, the Rule applies to any consumer credit transaction secured by a consumer's dwelling, whether first or subordinate lien loans, and rests on the following framework:

> Frame # 1: No loan originator compensation in connection with a consumer credit transaction may be based on the transaction's terms and conditions (i.e., interest rate or annual percentage rate), other than the amount of principal, unless the amounts are *bona fide* or reasonable third-party charges. The provision is directed at yield spread premiums (YSPs) paid by the creditor to the loan originator.
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> Frame # 2: In order to ensure that loan originators do not evade the consumer protection provision of Regulation Z, no loan originator may receive compensation from any person other than the consumer if the loan originator receives direct compensation payment from the consumer. The Rule establishes, therefore, a "one or the other" compensation scheme with respect to loan originator compensation for specific consumer credit transactions.

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Frame # 3: No loan originator may direct or "steer" a consumer to consummate a consumer credit transaction secured by a dwelling based on the fact that the originator will receive greater compensation from the creditor in that transaction than in other transactions that the originator could have offered to the consumer, unless the consummated transaction is in the consumer's interest. The FRB provides a safe harbor rule intended to provide loan originators with clear guidance to ensure compliance with the anti-steering rule.

Lesser of Two Evils?

A basic presumption of the FRB is best left to the FRB to so state:

> "The Board believes that compensation based on the amount of credit extended is less subject to manipulation by the originator than compensation based on terms such as the interest rate or prepayment penalties."

Thus, the FRB holds that limiting compensation to the loan amount is "less subject to manipulation" than basing compensation on the terms associated with the loan amount or loan type.

In effect, the FRB has determined that basing compensation on the loan amount is a lesser evil than basing it on the loan terms.

As but one example of the argument, mortgage brokers assert that the use of Yield Spread Premiums (YSPs) can help consumers cover closing costs including loan origination fees. However, the FRB maintains that YSPs can also serve as an incentive for mortgage brokers to steer consumers into higher interest rate loans; therefore, the Rule restricts the way in which YSPs may be used.

Mortgage brokers counter by highlighting the fact that they willingly disclose the YSPs, yet bankers and banks do not disclose their Service Release Premiums (SRPs) which they collect on higher interest rate loans sold to the secondary market.

YSP versus SRP

I have written extensively about the controversy involving the YSP and the SRP here, here, and here.

In fact, I have published remedies to resolving the controversy involving the YSP and consumer financial protection issues, such as my suggestion in July 2009 (PDF) to provide a credit to the consumer of the YSP and allowing the consumer to apportion it - a remedy, actually, that was later adopted in the RESPA reform provisions effective on January 1, 2010.

As a basis to the Rule, it seems the FRB contends that the consumer simply can't differentiate between compensating a mortgage broker for a higher interest rate loan through a YSP and compensating a banker or bank for a higher interest rate loan through an SRP.

States the FRB:

> "Although consumers may reasonably expect creditors to compensate their own employees, consumers do not know how the loan officer's compensation is structured or that the loan officer can increase the creditor's interest rate or offer certain loan terms to increase their own compensation."

Such is the FRB's conclusion, notwithstanding due and fully articulated notice to the consumer.

To make sense of this conclusion, one would have to assume the consumer just can't seem to figure out that an increased interest rate charged by a creditor receives concomitant compensation in some form *qua* SRP in the secondary market.

The fact that one form of compensation is disclosed to the consumer (YSP) and the other is not disclosed to the consumer (SRP) seems to be left out of the argument entirely.

Indeed, in the entire Dodd-Frank Act of 2,319 pages, the words "Service Release Premium" do not occur even once. But these words can be found:

"No provision ... shall be construed as

(A) permitting any **yield spread premium** or other similar compensation that would, for any residential mortgage loan, permit the total amount of direct and indirect compensation from all sources permitted to a mortgage originator to vary based on the terms of the loan (other than the amount of the principal) (My emphasis.)

(B) limiting or affecting the amount of compensation received by a creditor upon the sale of a consummated loan to a subsequent purchaser"

NOTE: Elided, intentionally or not, in (B) are the words "service release premium."

Thought Experiment

Now, let's consider some implications of the FRB's view, by indulging in a Thought Experiment.

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Prior to August 6, 2011, a broker paid its loan officer employee on production of closed loans, which included terms and conditions. This compensation model, really, is one of the oldest financial models in economic theory. There is virtually no economic theory ever propounded - from Marxist to Capitalist - that does not recognize this particular model as a fundamental basis to incentive. It predates the ancient Greek *Agora,* or marketplace.

Of course, I'm referring to the Commission Model. This model applies to any transaction between parties to a financial transaction where incentive is associated with many aspects of production. It represents a fee charged by a broker or agent for services rendered in facilitating a financial transaction. For example, the commission model applies to insurance agents, real estate agents, securities brokers, financial advisers, car salespersons, shoe salespersons, broom salespersons - actually to any sales job that relies on commissioned income, in whole or in part, to sell a product or service.

Here's the question: is the consumer really unable to figure out that the compensation earned by a commissioned shoe salesperson is not of a piece with the compensation - part of which is "profit" - earned by the shoe store itself when the consumer buys shoes?

And, if not - if the consumer lacks the kind of discretion that has been fundamentally a part of market activity since the days of earliest recorded history - how and when was this discretion lost?

And if the consumer, having now lost this age-old ability that previously seems to have been ingrained in human nature - but, perhaps, apparently no more! - has to be protected, how is the consumer protected by de-incentivizing the shoe salesperson, yet preserving the profit incentives of the shoe store itself?

And, if the shoe store must re-incentivize the shoe salesperson by building into its price for shoes the cost to adequately compensate the shoe salesperson, how is this increased cost of doing business not passed onto the consumer in the form of higher priced shoes?

After all, the shoes still need to be sold, and bring a profit to all market participants - come what may!

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The Unpredictable Future

The Thought Experiment given above, like all analogies, is not meant to be precise.

But it is suggestive of what may yet happen.

However we got here, we're here. But where do we go from here?

Or, better said, where does any commission-based industry go from here?

Labels: Loan Officer, Loan Officer Commission, Loan Officer Compensation, Loan Originator, Loan Originator Compensation, MLO Compensation, Mortgage Broker Compensation, S.A.F.E. Act, TILA

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