COMMUNITY HOME LENDERS of AMERICA

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CHLA WHITE PAPER
REFORM OF LO COMP

Restore LO Comp to its Original Purpose:

Regulate Compensation Practices Between Firms

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Executive Summary

BACKGROUND

- The original impetus for LO Comp was "yield spread premiums" (YSP) – a practice where banks or other aggregators offered higher fees as incentives to mortgage brokers to secure loans with a higher mortgage rate.

- In its statutory Dodd-Frank remedy, Congress went way beyond this to restrict mortgage banker compensation to their own employee loan originators – an unprecedented regulation of employee compensation practices.

- And, instead of just prohibiting explicit compensation incentives to secure higher mortgage rates, the law generally prohibits any variation in the compensation level to a loan originator, except on the basis of the loan amount itself.

- This expansion beyond a targeted remedy merely outlawing YSP incentives for 3rd parties appears to be based on:
  (1) An objective that all borrowers a firm originates mortgage loans for should be offered identical loan terms.
  (2) A premise that any variation in LO compensation, for whatever reason, is deemed to be pernicious.
  (3) A framework without flexibility to permit variations in LO compensation to avoid adverse consequences.

FINDINGS

- Inflexible prohibitions against any variations in compensation to employee loan originators harm consumers:
  (1) If a borrower obtains a better mortgage loan offer from a third party after working for months with a loan originator, such borrower often prefers to close the loan with that LO they have worked with – but often can't - since the LO is prohibited by law from reducing their compensation in order to accommodate the revised offer.
  (2) Since loan originators can't cut fees to compete with last minute offers, they are disincentivized to work with borrowers over many months – e.g., to pre-qualify them, fix their credit score, identify the best loan product.
  (3) Many mortgage bankers have stopped using state HFA bond-financed low down payment mortgage loan programs for underserved and minority borrowers, as LO Comp restrictions can make these loans unprofitable.
  (4) Many mortgage bankers have reduced use of brokered loans for loan products they don't offer in-house, due to uncertainty as to whether they can reduce LO compensation to adjust for lower profitability of brokered loans.

- Applying LO Comp to a firm's employee LO compensation practices on the theory that less sophisticated borrowers cannot negotiate a fair deal for themselves has been overtaken by developments that significantly enhance the ability to do mortgage price shopping – such as TRID disclosures and online mortgage competition.

- Applying LO Comp prohibitions to a firm's internal LO compensation has set a harmful precedent – that would be unworkable and impede the goals of competition if applied to other areas like realty broker fees.

- Since mortgage brokers have found ways to flout LO Comp rules, we have the strange result that the only entities that don't uniformly comply with LO Comp law are the very entities whose YSP practices gave rise to the law.

CONCLUSIONS

- **LO Comp restrictions on compensation to a lender's employee LOs harms consumers, is based on a flawed theory, ignores increased price shopping, sets a harmful precedent, and creates an unlevel playing field.**

CHLA RECOMMENDATIONS

- **Congress should revise the Dodd-Frank Loan Originator (LO) Comp statute to limit its applicability to compensation practices <u>between</u> firms - the problem that gave rise to the LO Comp law in the first place.**

- **Until Congress can act, the CFPB should create flexibility as possible within the existing LO Comp law, to:**
  (1) Allow reduced LO compensation to match competitive offers for a borrower the LO is working with.
  (2) Allow a different LO compensation level for State HFA Bond Financed mortgage loans.
  (3) Clarify that mortgage bankers can have a different LO compensation level for loans they broker out.
  (4) Allow reduced compensation on a loan where the loan originator makes an underwriting error.

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Yield Spread Premiums

Yield spread premiums were widely used in the period leading up to the 2008 Housing Crisis. Banks and other mortgage loan aggregators offered to pay a mortgage broker a higher broker loan fee if they could secure a higher mortgage rate on the loan. This was typically executed through a rate sheet. For example, a lender would offer to pay the broker 2% if the mortgage rate they secured was 7% but would agree to pay the broker 3% if the mortgage rate was 7.25%.

Senate Banking Committee Chair Paul Sarbanes [D-MD] put it simply at a 2002 **Senate Banking Committee Hearing:**

> **"Borrowers pay the broker a fee for this service, either out of their savings or with the proceeds of the loan. Unbeknownst to the borrower, however, that broker may also be paid a yield spread premium by the lender if he can get the borrower to sign up for a loan at a higher rate than the borrower qualifies for. The higher the mortgage rate, the higher the payment.**

Consumer Action described the problem of abusive yield spread premiums in November 2007:

> **"When a mortgage broker steers a borrower toward a high-rate loan for which the broker collects a rebate from the lender, that payment is called a yield spread premium.**
>
> **When the broker does so without the knowledge of the borrower, that's abusive.**
>
> **Getting rid of yield-spread-premium abuse is one of the goals of legislation now moving through Congress"**

The conclusion that such practices are abusive or at least harmful to consumers is simple:
(1) The borrower qualified for a lower mortgage rate that the lender was willing to buy the loan from the mortgage broker.
(2) The broker had a financial incentive to put the borrower into a loan with a higher rate than they were eligible for.
(3) The relationship between the lender and broker was arms-length; no other factors went into the pricing or loan decision.

The LO Comp provision enacted in Dodd-Frank arose in response to a general conclusion that Yield Spread Premiums were predatory and anti-consumer. The legislative history is clear.

These rate sheet offers created an incentive for the mortgage broker to put the borrower into a higher mortgage rate than they qualified for.

Notably, this practice also contradicted the implied and even advertised role of the mortgage broker, which was to find the best available loan for the borrower.

Dodd-Frank LO Comp Statutory Provisions

The statutory Loan Originator (LO) Comp provision adopted as a part of Dodd-Frank went <u>significantly</u> beyond merely fixing the Yield Spread premium problem that had developed in the period leading up to the housing crisis.

Instead of merely prohibiting the payment of higher fees between two unrelated parties – i.e., a mortgage aggregator offering to pay a broker a higher fee when they secure a higher mortgage interest rate for the aggregator - the statute also:

1. **Regulates the payment of compensation to a loan originator employee of the lender, and**
2. **Prohibits any variations in LO compensation, regardless of the underlying reason for a variation, for all loans by that lender [except that the compensation may vary solely on the basis of the loan amount].**

This significant expansion of a LO Comp remedy beyond merely prohibiting yield spread premiums was apparently based on a theory that less sophisticated borrowers cannot negotiate for themselves and therefore the objective should be that all borrowers should get the same mortgage rate, to be accomplished by mandating a uniform loan originator compensation.

As noted in the following sections, this strict restriction on the compensation a lender can pay their own employees has caused significant harm to consumers – by: (1) reducing competition, (2) making it harder to do state HFA bond deal loans and (3) making it harder to broker out mortgage loan products the firm offers in-house.

Moreover, there was no evidence in the public record, in the period leading up to the adoption of the statutory LO Comp provision, that practices with regard to compensation to employee loan originators by a mortgage lender resulted in consumer harm or resulted in practices that took advantage of less sophisticated consumers.

Therefore, when the tangible harms cited above are compared to the theoretical benefits of uniform loan originator compensation (and by implication identical loan terms for all borrowers), the harms far outweigh the benefits.

Moreover, restricting the internal compensation practices of a mortgage banker/lender in this manner is somewhat unprecedented. Applying this rule to other financial products – such as broker compensation at realty firms – would simply be unworkable. It would likely undermine the goals of recent MLS reforms to create more price competition.

Additionally, the theory that less sophisticated consumers need unprecedented restrictions on compensation paid to loan originators by their employers has been overtaken and has been undermined by significantly increased transparency over the last decade, which have made it much easier for a consumer to price shop for mortgage loans.

These include new TRID disclosure mandates making mortgage comparison rate shopping much easier and the growing practice of mortgage lenders advertising rates on the internet.

Moreover, even after Congressional passage of legislation to eliminate applicability of LO Comp to a lender's employee loan originators, numerous other related consumer protections will still be in place.

Notably separate provisions of Dodd-Frank prohibit a loan originator from steering any borrower to a mortgage loan:
1. that the borrower lacks a reasonable ability to repay.
2. that has predatory characteristics or effects (such as equity stripping, excessive fees, or abusive terms).
3. that is a loan that is not a Qualified Mortgage - from a loan that is a qualified mortgage.

Moreover, separate Dodd-Frank provisions also prohibit *"abusive or unfair lending practices that promote disparities among consumers of equal credit worthiness but of different race, ethnicity, gender, or age."*

Finally, for mortgages originated by a non-bank lender, the loan originator must be licensed – i.e., must: (1) pass the SAFE Act test, (2) pass an independent background check, (3) take 20 hours of SAFE Act pre-licensing courses, and (4) take 8 hours of annual Continuing Education courses. [Note: this is only true for non-banks; bank loan originators are not licensed and are not subject to any of these four SAFE Act requirements].

LO Comp Rules are Extremely Complex

The **final LO Comp rule** is extremely complex. At 541 pages, the nuances and complexity of what is and isn't allowed is mind numbing. Moreover, this is just one more complex regulatory compliance challenge among many for smaller mortgage lenders lacking the loan volume economies of scale to hire high priced consultants and lawyers to parse details.

The consequences can be significant for failing to divine differing compliance interpretations of different regulators (for IMBs, the CFPB and all states they lend in). Such consequences can include lawsuits, enforcement actions and fines.

Generally, the only factor that can be used as a basis to vary loan originator compensation from loan to loan is the loan amount. According to the 2019 **CFPB Small Entity Compliance Guide** for Loan Originator Compensation (which purports to "simplify" compliance, at a slightly less mind numbing 89 pages), the amount of compensation can vary based on a fixed percentage of the loan. Additionally, *"compensation may be subject to a minimum or maximum dollar amount, as long as the amounts to not vary with each transaction."* However, the Guide goes on to note that a lender may not base compensation on a sliding scale – even though this is probably the best approximation of loan profitability.

The CFPB compliance guide cited above also goes into great detail on a key component of LO Comp, which is the prohibition against other forms of compensation which are in some way related to loan origination and the prohibition against the use of proxies for varying compensation.

This imposes burdens on lenders to analyze their overall compensation practices and compare to LO Comp rules. It also imposes burdens on analyzing what is a proxy for a transaction term. For example, the CFPB guide says that is it possible to vary compensation based on whether loans are held in portfolio or sold into the secondary market – but only based on a series of subjective considerations regarding whether loans *"consistently differ"* or whether the loan originator *"has the ability to encourage a consumer to take one set of terms over another."* However, this distinction (portfolio vs. secondary market) ignores the main two options most independent mortgage banks (IMBs) have – to either securitize the loan or to sell or broker a loan to an aggregator - and these options have significantly different profitability expectations.

All these details further demonstrate the folly of this unprecedented experiment with regulating a firm's compensation practices to its employees - – especially to such a degree of restriction, detail, and complexity.

Brokers Use Different Channels to Flout LO Comp Rule

While the LO Comp restrictions seem to be all-encompassing, in practice, brokers are often able to circumvent them.

Unlike loan originators that work for mortgage bankers, mortgage brokers have two options for compensation. They can be paid by the lender or they can be paid by the borrower. Thus, many mortgage brokers circumvent the LO Comp restrictions by using these two different channels to receive a different level of compensation – varying by channel.

In theory, this should not be allowed. However, in practice, mortgage brokerage firms are small and their regulators (states and the CFPB) are simply not able to monitor them and police behavior that violates LO Comp rules.

Thus, ironically, mortgage brokers, the very practitioners that LO Comp was designed to regulate, often flout the LO Comp rules – while mortgage bankers that originate loans have a much stronger compliance record.

LO Comp Restrictions Undermine Competition

The CFPB has encouraged mortgage loan competition and consumer price shopping.

However, inflexible LO Comp restrictions on compensation to a loan originator employee undermine that objective.

Lenders are currently permitted to respond to a consumer that is price shopping by lowering the rate to match a competing loan offer. However, the prohibition against reducing (varying) LO compensation discourages such actions, since a lenders' profit would be reduced or eliminated without the commensurate ability to reduce compensation being paid to LOs.

The impact is to reduce a lender's willingness to engage in such a competitive price matching. Put simply, the lender is not willing to lose money in these more competitive situations, since they are required to pay their loan originator a fixed fee.

This is frustrating to the loan originator, who may have been working to help the borrower for an extended period of time, only to lose the loan at the last minute to a competitor that did nothing to help the borrower qualify for a loan. However, because of LO Comp, the loan originator cannot reduce their compensation to compete on the deal and maintain the client relationship. And, understandably, their employing lender is unwilling to originate the loan at a loss.

This is harmful to borrowers for a number of reasons:

(1) It discourages loan originators from taking the time and making the effort to help the borrower increase their credit score, pre-qualify the borrower, identify different loan options, and help the borrower in other ways – since once the borrower is in this position, the loan originator cannot cut their fee to compete against a last minute competing offer.
(2) Often the borrower would like to close the loan with the loan originator they have been working with for months, but now has to chose between a lower competing last minute offer with a loan originator they don't know and the loan originator they are comfortable with, which can't match the last minute offer.

So, in September 2018 a number of national lender groups, including CHLA, sent the CFPB a letter making this point and asking for targeted flexibility for loan originators to lower their compensation voluntarily, in order to facilitate a more competitive offer and *"pass along the savings to the consumer."*

However, this approach was criticized by some consumer groups as being too broad, effectively opening the door to allowing pricing discrimination between more and less sophisticated borrowers or borrowers with lower income.

CHLA does not agree with this conclusion. However, in an effort to address these concerns, in April 2019 CHLA sent a letter to the CFPB, putting forth a CHLA proposal to circumscribe the narrow circumstances that constitute ***"demonstrable price competition"*** that should be the basis for allowing lenders to reduce loan originator compensation in order to match or compete with other offers that the borrower they are working with have obtained.

The CHLA proposal would limit flexibility regarding LO Compensation to the following circumstances:

- *The lender has an agreed upon a compensation schedule for the loan originator and has provided a loan estimate, with specific rates and terms, to a potential borrower.*
- *After some period of time working with the borrower, the borrower requests that the lender improve upon the rate or terms of that loan estimate offer, citing a better offer from a different lender.*
- *In response, the lender improves the rate or loan terms of its original loan estimate.*
- *The lender must maintain a log or in some other way provide documentation that it has met all of the four preceding requirements.*

This proposal addresses some of the harmful effects of the current application of LO Comp to loan originator employees of lenders. **However, a better approach is simply to exempt compensation paid to loan originator employees.**

LO Comp Restrictions Reduce State Bond Loans

State Housing Finance Agencies (HFAs) operate bond programs to facilitate low down payment single family homeownership programs to help qualified families become first-time homebuyers.

However, such bond programs typically involve more complexity than other single family loan options, including robust underwriting, tax law-related paperwork, yield restrictions, limits on rates and fees, and other program requirements and restrictions. As a result, HFA loans are generally more expensive to manufacture and/or less profitable to originate.

Before the LO Comp rule, it was common for the lender to absorb some of these costs by paying their loan originators a smaller fee for an HFA loan than a non-HFA loan. The LO Comp rule put an end to that.

As a result, many lenders simply don't originate state bond loans – or do so only in certain states.

Consumers are harmed by being denied access to these low down payment loan programs.

The argument has been made by some that LO Comp's restrictive rules actually protect the origination of state bond loans. The theory is that allowing LO Compensation to vary on state bond deals would discourage their use, since a lower compensation level provides less of an incentive for the loan originator to originate.

While this is possible in a few cases, CHLA lenders' experience is that this is generally not the case.

Because state bond deal loans involve more work and generally do not price as well as other loans, loan originators typically try to identify other better priced loans for the borrower – and only resort to state bond deal loans when there are not options more favorable to the borrower.

Moreover, because HFA loans are generally more costly to underwrite and therefore less profitable, providing LO comp flexibility for such loans does not create financial incentives to steer borrowers to higher priced loans.

Finally, creating flexibility for this category of HFA loans is a simple bright line test. If policy makers want to maintain the fixed LO compensation principle, they could still impose this for all loans in this class – all state bond loans.

This remedy addresses some of the harmful effects of the current application of LO Comp to loan originator employees of lenders. **However, a better approach is simply to exempt compensation paid to loan originator employees.**

LO Comp Reduces Mortgage Bankers' Brokered Loans

At the same time that mortgage brokers are widely able to circumvent LO Comp rules by using different channels to undermine the purpose of the rules, mortgage bankers are prevented from varying loan originator compensation on loans it brokers out – even though there is a much strong case for varying compensation between the two classes of loans.

Mortgage bankers are lenders that close loans in their own name and then either securitize the loans or sell them to aggregators. However, they can also act as a mortgage broker. Typically, they tend to do so for loans where they have not developed an internal loan product, offering such loans as a convenience to their borrowers.

Generally, the cost structure and profitability for loans that a mortgage banker closes in their name vs. loans that they broker out is significantly different. However, under LO Comp rules, it is not clear whether a mortgage banker can vary their compensation based on this distinction. The CFPB has offered some guidance on the subject, but lenders and compliance attorneys differ on interpretations.

Some lenders that have concluded that the LO Comp rules do not allow different levels of compensation have elected as a result not to broker out certain loans. This harms borrowers.

Even if one supports the LO Comp rule, it makes no sense to require the same level of loan origination compensation for a brokered loan as a securitized loan, since loan profitability varies so much between them.

Therefore, the CFPB should provide clear guidance that a mortgage banker can utilize a different level of loan originator compensation for their brokered loans than for loans they originate and close in their own name.

This remedy addresses some of the harmful effects of the current application of LO Comp to loan originator employees of lenders. **However, a better approach is simply to exempt compensation paid to loan originator employees.**

LO Comp Hurts Ability to Hold LOs Accountable for Mistakes

The inflexible nature of the LO Comp rules is illustrated by the fact that many lenders believe that they are not permitted to penalize loan originators financially when they make mistakes in underwriting loans.

For example, if a loan originator mishandles a loan lock, costing the lender, such lender should be able to penalize the loan originator by reducing LO compensation by the cost to the lender of the LO's mistake.

Alternatively, if a loan originator makes a mistake related to the underwriting of the loan, the lender should be able to penalize the loan originator financially for such mistake. The lack of such flexibility removes a potentially important financial tool that lenders have to hold loan originators accountable for sound underwriting practices and diligence.

Therefore, the CPFB should provide clear guidance that lenders have broad flexibility to impose financial consequences for loan originators when the loan originator makes an underwriting error.

This remedy addresses some of the harmful effects of the current application of LO Comp to loan originator employees of lenders. **However, a better approach is simply to exempt compensation paid to loan originator employees.**

Proposed Legislation:
Limit LO Comp Statute to Compensation Between Firms

The LO Comp statute provides that:

> **'(1) IN GENERAL.—For any residential mortgage loan, no mortgage originator shall receive from any person and no person shall pay to a mortgage originator, directly or indirectly, compensation that varies based on the terms of the loan (other than the amount of the principal). '**

While not explicitly stated in the statute, this is intended as and construed broadly so that the word "person" refers to any individual or firm, including the loan originator's employer.

The simplest and clearest solution to limiting applicability of this severe restriction on the compensation a loan originator can receive to payments between firms is to add to the subparagraph **"(4) RULES OF CONSTRUCTION.----No provision of this subsection shall be construed as---"** -- the following:

"(B) limiting or affecting the amount of compensation paid by a lender originating the loan to an employee who is a loan originator;"

Additionally, the phrase **"except as provided in subparagraph (4)(B)** should be added to subparagraphs (c)(1) and (c)(4)(A) to further clarify that the loan originator compensation restrictions do not apply to a firm's payments to a loan originator that is an employee.

Interim Actions the CFPB Could Take

Until Congress can enact the statutory fix identified in the previous section, the CFPB should, through rulemaking or other appropriate action, to provide much needed and appropriate flexibility from LO Comp restrictions, as follows:

(1) Allow a lender to reduce compensation to their loan originator employees, for the purpose of being able to match a competing offer for a borrower an LO has been working with.

(2) Allow different LO compensation structures and levels for State HFA Bond Financed mortgage loans.

(3) Allow flexible LO compensation structures and levels in cases where mortgage bankers may choose to broker out loans rather than originating those transactions as a mortgage bank

(4) Allow a lender to reduce the compensation to a loan originator employee on a loan where the loan originator makes an error on the loan – in order to create incentives for more diligent loan underwriting.

Guidance and Enforcement

Until such time as the CFPB can make the changes identified above, the CFPB should issue guidance that it will de-prioritize enforcement of LO Comp rules in these areas.