MORTGAGE LOAN ORIGINATOR COMPENSATION

Regulation Z provides strict limitations on compensation of loan originators ("LO"), which is defined in Regulation Z as an individual who:

- Takes a residential mortgage loan application
- Arranges a credit transaction
- Assists a consumer in applying for credit
- Offers or negotiates credit terms
- Makes an extension of credit
- Refers a consumer to a loan originator or creditor
- Advertises or communicates to the public that he can or will perform any loan origination service.

An LO does not include an individual who:

- Performs purely administrative or clerical tasks on behalf of a mortgage loan originator ("MLO")
- Performs real estate brokerage activities and is licensed or registered as a real estate broker under state law unless the individual acts as an MLO and is compensated by a lender, mortgage broker or other mortgage loan originator or an agent of one of these entities
- Is solely involved in extensions of credit related to timeshare plans
- Provides HUD-approved housing counseling services
- Provides general explanations, information, or descriptions of credit products in response to consumer queries
- Describes other product-related services
- Is an employee who provides contact information of an LO or creditor for whom he works or of another person who works for that entity so long as he does not discuss particular credit terms with the consumer or direct the consumer to a particular loan originator or creditor seeking to originate credit transactions to consumers with the consumer's financial characteristics based on the employee's assessment of the characteristics
- Performs loan-processing activities, such as compiling and assembling credit application packages and supporting documentation for an LO

- Coordinates consummation of the credit transaction or other aspects of the credit transaction process (such as informing consumer about needed documents or process deadlines)
- Performs credit underwriting, so long as he does not communicate directly with the consumer about specific credit terms.

LO's may not receive compensation based on a transaction term. This includes the term of a single transaction, the terms of multiple transactions conducted by the LO, and the terms of multiple transactions conducted by multiple loan originators in the aggregate (including bonus plans). "Transaction term" is any right or obligation of the parties to a credit transaction, except for the amount of credit extended and includes the following:

- Interest rate
- Annual percentage rate
- Collateral type (e.g. condo, detached home, or manufactured housing)
- Existence of a prepayment penalty
- Origination points or fees paid to the creditor or loan originator
- Fees for creditor-required title insurance.

It does not include the amount of credit extended. It does include proxies for transaction terms. Examples applying the proxy test include the following:

<u>Portfolio loans versus loans sold into the secondary market</u>—could be a proxy if the terms of the loans held in portfolio consistently differ from those in the sold loans (e.g. balloon notes in-portfolio) and the LO has the ability to encourage a consumer to take one set of terms over another.

<u>State where property securing the loan is located</u>—This is likely NOT a proxy for loan terms even if the loans secured by property in State A have terms that consistently differ from the terms of loans secured by property in State B. The LO typically can't influence whether the transaction is secured by property in particular state.

<u>Low-to-moderate-income consumer</u>—This is likely NOT a proxy as an LO can't change the status of a consumer.

The following are safe compensation methods not based on transaction term:

- LO's overall dollar volume
- <u>Long-term</u> performance of the LO's loans
- Hourly pay rate based on the actual number of hours worked
- Loans made to new customers versus loans to existing customers'
- Payment fixed in advance for every loan (flat fee)
- Percentage of the LO's applications that close
- Quality of the LO's loan files

Profit-based compensation plans are subject to the limitations. However, LOs may participate in the following:

- Retention bonus budgeted for in advance

- Performance bonus paid out of a bonus pool set aside at the beginning of the annual account period as part of the Bank's operating budget
- Tax-advantaged plan (e.g. defined contribution plan under ERISA)
- Non-deferred profits-based compensation plan that is limited to 10% of aggregate compensation.

If a bank's year-end bonus takes into consideration earnings on mortgage loans, it may violate the anti-steering rules found in Regulation Z. As described above, the CFPB maintains a very broad interpretation with regard to Section 1026.36 of Reg Z. That section prohibits mortgage loan originators and brokers from receiving compensation based on the terms of the loans they originate.

Thus, if the incentive compensation plan or year-end bonus is based on the performance of the bank, and the performance criteria include a component for interest on loans for the year, then that criteria will indirectly be affected by the interest rate that was applied to mortgage loans in the portfolio.

PERMITTED EXCEPTIONS FOR LOAN ORIGINATOR COMPENSATION

There are two specific exceptions. The first exception applies if the bonus compensation paid to the LO is not in excess of 10-percent of his or her total compensation. The second exception applies if the LO originated 10 or fewer covered transactions in the preceding twelve months.
See 12 CFR 1026.36(d):

> *(iv) An individual loan originator may receive, and a person may pay to an individual loan originator, compensation under a non-deferred profits-based compensation plan (i.e., any arrangement for the payment of non-deferred compensation that is determined with reference to the profits of the person from mortgage-related business), provided that:*
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> *(A) The compensation paid to an individual loan originator pursuant to this paragraph (d)(1)(iv) is not directly or indirectly based on the terms of that individual loan originator's transactions that are subject to this paragraph (d); and*
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> *(B) At least one of the following conditions is satisfied:*
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> *(1) The compensation paid to an individual loan originator pursuant to this paragraph (d)(1)(iv) does not, in the aggregate, exceed 10 percent of the individual loan originator's total compensation corresponding to the time period for which the compensation under the non-deferred profits-based compensation plan is paid; or*
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> *(2) The individual loan originator was a loan originator for ten or fewer transactions subject to this paragraph (d) consummated during the 12-month period preceding the date of the compensation determination.*

Calculation of the 10% test. The relevant time period for compensation subject to the 10% limit is the time period for which the bank makes reference to profits in determining the compensation. It doesn't matter whether the bonus is actually paid during that particular time period. The total compensation for the LO is the wages and tips reportable for Medicare tax purposes (box 5 on IRS Form W-2) that are actually paid during the relevant time period, excluding compensation under a non-deferred profits based-compensation plan that is earned during a different time period.

To determine the 10% limit, aggregate the proposed bonus with the total compensation. Here is an example from the Small Entity Compliance Guide.

Assume for calendar year 2014 you pay an LO the following amounts:

- $80K in commissions based on the individual LO's performance and volume of loans generated during 2014
- $10K in an employer contribution to a designated tax-advantaged contribution plan (e.g. 401k) in 2014
- Year-end bonus of $10K from non-deferred profits-based compensation plan to be paid in January 2015

Even though the non-deferred bonus is to be paid in January 2015, it may be included in the total compensation, resulting in a total of $100K. The bonus of $10K, thus, meets the 10% test.

AVOIDING VIOLATION OF THE ANTI-STEERING RULE

In addition to the two exceptions above, there are at least three fairly straight forward approaches that will eliminate the potential for violation of the anti-steering rule.

First, exclude residential mortgage loan interest from a calculation of bank earnings. This means that the compensation is not influenced by interest rate on residential mortgages. This might work if mortgage loans are not a significant source of revenue for the bank.

Second, exclude mortgage loan originators from the pool of employees who are compensated based on overall bank performance. Calculate their incentive compensation differently. The rule permits a bonus based on a fixed percentage of the amount financed.

CONTRIBUTION TO A DEFINED PLAN

The third and final approach would be to make a contribution to a defined contribution plan that is a designated tax-advantaged plan and the contributed amount is not based directly or indirectly upon the terms of the contract. This is described in 12 CFR 1026.36(d)(iii):

> *(iii) An individual loan originator may receive, and a person may pay to an individual loan originator, compensation in the form of a contribution to a defined contribution plan that is a designated tax-advantaged plan or a benefit under a defined benefit plan that is a designated tax-advantaged plan. In the case of a contribution to a defined contribution plan, the contribution shall not be directly or indirectly based on the terms of that individual loan originator's transactions. As used in this paragraph (d)(1)(iii), "designated tax-advantaged plan" means any plan that meets the requirements of Internal Revenue Code section 401(a), 26 U.S.C. 401(a); employee annuity plan described in Internal Revenue Code section 403(a), 26 U.S.C. 403(a); simple retirement account, as defined in Internal Revenue Code section 408(p), 26 U.S.C. 408(p); simplified employee pension described in Internal Revenue Code section 408(k), 26 U.S.C. 408(k); annuity contract described in Internal Revenue Code section 403(b), 26 U.S.C. 403(b); or eligible deferred compensation plan, as defined in Internal Revenue Code section 457(b), 26 U.S.C. 457(b).*