A Look at the Consumer Financial Protection Bureau's New Loan Originator Compensation Rule Under the Truth in Lending Act

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I. Introduction

On February 15, 2013, the Office of the Federal Register published the Consumer Financial Protection Bureau’s ("CFPB") final rule on loan originator compensation requirements under the Truth in Lending Act (Regulation Z). Because consumers rely so heavily on loan originators, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) provided new requirements for industry compensation practice, loan originator qualification, arbitration agreements, and the financing of insurance with a mortgage loan. The CFPB's new rule implements the Dodd-Frank requirements by revising and amending Regulation Z to keep loan originators from steering borrowers towards high-cost and risky loans. The final rule is effective January 10, 2014, although two provisions are effective June 1, 2013.

II. Key Elements

The final rule contains four primary elements:

- Loan originators cannot receive compensation based on the terms or proxy terms of the transaction.
- Loan originators cannot receive compensation from both the consumer and the creditor.
- Loan originators must meet specific qualification and identification requirements.
- Consumers may still pay upfront points and fees.

Perhaps the most important element of the CFPB's new rule on loan originator compensation, and most certainly the heart of the rule, is the prohibition of compensation based on the terms of the transaction. Although Regulation Z already prohibited compensating a loan originator for "any of the transaction's terms or conditions", the new rule greatly clarifies the rule's scope. Loan originators are prohibited from receiving compensation directly or indirectly based on a term of the transaction. "A term of a transaction" is now specifically defined as "any right or obligation of the parties to a credit transaction". For example, a loan originator cannot be compensated based on the loan's rate or a consumer's purchase of a title insurance affiliated with the loan originator. In addition, the final rule specifies that compensation based on proxy terms of transactions is also prohibited. For example, if a factor is not necessarily a term of the transaction, but the loan originator has the ability to manipulate the factor, and it consistently varies with a term over many transactions, that factor is a proxy term and the loan originator cannot be compensated for it.

The second key element of the new rule is fairly straight-forward—loan originators are prohibited from receiving dual compensation. In short, a loan originator may not receive compensation directly from both a consumer and a creditor in connection with a mortgage loan. The idea is simply that consumers rely heavily on loan originators and consumers likely assume that their loan originator is concerned with the consumer's best interest, not a third party creditor's best interest. By prohibiting dual compensation, the new rule eliminates consumer confusion of where the loan originator's loyalties actually lie.

The final rule's third major element imposes qualification and identification requirements on loan originators. Loan officers, mortgage brokers, and creditors have a new duty under Regulation Z to be licensed or registered under any applicable federal and state law, including the Secure and Fair Enforcement for Mortgage Licensing Act of 2008 (SAFE Act). For those who are not legally obligated to be licensed—for example, employees at depository institutions or bona fide non-profits—this new rule imposes character, fitness, and criminal background standards. In addition, employers are also required to appropriately train their loan originator employees. This element of the final rule has specific provisions and disqualifications. For example, a felony conviction involving an act of fraud, dishonesty, a breach of trust, or money laundering is disqualifying. In addition to the qualification standards, the new rule also imposes identification standards. The rule requires loan originators to register their unique identifiers with the Nationwide Mortgage Licensing System and Registry (NMLSR) and to list that NMLSR identifier on enumerated loan documents with their name.

Seemingly contrary to the rest of the new rule, the final rule's fourth major element is the *exemption* of a prohibition on consumer payment of upfront points and fees when the loan originator is compensated by a third party. Dodd-Frank actually required this prohibition, but also authorized the CFPB to create waivers or exemptions for this prohibition. At first, as proposed by the CFPB, this rule would waive the ban to allow creditors to charge upfront points and fees, if they also provided a "zero-zero" alternative with no points or fees. The thinking behind this proposal was that it would provide more consumer options and assist consumers in their decision-making. The proposal, however, was met with many concerns about consumer confusion and the feasibility of implementation in the industry. Therefore, the CFPB is now researching issues related to design, operation, and consequences of the Dodd-Frank's required prohibition on upfront points and fees to better understand the potential affects on consumers. In the meantime, the CFPB's final rule creates a complete exemption to the prohibition on upfront points and fees.

III. Other Notable Provisions

In addition to the key elements listed above, the final rule on loan origination makes other notable provisions. First, the new rule prohibits mandatory arbitration clauses. Loan agreements may not contain clauses that require a consumer to use arbitration or that bar consumers from bringing a federal claim in court. Second, the new rule bans fees or premium financing for credit insurance—for example, credit life insurance—for consumer transactions that are secured by a dwelling. However, the rule does allow credit insurance to be paid on a monthly basis. Third, the new rule applies the existing three-year recordkeeping requirements for loan originator compensation to mortgage brokers and creditors.

Fourth, the final rule makes some key definitions. Most notably, the final rule defines "loan originator":

> a person who, in expectation of direct or indirect compensation or other monetary gain or for direct or indirect compensation or other monetary gain, performs any of the following activities: takes an application, offers, arranges, assists a consumer in obtaining or applying to obtain, negotiates, or otherwise obtains or makes an extension of consumer credit for another person; or through advertising or other means of communication represents to the public that such person can or will perform any of these activities.

The definition specifically includes employees, agents, and contractors of creditors or loan originator organizations as well as creditors that engage in loan origination activities, even if the creditor does not finance the transaction with its own resources. However, this definition excludes the following: people who perform administrative tasks for a loan originator; people who only perform licensed real estate brokerage activities and do not receive compensation from a creditor or loan originator for consumer credit transactions; certain seller financers (also defined); servicers "who offer or negotiate terms for purposes of renegotiating, modifying, replacing, or subordinating principal of existing mortgages where consumers are behind in their payments, in default, or have a reasonable likelihood of defaulting or falling behind"; and people who do not take credit applications, offer or negotiate terms, or advise consumers on credit terms, but work for a manufactured home retailer.

Finally, it is worth noting that the new rule does not make any changes to the liability already created in Regulation Z and by the Dodd-Frank Act. This liability already included the following:

- Private right of action against both the lender and the originator.
- Originator liability cannot exceed the greater of actual damages or an amount equal to three times the total amount of direct and indirect compensation or gain to the originator, plus costs and attorneys fees.
- Lenders are liable for all interest and fees paid by the borrower and actual and statutory damages.
- The statute of limitations is three years after the date of the violation.

IV. Conclusion

The CFPB's new rule implements the Dodd-Frank Act loan origination requirements by amending Regulation Z provisions to protect consumers from being sold risky, expensive, and unnecessary loans from disloyal loan originators who benefit from pushing those high-risk loans. Therefore, loan originators are no longer allowed to receive compensation from creditors for terms of a consumer's transaction, or even generally to receive dual compensation from both the consumer and a creditor. Also, loan originators now must meet minimum qualification and identification standards and arbitration agreements and financing credit insurance are no longer traps that unaware consumers can fall into. The majority of the final rule is effective January 10, 2014, although the provisions on arbitration and financing credit insurance are effective June 1, 2013.

V. References

- *Consumer Financial Protection Bureau issuing rules to prevent loan originators from steering consumers into risky mortgages,* http://www.consumerfinance.gov/pressreleases/consumer-financial-protection-bureau-rules-to-prevent-loan-originators-from-steering-consumers-into-risky-mortgages/.
- *Dodd-Frank Wall Street Reform and Consumer Protection Act* http://www.sec.gov/about/laws/wallstreetreform-cpa.pdf.
- *Preamble of the Amended Loan Originator Compensation Requirements under the Truth in Lending Act (Regulation Z)*, http://files.consumerfinance.gov/f/201301_cfpb_final-rule_loan-originator-compensation-preamble.pdf.
- *Regulatory Text of the Amended Loan Originator Compensation Requirements under the Truth in Lending Act (Regulation Z)*, http://files.consumerfinance.gov/f/201301_cfpb_final-rule_loan-originator-compensation-amendments.pdf.
- *Summary of the final rule on mortgage loan originator qualification and compensation practices*, http://files.consumerfinance.gov/f/201301_cfpb_loan-originator-compensation-rule_summary.pdf.

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