

# Lenders Compliance Group

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## Loan Originator Compensation—The Regulatory Examination

**The easy part is over. Now the real fun begins.**

Since April 6, 2011, the mortgage industry has been required to implement the new loan originator compensation rules (Rule). The Rule applies to closed-end transactions secured by a dwelling where the creditor receives a loan application on or after April 6, 2011.<sup>[1]</sup> The Rule placed restrictions on residential mortgage loan transactions in order to protect consumers against the unfairness, deception, and abuse that can arise with certain loan origination compensation practices, generally prohibits payments to loan originators based on loan terms and conditions, eliminates dual compensation to originators by consumers and any other person, and prohibits "steering" consumers to loans to receive greater compensation.

I have extensively explored the features of this Rule, unraveling its complexity in articles, newsletters, presentations, and panels.<sup>[2]</sup> Indeed, I have even published a compendium of analysis, called the [FAQs Outline - Loan Originator Compensation](#), which, as of this writing, consists of over 400 FAQs and reaches to over 130 pages. <sup>[3]</sup> These are deep and narrow waters, and considerable caution is needed in order to navigate their many demanding twists and turns.

The development of these rules, from a regulatory perspective, stretches back to August 26, 2009, when the Federal Reserve Board (FRB) published a Proposed Rule in the Federal Register pertaining to closed-end credit; to July 21, 2010, when the [Dodd-Frank Wall Street Reform and Consumer Protection Act](#) (Dodd-Frank) <sup>[4]</sup> enacted Title XIV into law, which amended the Truth in Lending Act (TILA) to establish certain mortgage loan origination standards; then to August 16, 2010, when the FRB published its Final Rules amending Regulation Z (TILA's implementing regulation); on through September 24, 2010, as the FRB issued final rulemaking and official staff commentary with respect to the loan originator compensation rules and anti-steering provisions (Rule); and finally coming to a virtual full stop on January 26, 2011, when the FRB issued its "Compliance Guide for Small Entities on Loan Originator Compensation and Steering." <sup>[5]</sup> After that, the FRB offered some conference calls, a webinar - which cleared up some confusion, while causing still other confusion - and occasional updates of the oral, rather than the written, official variety. <sup>[6]</sup>

When April 6, 2011 arrived, the mortgage industry was still scrambling to understand the Rule, how to implement it across various origination channels, and, most importantly, how to integrate it into operational, logistical, and financial components. Vendors provided considerable updates and integration features. Nevertheless, for months afterward the Rule continued to perplex and frustrate, particularly with respect to properly implementing disclosures and compensation plans. It still causes considerable consternation.

As we all know, generally there is no regulation issued - whether the statutes are at the federal or state level - that does not have a corresponding regulatory examination to assure enforcement. And so it goes: on October 6, 2011 - exactly six months to the day when the Rule became effective - the first examination guidelines for loan originator compensation were promulgated. <sup>[7]</sup>

In the "State Nondepository Examiner Guidelines for Regulation Z - Loan Originator Compensation Rule," hereinafter "Examiner Guidelines," issued by the Multi-State Mortgage Committee (MMC), we now have a pretty good idea of the direction that federal and state regulators will be taking in their regulatory examinations for loan originator compensation. The Multi-State Mortgage Committee (MMC) is a ten-state representative body created by the Conference of State Bank Supervisors (CSBS) and the American Association of Residential Mortgage Regulators (AARMR). <sup>[8]</sup>

Are these examination guidelines perfectly worked through? Not really. Not yet. After some field testing, we should expect revisions. But as a first stab at a complex issue, they are helpful in giving a sense of the kind of information and documentation that examiners will be reviewing. These are revised procedures and they supersede the Regulation Z Interagency examination procedures. The Task Force on Consumer Compliance of the Federal Financial Institutions Examination Council (FFIEC) has approved interagency examination procedures for Regulation Z - Truth in Lending, including the Rule. The Examiner Guidelines supplement the Interagency procedures and are intended to assist state regulators of nondepository mortgage loan originators and creditors in standardized and uniform reviews of the Rule.

When the aforementioned Examiner Guidelines were issued, my firm re-set our audit and due diligence reviews for the Rule to accord with them, even in the midst of actual reviews of loan originator compensation compliance that we were then conducting for our clients.

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As I have said many times, preparation is protection. Don't wait for the regulator's Document Request letter to implement any regulatory requirement. If you wait, by then it's often too late. Remember, most examinations are look-backs, reaching to the previous examination, or a stated timeframe previous to the current examination. Most examiners have a "No Tolerance" view of firms that cannot provide supporting documents and information in a timely manner. The "record speaks for itself" is the inflexible standard! Our audit and due diligence reviews are the property of our client, and as fully confidential as if the client conducted its own review, with its internal resources - which, of course, is certainly a viable option. So, there really is no excuse for not being prepared for a regulatory examination for loan originator compensation or any other examination.

In my view, undertaking preparedness action for a loan originator compensation examination should consist of the following basics. [9] My remarks include some of my firm's audit and due diligence practices as well as certain features of the recently issued Examiner Guidelines.

### Preparation is Protection

#### REVIEW CONSTRUCT

- It is critical to set forth the bounds of the review. Indicate a research range that utilizes an audit sequence which, in part, incorporates federal Interagency procedures and guidelines implemented prior to the effective date of the Rule, as well as federal Interagency procedures and guidelines effective after the date of the Rule, as promulgated by the Multi-State Mortgage Committee (MMC) examiner guidelines, any federal agency, and, when issued, state government agencies.
- A significant portion of the review should be devoted to (1) completing the *Institution Information Request* and *Institution Questionnaire* provided in the Examiner Guidelines, (2) assembling items required in a Document Request, (3) providing information asked for in an Audit Checklist (whether specifically designed or Interagency), and (4) including independent review criteria through documentation review, on-site transaction testing (if required), off-site sampling of transaction documents, and interviews of institution staff or other parties.

#### REVIEW COMPONENTS

Report of Findings

Review of Policy and Procedures

Institution Information Request

Institution Questionnaire

Document Request

Auditing of Sampling Indicia

#### METHODOLOGY

There are several ways to go about preparing for a regulatory examination of loan originator compensation.

Prior to determining the most suitable procedures to follow, three Modules should be outlined, as follows:

#### **MODULE 1 – EXAMINER CHECKLIST**

This consists of certain kinds of questions that would be expected to guide the examiner throughout the course of the examination. It is important to be familiar with the criteria that will be applied.

#### **MODULE 2 – INSTITUTION INFORMATION REQUEST**

The information that we would seek does not apply to dates prior to April 6, 2011. However, this module does take into consideration a very comprehensive review of all information and documentation that affect loan originator compensation.

#### **MODULE 3 – INSTITUTION QUESTIONNAIRE**

This module is meant to save time and resources. We usually incorporate this in every Document Request, and, unless we direct otherwise, we expect this questionnaire to be completed and returned to us prior to our audit and due diligence review. Most clients know to support their answers with documentation. Certain questions, though, may be answered with a Yes or No response, but most questions require comprehensive, fully documentable responses.

#### SCOPE

There are, essentially, three options in fulfilling the scope of exam preparedness, each of which consists of one or more of the aforementioned modules.

#### **Full Scope**

The Full Scope requires the completion of Modules 2 and Module 3, followed by completion of Module 1 through a documentation review, on-site transaction testing, and interviews of institution staff or other parties.

#### **Limited Scope**

A Limited Scope only requires completion of Module 1, and it excludes transaction testing and interviews, based on the institution's responses to Modules 2 and 3.

#### **Limited Scope with off-site testing**

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This review combines the Limited Scope with off-site sampling of transaction documents and/or telephone interviews of institution staff or other parties.

CAVEAT: Before moving on to the next section, I want to mention that the appropriate risk management approach vis-à-vis the selection of the scope depends on a financial institution's type, size, complexity, and risk profile. Conferring with a risk management professional would be helpful to determining which scope is most suited to providing the level of exam preparedness needed.

### Information Questionnaire

Please give earnest consideration to the following questions, as these will come up in one form or another during an examination of loan origination compensation. The financial institution may or may not know the answers to all the questions, but that very fact demonstrates weakness in policies, procedures, and compliance enforcement. When my firm issues a Document Request, the Information Questionnaire is now always included. Prior to the examination, it is unlikely that the examiner will provide information about appropriate answers to these kinds of questions. While some of the questions may seem relatively simple on the surface, they are not really simple at all. The answers are either clearly stated or they are not, and if they are not stated or incorrectly stated, this in itself alerts the examiner to the financial institution's level of preparedness, its management competence, its implementation awareness, and the additional information and documentation that may be need to be requested for the examination.

1. How are loan originators compensated? Provide details of all compensation procedures and calculations.
2. What incentive plans are offered to loan originators? Provide details.
3. Are loan originators ever compensated based on:
  1. The interest rate or Annual Percentage Rate obtained on a loan?
  2. The loan to value obtained on a loan?
  3. Originating a loan with a prepayment penalty?
  4. The amount of loan fees paid to the institution or creditor?
4. Are credit scores a determining factor in the amount of compensation earned by a loan originator? Explain.
5. Is debt to income a determining factor in the amount of compensation earned by a loan originator? Explain.
6. Are loan originators allowed to receive reimbursement for third party costs (i.e., appraisal, credit report, et cetera)?
7. Are loan originators allowed to charge more for third party costs than the actual cost of the service and retain such costs as compensation? Explain.
8. Are loan originators allowed to charge for services other than loan origination services that are performed by the originator? For example: loan processing, document preparation, inspection fees, and so forth.
9. Is the loan originator compensated any differently when price is increased by the creditor or employer to offset loan costs?
10. Is loan originator compensation ever reduced in order for the institution to compete on loan terms? (For example: the institution reduces its rate by 50 basis points to induce a shopping consumer to stay with the institution, and the loan originator's compensation is reduced accordingly.)
11. Are loan originators able to deliver loans to more than one affiliate or subsidiary of the institution's parent company? If so, are loan originators compensated differently based on which affiliate the loans are delivered to?
12. Are loan originators allowed to receive compensation (including yield spread premium or similar compensation) from both the consumer and any other person on the same transaction?

**Brokered Loans:** Questions 13 through 18 must be answered by both mortgage broker loan originators originating loans and creditor institutions receiving brokered loans.

1. Does the institution allow loan originators to "steer" consumers to transactions where the loan originator receives more compensation and the loan is not in the consumer's interest? Explain.
2. Does the institution require or use the steering Safe Harbor provision under the Rule? [\[10\]](#)
3. During the examination period or the last three years, in how many transactions has the institution required or used the steering Safe Harbor provision under the Rule? Institution may answer with a number or the percentage of total loans originated.
4. Does the institution require third party originators to use the steering Safe Harbor provision?
5. If a creditor, what action does the institution take to monitor third party compliance with the steering Safe Harbor provision?
6. If the institution does not require or use the steering Safe Harbor provision what methods does it use to determine that steering has not and will not occur?
7. How does the institution determine if steering has occurred?

7. How long does the institution retain compensation agreements?
8. How long does the institution retain records of actual compensation?
9. How long does the institution retain records that support the options offered under the steering Safe Harbor provision?

### Documents and Information

I would like to end this article with a brief overview of the kinds of documents that should be involved in a thorough review involving loan originator compensation. The list I am providing is not meant to be complete, since each financial institution differs in many ways. This is a general list that we would require in a Document Request. A financial institution should be prepared to provide the documentation and information virtually immediately. If a lot of time is needed to get the documents together, the financial institution is, unfortunately, simply not prepared for the examination and should expect the examiner to notice the lack of preparedness.

In addition to the Institution Information Request and Institution Questionnaire that I have described, expect to provide Employment Agreements for Loan Officers, Sales Managers, Producing Branch Managers, and Non-Producing Branch Managers. If the Compensation Plans are not part of the Employment Agreements, but separately attested to, then expect to provide them for these same individuals. A list of affiliates will be required (i.e., title companies), if applicable. [11]

Wholesale channels must be able to deliver the Wholesale Broker Agreement, Compensation Plan, and any Announcements. Indeed, any origination channel must be ready to provide Presentations and all relevant Announcements.

Examiners will audit certain areas of interest that directly impact actual loan originations. In this regard, expect to provide the loan application register for all applications taken from April 6, 2011 to the date stipulated in the examiner's Document Request letter. For that same period, also expect to provide Monthly Production Reports, and Rate Sheets.

Finally, the examiner will test the data provided against a complete analysis of loan originator specific data, such as the loan number, loan originator's name, and borrower's name, as well as the subject property state, each MLO's compensation payments, and each MLO's date of employment or affiliation.

### Final Words of Advice

Most of our clients know that I tend to be a Mother Hen when it comes to taking care of their mortgage compliance needs. I admit it wholeheartedly. In my opinion, each institution should appoint its own version of a Mother Hen in order to assure that examination preparation for loan originator compensation is properly vetted and readied.

The penalties for violations are steep and could be catastrophic, not only with respect to the so-called "traditional" penalties, such as actual damages, statutory damages (up to \$4,000 for each individual action and potential class action), and attorneys' fees and costs, but also there is "enhanced" liability for creditors, such as refunding all finance charges and fees paid by the consumer (unless the creditor demonstrates that the failure to comply is not material). Loan originators are exposed to penalties of the greater of actual damages or three times the compensation or gain on the loan (i.e., liability even if there are no damages); a longer "statute of limitations" for loan originator compensation and certain other violations so that actions may be brought until the end of a three year (i.e., not a one year) period from the date of the violation; and, state Attorneys General are authorized to enforce violations of loan originator compensation and certain other requirements.

Given the penalties for violations of the loan originator compensation guidelines, now is the time to prepare, in advance, and be continually ready for the inevitable notice of the forthcoming regulatory examination.

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[1] Due to litigation, the April 1, 2011 implementation date was temporarily stayed. The stay was dissolved. The effective compliance implementation date of the Rule is April 6, 2011.

[2] For instance, Foxx, Jonathan, *Landmark Financial Legislation: New Rules for Mortgage Originators - Part I: Reformation and Regulations*, National Mortgage Professional Magazine, August 2010, Volume 2, Issue 8, pp 28-42; Foxx, Jonathan, *A New Era of Mortgage Reform - Part II: Legislation - Reactive or Proactive*, National Mortgage Professional Magazine, September 2010, Volume 2, Issue 9, pp 22-28; Foxx, Jonathan, *A New Era of Mortgage Reform - Part III: Consumer Financial Protection - Bureau and Bureaucracy*, October 2010, Volume 2, Issue 10, pp 22-40; Foxx, Jonathan, *The Birth of an Agency*, in National Mortgage Professional Magazine, September 2009, Volume 1, Issue 5, pp 24-27; and, Foxx, Jonathan, *The CFPA Controversy: Asking the Tough Questions*, in National Mortgage Professional Magazine, October 2009, Volume 1, Issue 6, pp 22-25. All Newsletters and Articles through 2011 are available at: <http://publications.lenderscompliancegroup.com/>.

[3] See information about the [FAQs Outline - Loan Originator Compensation](#) by visiting the Library section of my firm's website. See: <http://lenderscompliancegroup.com>.

[4] H.R. 4173: Dodd-Frank Wall Street Reform and Consumer Protection Act, 111th Congress (2009-2010): "A bill to promote the financial stability of the United States by improving accountability and transparency in the financial system, to end "too big to fail", to protect the American taxpayer by ending bailouts, to protect consumers from abusive financial services practices, and for other purposes." Sponsored by Representative Barney Frank (D-MA) and Senator Christopher Dodd (D-CT)

[5] *Compliance Guide to Small Entities*, Regulation Z: Loan Originator Compensation and Steering, 12 CFR 226, Federal Reserve Board, January 26, 2011

[6] July 21, 2011 is the date, pursuant to Dodd-Frank, that the Consumer Financial

Protection Bureau (CFPB) receives rulemaking and examination authority over the "enumerated laws," the so-called "Designated Transfer Date." See Designated Transfer Date, Bureau of Consumer Financial Protection, Federal Register, Vol. 75, No. 181 (09/20/10). The Designated Transfer Date must be between January 17, 2011 and July 21, 2011, unless the Treasury Secretary determines that the orderly implementation of Title X is not feasible within 12 months; but, in no case may the Designated Transfer Date be later than January 21, 2012. In fact, the loan originator compensation guidance was transferred to the CFPB on July 21, 2011.

[7] The *State Nondepository Examiner Guidelines for Regulation Z - Loan Originator Compensation Rule* is dated October 6, 2011, although the announcement of its issuance was on October 7, 2011.

[8] The Multistate Mortgage Committee (MMC) released this set of examiner guidelines to assist state regulators in implementing the FRB's loan originator compensation restrictions under Regulation Z [12 C.F.R. § 226.36(d), (e)]. Earlier this year, the MMC also issued the *Mortgage Examination Manual*, which provides information and criteria for the examination of multistate mortgage entities, and further provides guidance on examination planning and administration.

[9] Please take note: this article is being published in the November 2011 edition of National Mortgage Professional Magazine, and it reflects certain information available at this time. Please be mindful that regulatory requirements and preparedness actions may change in the future and at any time.

[10] See §226.36(e)(1)

[11] See §226.36(d)(3)



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