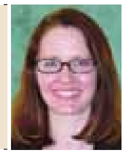

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On the Origin of Income

Broker compensation will soon take on a new look

The landscape for mortgage-broker compensation is changing. Are you ready? Here's a look at what's coming and how brokers — and their lenders — can evolve their payment models and prepare for the future.

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The Federal Reserve Board's final rule on loan-originator compensation takes effect April 1. That date marks the end of an era in how mortgage brokers, mortgage-company employees and even loan officers within banks are paid.

The final rule, announced this past Aug. 16, prohibits paying mortgage brokers and other loan originators based on the interest rate paid by borrowers or on any other term or condition of the loan other than the amount of credit extended. As a result, the rule prohibits yield-spread premium (YSP) that is based on the interest rate and interest-rate overages paid to loan originators. For many brokers and other loan originators, YSP has become a common means of getting paid.

Because the new rule applies to loan originators — defined as people who arrange consumer credit for compensation — it will cover mortgage brokers, certain employees of mortgage companies and financial institutions, and lenders themselves if they are extending a loan that is funded by another creditor.

The rule, however, only applies to closed-end consumer credit secured by a dwelling. Consequently, commercial loans aren't covered even if they're secured by someone's home.

Home-equity lines of credit and consumer loans not secured by a dwelling also aren't covered by the rule, although the Federal Reserve plans to consider whether they should be as it issues more regulatory requirements in the future.

Illustration: Dennis Wunsch

Compensation limits

The final rule contains two primary provisions:

1. **Limits on how compensation is calculated and paid;** and
2. **A prohibition on steering.**

The compensation limit states that a loan originator, such as a mortgage broker, cannot be paid based on the terms and conditions of the loan. As a result, mortgage-broker compensation can't be calculated based on interest rate, annual percentage rate, loan-to-value ratio or the existence of prepayment penalties on the loan.

To prevent evasion, the Federal Reserve also prohibits compensation based on a proxy for the loan's terms and conditions — such as borrower credit scores, debt-to-income ratios or credit risk. A mortgage broker may, however, be compensated based on factors that don't represent terms or conditions of a loan, such as:

- **The total number of loans** from the broker that were originated;
- **The total amount of credit** that was extended from the broker's loans;
- **The performance of the broker's loans** in the long run;
- **The number of actual hours of work** performed by the broker, paid at an hourly rate;

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- **Legitimate business expenses,** such as overhead;
- **Whether the borrower is a new or existing customer**;
- **The percentage of applications submitted** by the broker that result in closed loans; and
- **The quality of the broker's loan files,** such as their accuracy and completeness.

Brokers also can receive a payment fixed in advance, such as a per-loan fee. This can be a flat fee for all loans arranged, or it can differ for specific loan tranches. For example, brokers could be paid $1,000 for each of the first 1,000 loans they arrange and a different amount for each loan after that.

Another compensation option includes paying brokers a percentage of each loan amount. Specific requirements apply if this option is used, however. First, the percentage must be fixed and can't vary with different loan amounts. Second, the compensation arrangement can include minimum and maximum amounts of compensation, but these limits must not vary for different transactions.

For example, brokers can be paid 1 percent of the loan amount for all loans originated and can have a minimum and maximum fee in their agreement with the lender. The broker cannot, however, be paid different percentages for different loan scenarios, such as 2 percent for loans to $300,000 and 3 percent for loans of more than $300,000.

Exception to the rule

The rule includes one major exception: Mortgage brokers can be paid based on the terms and conditions of a loan if they are paid by the consumer only. In other words, when a consumer pays a mortgage broker's or other loan originator's compensation, no one else can compensate the broker or originator regardless of how the compensation is determined.

Consumers are considered to have paid broker compensation when they pay a broker directly or from loan proceeds. Consumers aren't, however, considered to have compensated brokers simply because they paid points to the lender — whether in cash or from the loan proceeds — or because they paid the broker for third-party fees incurred, such as an appraisal fee.

Note that if a broker adds an up-charge to a third-party fee, it will be treated as broker compensation.

Steering prohibition

The new compensation limits under the Fed's final rule meet requirements of the Dodd-Frank Wall Street Reform and Consumer Protection Act as well as provisions proposed by the Fed in its ongoing efforts to overhaul mortgage-lending rules. The final rule, however, added another provision — the steering prohibition — that goes beyond the requirements of the Dodd-Frank Act.

Under the rule, mortgage brokers and loan originators are prohibited from steering consumers to loans based on the fact that they will receive higher compensation — unless the loan also is in the consumers' best interest. Mortgage brokers may offer loans that will deliver them less than or the same amount of compensation as what they would earn on other loan options for which a consumer would likely qualify. When brokers offer loans that would allow them to receive more compensation, they must establish that the loan offered is in the consumers' best interest.

The final rule includes a safe harbor for meeting these requirements. For each fixed-rate loan, variable-rate loan and reverse mortgage in which a consumer expresses interest, brokers must provide three loan options for which the consumer would likely qualify.

One option must be the loan that has the lowest dollar amount of discount points and origination points or fees. Another must be the loan with the lowest interest rate for which the consumer would likely qualify. The third must be an option that doesn't have negative amortization, a prepayment penalty, interest-only payments or a balloon payment in the first seven years. In the case of reverse mortgages, this option must be a loan without a prepayment penalty, shared equity or shared appreciation.

In determining what loan option has the lowest interest rate for a variable-rate loan, the broker must determine if the initial rate will be fixed for at least five years. If it will be, then the broker will use the initial interest rate that will be in effect at closing. If the rate isn't fixed for at least five years and the rate varies based on an index, then the broker must look to the fully indexed rate at closing without regard for any premium or discount on the rate.

If the loan is instead a stepped-rate loan, then the broker must use the highest rate that would apply in the loan's first five years.

If there are not three loan options that meet the criteria in the safe harbor, then the broker can offer fewer options. Brokers can offer more than three options only if they highlight which of the loan options meet the safe-harbor criteria. Further, brokers must consider loan options from a significant number of lenders with which they do business regularly.

This means brokers who regularly do business with three or more lenders must look at loan options from at least three of those lenders. If brokers only regularly do business with one or two lenders, then they may get loan options from only those lenders and won't be required to start business relationships with others.

The loans that brokers eventually offer to consumers don't have to be from all the lenders considered, however. Rather, brokers simply must look at their loan options to identify loans that would meet the safe-harbor criteria.

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The Federal Reserve's final rule on lending compensation and steering marks a major shift in how mortgage brokers and originators will be paid, as well as how they will document their decisions about which loan products are offered to consumers. Brokers also should know that this rule won't be the last new requirement regarding compensation practices they will face in the coming months and years.

Although it's hard to say when other new requirements and legislation will be implemented or take effect, brokers who evolve quickly will put themselves in the best position to succeed moving forward. ●