FEDERAL RESERVE SYSTEM

12 CFR Part 226

Regulation Z; Docket No. R–1366

Truth in Lending

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Final rule; official staff commentary.

SUMMARY: The Board is publishing final rules amending Regulation Z, which implements the Truth in Lending Act and Home Ownership and Equity Protection Act. The purpose of the final rule is to protect consumers in the mortgage market from unfair or abusive lending practices that can arise from certain loan originator compensation practices, while preserving responsible lending and sustainable homeownership. The final rule prohibits payments to loan originators, which includes mortgage brokers and loan officers, based on the terms or conditions of the transaction other than the amount of credit extended. The final rule further prohibits any person other than the consumer from paying compensation to a loan originator in a transaction where the consumer pays the loan originator directly. The Board is also finalizing the rule that prohibits loan originators from steering consumers to consummate a loan not in their interest based on the fact that the loan originator will receive greater compensation for such loan. The final rules apply to closed-end transactions secured by a dwelling where the creditor receives a loan application on or after April 1, 2011.

DATES: The final rule is effective on April 1, 2011.

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SUPPLEMENTARY INFORMATION:

I. Background and Implementation of the Reform Act

A. Background: TILA and Regulation Z

Congress enacted the Truth in Lending Act (TILA), 15 U.S.C. 1601 *et seq.,* based on findings that economic stability would be enhanced and competition among consumer credit providers would be strengthened by the informed use of credit resulting from consumers' awareness of the cost of credit. TILA directs the Board to prescribe regulations to carry out its purposes and specifically authorizes the Board, among other things, to issue regulations that contain such classifications, differentiations, or other provisions, or that provide for such adjustments and exceptions for any class of transactions, that in the Board's judgment are necessary or proper to effectuate the purposes of TILA, facilitate compliance with TILA, or prevent circumvention or evasion of TILA. 15 U.S.C. 1604(a).

In 1995, the Board revised Regulation Z to implement changes to TILA made by the Home Ownership and Equity Act (HOEPA). 60 FR 15463; Mar. 24, 1995. HOEPA requires special disclosures and substantive protections for home-equity loans and refinancings with annual percentage rates (APRs) or points and fees above certain statutory thresholds. HOEPA also directs the Board to prohibit unfair and deceptive acts and practices in connection with mortgages. 15 U.S.C. 1639(l)(2).

On August 26, 2009, the Board published a proposed rule in the **Federal Register** pertaining to closed-end credit (August 2009 Closed-End Proposal). As part of that proposal, the Board proposed to prohibit certain compensation payments to loan originators, and to prohibit steering consumers to loans not in their interest because the loans would result in greater compensation for the loan originator. As stated in the **Federal Register**, this proposal was intended to protect consumers against the unfairness, deception, and abuse that can arise with certain loan origination compensation practices while preserving responsible lending and sustainable homeownership. *See* 74 FR 43232; Aug. 26, 2009. The comment period on the August 2009 Closed-End Proposal ended December 24, 2009. The Board received approximately 6000 comments in response to the proposed rule, including comments from creditors, mortgage brokers, trade associations, consumer groups, Federal agencies, state regulators, state attorneys general, individual consumers, and members of Congress. As discussed in more detail elsewhere in this **SUPPLEMENTARY INFORMATION,** the Board has considered comments received on the August 2009 Closed-End Proposal in adopting this final rule.

B. The Reform Act

On July 21, 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act (Reform Act) was enacted into law.[1] Among other provisions, Title XIV of the Reform Act amends TILA to establish certain mortgage loan origination standards. In particular, Section 1403 of the Reform Act creates new TILA Section 129B(c), which imposes restrictions on loan originator compensation and on steering by loan originators. The Board intends to implement Section 129B(c) in a future rulemaking after notice and opportunity for further public comment.

Many of the provisions in TILA Section 129B(c) are similar to the Board's proposed rules concerning loan originator compensation. However, Section 129B(c) also has some provisions not addressed by the Board's August 2009 Closed-End Proposal. Implementation of those provisions of the Reform Act will be addressed in a future rulemaking with opportunity for public comment.

The Board has decided to issue this final rule on loan originator compensation and steering, even though a subsequent rulemaking will be necessary to implement Section 129B(c). The Board believes that Congress was aware of the Board's proposal and that in enacting TILA Section 129B(c), Congress sought to codify the Board's proposed prohibitions while expanding them in some respects and making other adjustments. The Board further believes that it can best effectuate the legislative purpose of the Reform Act by finalizing its proposal relating to loan origination compensation and steering at this time. Allowing enactment of TILA Section 129B(c) to delay final action on the Board's prior regulatory proposal would have the opposite effect intended by the legislation by allowing the continuation of the practices that Congress sought to prohibit.

In issuing this final rule, the Board is relying on its authority in TILA Sections 129(l)(2)(A) and (B) to prohibit acts or practices relating to mortgage loans that are unfair and to refinancings of mortgage loans that are abusive and not in the interest of the borrower. However, this final rule is also consistent with the Reform Act for the following reasons: Section 226.36(d)(1) of the final rule is consistent with TILA Section 129B(c)(1), which prohibits payments to a mortgage loan originator that vary based on the terms of the loan, other than the amount of the credit extended. Likewise, the Board finds that § 226.36(d)(2) of the final rule is consistent with TILA Section 129B(c)(2), which allows mortgage loan originators to receive payment from a person other than the consumer (such as

[1] Public Law 111–203, 124 Stat. 1376.

a yield spread premium paid by the creditor) only if the originator does not receive any compensation directly from the consumer. TILA Section 129B(c)(2) also imposes a second restriction when an originator receives compensation from someone other than the consumer: The consumer also must not make any upfront payment to the lender for points or fees on the loan other than certain bona fide third-party charges. This restriction was not contained in the proposed rule, and therefore is not included in this final rule and will be addressed in a subsequent rulemaking.

TILA Section 129B(c)(3) directs the Board to prescribe regulations that prohibit loan originators from steering consumers to certain types of loans, and prohibits other specified practices. These provisions will be also be implemented in a subsequent rulemaking. TILA Section 129B(c)(3) does not expressly include an anti-steering provision similar to proposed § 226.36(e). Nevertheless, the Board continues to believe that the prohibition in § 226.36(e) is necessary and proper to effectuate and prevent circumvention of the prohibition contained in § 226.36(d)(1), and, as explained further below, § 226.33(e) prohibits acts and practices that are unfair, abusive, and not in the interest of the borrower. Thus, the Board is adopting proposed § 226.36(e) in the final rule with some modifications in response to the public comments.

The Board's proposed prohibitions related to mortgage originator compensation and steering applied to closed-end consumer loans secured by real property or a dwelling, but comment was solicited on whether the prohibitions also should be applied to home-equity lines of credit (HELOCs). However, the provisions of the Reform Act relating to originator compensation and steering apply to "residential mortgage loans," which include closed-end loans secured by a dwelling or real property that includes a dwelling, but exclude HELOCs extended under open-end credit plans and timeshare plans (as described in the bankruptcy code, 11 U.S.C. 101(53D)). *See* TILA Section 103(cc)(5), as enacted in Section 1401 of the Reform Act.

The Board is adopting this final rule consistent with the definition of "residential mortgage loan" in the Reform Act. Accordingly, the final rule does not apply to HELOCs or time-share transactions. It also does not apply to loans secured by real property if such property does not include a dwelling. The Board intends to evaluate these issues in connection with future rulemakings and assess whether broader coverage is appropriate or necessary.

The definition of "loan originator" used in the proposal and the final rule is consistent with the Reform Act's definition of "mortgage originators" in TILA Section 103(cc)(2). Specifically, TILA Section 103(cc)(2)(E) excludes certain persons and entities that originate loans but are also creditors that provide seller financing for properties that the originator owns. Because such persons would be "creditors" and are not loan originators using table funding, they are not covered by final rules that are applicable to loan originators.

The definition of "loan originator" in the Board's final rule is consistent with the exception in Section 1401 of the Reform Act that applies to persons and entities that perform only real estate brokerage activities. *See* TILA Section 103(cc)(2)(D).[2] This final rule only applies to parties who arrange, negotiate, or obtain an extension of mortgage credit for a consumer in return for compensation or other monetary gain. Thus, persons covered by the final rule would not be engaged only in real estate brokerage activities, and would not be covered by the statutory exception.

TILA Section 103(cc)(2)(G) contains an exception for loan servicers. The final rule only applies to extensions of consumer credit. The Board's final rule does not apply to a loan servicer when the servicer modifies an existing loan on behalf of the current owner of the loan. This final rule does not apply if a modification of an existing obligation's terms does not constitute a refinancing under § 226.20(a). The Board believes that TILA Section 103(cc)(2)(G) was intended to ensure that servicers could continue to modify existing loans on behalf of current loan holders. The Board will consider whether additional provisions are needed to implement TILA Section 103(cc)(2)(G) in a future rulemaking.

II. Consumer Protection Concerns With Loan Origination Compensation

A. HOEPA Hearings

In the summer of 2006, the Board held public hearings on consumer protection issues in the mortgage market in four cities. During the hearings, consumer advocates urged the Board to ban "yield spread premiums," payments that mortgage brokers receive from the creditor at closing for delivering a loan with an interest rate that is higher than the creditor's "buy rate." Consumer advocates asserted that yield spread premiums provide brokers an incentive to increase consumers' interest rates unnecessarily. They argued that a prohibition would align reality with consumers' perception that brokers serve consumers' best interests.

In light of the information received at the 2006 hearings and the rise in defaults that began soon after, the Board held an additional hearing in June of 2007 to explore how it could use its authority under HOEPA to prevent abusive lending practices in the subprime mortgage market while still preserving responsible lending. Although the Board did not expressly solicit comment on mortgage broker compensation in its notice of the June 2007 hearing, a number of commenters and hearing panelists raised the topic. Consumer and creditor representatives alike raised concerns about the fairness and transparency of creditors' payment of yield spread premiums to brokers. Several commenters and panelists stated that consumers are not aware of the payments creditors make to brokers, or that such payments increase consumers' interest rates. They also stated that consumers may mistakenly believe that a broker seeks to obtain the best interest rate available for consumers. Consumer groups have expressed particular concern about increased payments to brokers for delivering loans both with higher interest rates and prepayment penalties.[3] Several creditors and creditor trade associations advocated requiring brokers to disclose whether the broker represents the consumer's interests, and how and by whom the broker is compensated. Some of these commenters recommended that brokers be required to disclose their total compensation to the consumer and that creditors be prohibited from paying brokers more than the disclosed amount.

B. The Board's 2008 HOEPA Proposal

To address concerns raised through the series of HOEPA hearings, the Board's 2008 HOEPA Proposed Rule would have prohibited a creditor from paying a mortgage broker any compensation greater than the amount the consumer had previously agreed in writing that the broker would receive. 73 FR 1672, 1698–1700; Jan. 9, 2008. In

[2] The statutory exception applies to persons or entities that are licensed or registered to engage in real estate brokerage activities in accordance with applicable State law, and who do not receive compensation from a creditor, mortgage broker, or other mortgage originator, or their agents.

[3] *See Home Equity Lending Market; Notice of Hearings, 72 FR 30380; May 31, 2007; Home Equity Lending Market; Notice of Public Hearings,* 71 FR 26513; May 5, 2006.

support of the rule, the Board explained its concerns about yield spread premiums, which are summarized below.

A yield spread premium is the present dollar value of the difference between the lowest interest rate the wholesale lender would have accepted on a particular transaction and the interest rate the broker actually obtained for the lender. This dollar amount is usually paid to the mortgage broker, though it may also be applied to reduce the consumer's upfront closing costs. The creditor's payment to the broker based on the interest rate is an alternative to the consumer paying the broker directly from the consumer's preexisting resources or out of loan proceeds. Thus, consumers potentially benefit from having an option to pay brokers for their services indirectly by accepting a higher interest rate.

The Board shares concerns, however, that creditors' payments to mortgage brokers are not transparent to consumers and are potentially unfair to them. Creditor payments to brokers based on the interest rate give brokers an incentive to provide consumers loans with higher interest rates. Large numbers of consumers are simply not aware this incentive exists. Many consumers do not know that creditors pay brokers based on the interest rate, and the current legally required disclosures seem to have only a limited effect. Some consumers may not even know that creditors pay brokers: a common broker practice of charging a small part of its compensation directly to the consumer, to be paid out of the consumer's existing resources or loan proceeds, may lead consumers incorrectly to believe that this amount is all the consumer will pay or the broker will receive. Consumers who do understand that the creditor pays the broker based on the interest rate may not fully understand the implications of the practice. They may not appreciate the full extent of the incentive the practice gives the broker to increase the rate because they do not know the dollar amount of the creditor's payment.

Moreover, consumers often wrongly believe that brokers have agreed or are required to obtain the best interest rate available. Several commenters in connection with the 2006 hearings suggested that mortgage broker marketing cultivates an image of the broker as a "trusted advisor" to the consumer. Consumers who have this perception may rely heavily on a broker's advice, and there is some evidence that such reliance is common. In a 2003 survey of older borrowers who had obtained prime or subprime refinancings, majorities of respondents with refinance loans obtained through both brokers and creditors' employees reported that they had relied "a lot" on their loan originators to find the best mortgage for them.[4] The Board's recent consumer testing also suggests that many consumers shop little for mortgages and often rely on one broker or lender because of their trust in the relationship. In addition, a common perception among consumer testing participants was that brokers and lenders have no discretion over their loan terms, and, therefore, shopping actively would likely have no effect on the terms consumers receive.

If consumers believe that brokers protect consumers' interests by shopping for the lowest rates available, consumers may be less likely to take steps to protect their interests when dealing with brokers. For example, they may be less likely to shop rates across retail and wholesale channels simultaneously to assure themselves that the broker is providing a competitive rate. They may also be less likely to shop and negotiate brokers' services, obligations, or compensation upfront, or at all. They may, for instance, be less likely to seek out brokers who will promise in writing to obtain the lowest rate available.

In response to these concerns, the 2008 HOEPA Proposed Rule would have prohibited a creditor from paying a broker more than the consumer agreed in writing to pay. Under the proposal, the consumer and mortgage broker would have had to enter into a written agreement before the broker accepted the consumer's loan application and before the consumer paid any fee in connection with the transaction (other than a fee for obtaining a credit report). The agreement also would have disclosed (i) that the consumer ultimately would bear the cost of the entire compensation even if the creditor paid part of it directly; and (ii) that a creditor's payment to a broker could influence the broker to offer the consumer loan terms or products that would not be in the consumer's interest or the most favorable the consumer could obtain.

Based on the Board's analysis of comments received on the 2008 HOEPA Proposed Rule, the results of consumer testing, and other information, the Board withdrew the proposed provisions relating to broker compensation. 73 FR 44522, 44563–65; July 30, 2008. The Board's withdrawal of those provisions was based on its concern that the proposed agreement and disclosures could confuse consumers and undermine their decision making rather than improve it. The risks of consumer confusion arose from two sources. First, an institution can act as a creditor or broker depending on the transaction. At the time the agreement and disclosures would have been required, an institution could be uncertain as to which role it ultimately would play. This could render the proposed disclosures inaccurate and misleading in some and possibly many cases. Second, the Board was concerned by the reactions of consumers who participated in one-on-one interviews about the proposed agreement and disclosures as part of the Board's consumer testing. These consumers often concluded, not necessarily correctly, that brokers are more expensive than creditors. Many also believed that brokers would serve their best interests notwithstanding the conflict resulting from the relationship between interest rates and brokers' compensation.[5] The proposed disclosures presented a significant risk of misleading consumers regarding both the relative costs of brokers and lenders, and the role of brokers in their transactions.

In withdrawing the broker compensation provisions of the 2008 HOEPA Proposed Rule, the Board stated that it would continue to explore options to address potential unfairness associated with loan originator compensation arrangements, such as yield spread premiums. The Board indicated that it would consider whether disclosures or other approaches could effectively remedy this potential unfairness without imposing unintended consequences.

In the August 2009 Closed-End proposal discussed below, the Board proposed a more substantive approach to loan originator compensation. That proposal is the basis for this final rule.

III. The Board's August 2009 Closed-End Proposal

A. Summary of August 2009 Closed-End Proposal on Loan Originator Compensation

On August 26, 2009, the Board proposed regulations under TILA

[4] *See* Kellie K. Kim-Sung & Sharon Hermanson, *Experiences of Older Refinance Mortgage Loan Borrowers: Broker- and Lender-Originated* Loans, Data Digest No. 83, 3 (AARP Public Policy Inst., Jan. 2003), *available at http://assets.aarp.org/rgcenter/post-import/dd83_loans.pdf.*

[5] For more details on the consumer testing, see the report of the Board's contractor, Macro International, Inc., *Consumer Testing of Mortgage Broker Disclosures* (July 10, 2008), *available at http://www.federalreserve.gov/newsevents/press/bcreg/20080714regzconstest.pdf.*

Section 129(l)(2), 15 U.S.C. 1639(l)(2), to prohibit certain compensation payments to loan originators and steering to protect consumers against the unfairness, deception, and abuse that can arise with certain loan origination compensation practices while preserving responsible lending and sustainable homeownership. *See* 74 FR 43232; Aug. 26, 2009.

Specifically, the Board proposed to prohibit a creditor or any other person from paying compensation to a loan originator based on the terms or conditions of the transaction, or from paying a loan originator any compensation if the consumer paid the loan originator directly. The Board solicited comment, however, on an alternative that would permit compensation based on the loan amount. Under the proposal, "loan originator" would include both mortgage brokers and employees of creditors who perform loan origination functions. In addition, the Board proposed to apply the prohibition to all mortgage loans secured by real property or a dwelling, and solicited comment on whether the prohibition should apply to HELOCs.

The Board also proposed to prohibit a loan originator from steering a consumer to a transaction that would yield the most compensation for the loan originator, unless the transaction was in the consumer's interest. To facilitate compliance with this proposed prohibition, the Board proposed a safe harbor. A loan originator would be deemed in compliance with the anti-steering prohibition if the consumer chose a transaction from a choice of loans with (1) the lowest interest rate, (2) the second lowest interest rate, and (3) the lowest settlement costs. The Board solicited comment on whether the steering prohibition would be effective in achieving its stated purpose, as well as on the feasibility and practicality of such a rule, its enforceability, and any unintended adverse effects it might have.

B. Overview of Comments Received

The Board received approximately 6,000 comment letters on the proposal from various interested parties, including approximately 1,500 form letters. Individual mortgage brokers submitted the vast majority of comments. The remaining commenters included mortgage lenders, banks, community banks, credit unions, secondary market participants, industry trade groups, consumer advocates, Federal banking agencies, members of Congress, state regulators, state attorneys general, academics, and individual consumers.

Many commenters supported the Board's proposal to protect consumers from certain loan origination compensation practices. Consumer advocates supported the expanded definition of "loan originators" to include loan officers, because employees of creditors face the same incentives as mortgage brokers. They also supported covering all closed-end transactions regardless of loan price. Many of these commenters supported the Board's proposed anti-steering rule, but expressed some reservations on the breadth of the proposed safe harbor.

In contrast, industry commenters generally opposed the proposed prohibition on loan originator compensation based on the terms or conditions of the transaction, as well as the proposed anti-steering rule. Many of these commenters expressed concerns regarding the breadth of the definition of "loan originator," and urged the Board to limit the scope of its definition to individuals. Further, these commenters urged the Board to limit the scope of the proposal to higher-priced loans because the abuses targeted by the prohibition have historically been limited to the subprime market. In addition, many community banks, credit unions, and mortgage brokers maintained that prohibiting these types of origination compensation practices would hurt small businesses and reduce competition in the mortgage market. They argued that the proposal would increase the cost of credit for consumers.

These comments are discussed in further detail below in part VI.

IV. Summary of Final Rule

The Board is issuing final rules amending Regulation Z to prohibit certain practices relating to payments made to compensate mortgage brokers and other loan originators. The goal of the amendments is to protect consumers in the mortgage market from unfair practices involving compensation paid to loan originators. The final rule prohibits a creditor or any other person from paying, directly or indirectly, compensation to a mortgage broker or any other loan originator that is based on a mortgage transaction's terms or conditions, except the amount of credit extended. The rule also prohibits any person from paying compensation to a loan originator for a particular transaction if the consumer pays the loan originator's compensation directly.

The final rule adopts the proposal that prohibits a loan originator from steering a consumer to consummate a loan that provides the loan originator with greater compensation, as compared to other transactions the loan originator offered or could have offered to the consumer, unless the loan is in the consumer's interest. The rule provides a safe harbor to facilitate compliance with the prohibition on steering. A loan originator is deemed to comply with the anti-steering prohibition if the consumer is presented with loan options that provide (1) the lowest interest rate; (2) no risky features, such as a prepayment penalty, negative amortization, or a balloon payment in the first seven years; and (3) the lowest total dollar amount for origination points or fees and discount points.

The final rule applies to loan originators, which are defined to include mortgage brokers, including mortgage broker companies that close loans in their own names in table-funded transactions, and employees of creditors that originate loans (*e.g.,* loan officers). Thus, creditors are excluded from the definition of a loan originator when they do not use table funding, whether they are a depository institution or a non-depository mortgage company, but employees of such entities are loan originators. The final rule covers all transactions secured by a dwelling, but excludes HELOCs extended under open-end credit plans and timeshare transactions. The rule requires creditors and other persons who compensate loan originators to retain records for at least two years after a mortgage transaction is consummated.

As discussed further in part VII, the Board has determined that compliance with this final rule shall become mandatory on **April 1, 2011**. Accordingly, the final rule applies to transactions for which the creditor receives an application on or after April 1, 2011. The Board believes that this date gives parties sufficient time to develop new business models, train employees, and makes system changes to implement the rule's requirements. The Board has considered whether it would be appropriate to delay the effective date of this final rule so that the rules related to mortgage loan origination standards in the Reform Act could be implemented at the same time. Although such a delay might facilitate compliance and result in some cost savings, the Board finds that the benefits to consumers of an earlier effective date for rules pertaining to loan origination compensation and steering greatly outweigh any potential savings.

V. Legal Authority

A. General Rulemaking Authority

TILA Section 105 mandates that the Board prescribe regulations to carry out

the purposes of the Act. TILA also specifically authorizes the Board, among other things, to:

• Issue regulations that contain such classifications, differentiations, or other provisions, or that provide for such adjustments and exceptions for any class of transactions, that in the Board's judgment are necessary or proper to effectuate the purposes of TILA, facilitate compliance with the Act, or prevent circumvention or evasion. 15 U.S.C. 1604(a).

• Exempt from all or part of TILA any class of transactions if the Board determines that TILA coverage does not provide a meaningful benefit to consumers in the form of useful information or protection. The Board must consider factors identified in the Act and publish its rationale at the time it proposes an exemption for comment. 15 U.S.C. 1604(f).

In the course of developing this final rule, the Board has considered the views of interested parties, its experience in implementing and enforcing Regulation Z, and the results obtained from testing various disclosure options in controlled consumer tests. For the reasons discussed in this notice, the Board believes this final rule is appropriate pursuant to the authority under TILA Section 105(a).

B. The Board's Authority Under TILA Section 129(l)(2)

TILA Section 129(l)(2) authorizes the Board to prohibit acts or practices in connection with:

• Mortgage loans that the Board finds to be unfair, deceptive, or designed to evade the provisions of HOEPA; and

• Refinancing of mortgage loans that the Board finds to be associated with abusive lending practices or that are otherwise not in the interest of the borrower.

15 U.S.C. 1639(l)(2). The authority granted to the Board under TILA Section 129(l)(2) is broad. It reaches mortgage loans with rates and fees that do not meet HOEPA's rate or fee trigger in TILA Section 103(aa), 15 U.S.C. 1602(aa), as well as mortgage loans not covered under that Section, such as home purchase loans. Moreover, while HOEPA's statutory restrictions apply only to creditors and only to loan terms or lending practices, TILA Section 129(l)(2) is not limited to acts or practices by creditors, nor is it limited to loan terms or lending practices. See 15 U.S.C. 1639(l)(2). It authorizes protections against unfair or deceptive practices "in connection with mortgage loans," and it authorizes protections against abusive practices "in connection with refinancing of mortgage loans." Thus, the Board's authority is not limited to regulating specific contractual terms of mortgage loan agreements; it extends to regulating loan-related practices generally, within the standards set forth in the statute.

HOEPA does not set forth a standard for what is unfair or deceptive, but the Congressional Conference Report for HOEPA indicates that, in determining whether a practice in connection with mortgage loans is unfair or deceptive, the Board should look to the standards employed for interpreting state unfair and deceptive trade practices statutes and the Federal Trade Commission Act (FTC Act), Section 5(a), 15 U.S.C. 45(a).[6]

Congress has codified standards developed by the Federal Trade Commission (FTC) for determining whether acts or practices are unfair under Section 5(a), 15 U.S.C. 45(a).[7] Under the FTC Act, an act or practice is unfair when it causes or is likely to cause substantial injury to consumers, which is not reasonably avoidable by consumers themselves and not outweighed by countervailing benefits to consumers or to competition. In addition, in determining whether an act or practice is unfair, the FTC is permitted to consider established public policies, but public policy considerations may not serve as the primary basis for an unfairness determination.[8]

The FTC has interpreted these standards to mean that consumer injury is the central focus of any inquiry regarding unfairness.[9] Consumer injury may be substantial if it imposes a small harm on a large number of consumers, or if it raises a significant risk of concrete harm.[10] The FTC looks to whether an act or practice is injurious in its net effects.[11] The FTC has also observed that an unfair act or practice will almost always reflect a market failure or market imperfection that prevents the forces of supply and demand from maximizing benefits and minimizing costs.[12] In evaluating unfairness, the FTC looks to whether consumers' free market decisions are unjustifiably hindered.[13]

The FTC has also adopted standards for determining whether an act or practice is deceptive (though these standards, unlike unfairness standards, have not been incorporated into the FTC Act).[14] First, there must be a representation, omission, or practice that is likely to mislead the consumer. Second, the act or practice is examined from the perspective of a consumer acting reasonably in the circumstances. Third, the representation, omission, or practice must be material, that is, it must be likely to affect the consumer's conduct or decision with regard to a product or service.[15]

Many states also have adopted statutes prohibiting unfair or deceptive acts or practices, and these statutes employ a variety of standards, many of them different from the standards currently applied under the FTC Act. A number of states follow an unfairness standard formerly used by the FTC. Under this standard, an act or practice is unfair where it offends public policy or is immoral, unethical, oppressive, or unscrupulous, and causes substantial injury to consumers.[16]

In adopting this final rule under TILA Section 129(l)(2)(A), 15 U.S.C. 1639(l)(2)(A), the Board has considered the standards currently applied to the FTC Act's prohibition against unfair or deceptive acts or practices, as well as the standards applied in similar state statutes.

VI. Section-by-Section Analysis of Final Rules for Loan Origination Compensation

A. Overview

This part VI discusses the prohibitions on certain compensation payments to loan originators and steering. To address the unfairness that arises with certain loan originator compensation practices, the final rule prohibits creditors or any other person

[6] H.R. Rep. 103–652, 162 (Aug. 1994) (Conf. Rep.).

[7] *See* 15 U.S.C. 45(n); Letter from Commissioners of the FTC to the Hon. Wendell H. Ford, Chairman, and the Hon. John C. Danforth, Ranking Minority Member, Consumer Subcomm. of the H. Comm. on Commerce, Science, and Transp. (Dec. 17, 1980).

[8] 15 U.S.C. 45(n).

[9] Statement of Basis and Purpose and Regulatory Analysis, Credit Practices Rule, 42 FR 7740, 7743; Mar. 1, 1984 (*Credit Practices Rule*).

[10] Letter from Commissioners of the FTC to the Hon. Wendell H. Ford, Chairman, and the Hon. John C. Danforth, Ranking Minority Member, Consumer Subcomm. of the H. Comm. on Commerce, Science, and Transp., n.12 (Dec. 17, 1980).

[11] *Credit Practices Rule,* 42 FR at 7744.

[12] *Id.*

[13] *Id.*

[14] Letter from James C. Miller III, Chairman, FTC to the Hon. John D. Dingell, Chairman, H. Comm. on Energy and Commerce (Oct. 14, 1983) (*Dingell Letter*).

[15] *Dingell Letter* at 1–2.

[16] *See, e.g., Kenai Chrysler Ctr., Inc.* v. *Denison,* 167 P.3d 1240, 1255 (Alaska 2007) (quoting *FTC* v. *Sperry & Hutchinson Co.,* 405 U.S. 233, 244–45 n.5 (1972)); State v. Moran, 151 N.H. 450, 452, 861 A.2d 763, 755–56 (N.H. 2004) (concurrently applying the FTC's former test and a test under which an act or practice is unfair or deceptive if "the objectionable conduct * * * attain[s] a level of rascality that would raise an eyebrow of someone inured to the rough and tumble of the world of commerce") (citation omitted); *Robinson* v. *Toyota Motor Credit Corp.,* 201 Ill. 2d 403, 417–418, 775 N.E.2d 951, 961–62 (2002) (quoting *FTC* v. *Sperry & Hutchinson Co.,* 405 U.S. 233, 244–45 n.5 (1972)).

from paying compensation to a loan originator based on the terms or conditions of the credit transaction, other than the amount of credit extended. This prohibition does not apply to payments that consumers make directly to a loan originator. However, if the loan originator receives payments directly from the consumer, the loan originator is prohibited from also receiving compensation from any other party in connection with that transaction. In addition, the final rule prohibits a loan originator from steering consumers to loans not in their interest because the loans would result in greater compensation for the loan originator. Similar to the proposed rule, the final rule provides a safe harbor to facilitate compliance with the steering prohibition, with some modifications.

As discussed in further detail below, the Board finds that these prohibitions on payments to loan originators and steering are necessary and appropriate to prevent practices that the Board deems unfair in connection with mortgage loans and that are associated with abusive lending practices or are otherwise not in the interest of the consumer in connection with refinancings. *See* TILA Section 129(l)(2), 15 U.S.C. 1639(l)(2), and the discussion of this statutory authority in part IV above.

B. Public Comment

Industry commenters and their trade groups generally, although not uniformly, opposed the proposal to prohibit loan originator compensation based on the terms or conditions of the transaction. These commenters stated that such a prohibition would hurt small businesses, especially mortgage brokers, as well as community banks and credit unions. They maintained that adopting the proposed prohibition would increase the cost of credit for all creditors and consumers. Some industry commenters also suggested alternatives such as imposing a cap on originator compensation and requiring improved disclosures. They noted that the U.S. Department of Housing and Urban Development's (HUD) recently revised the disclosures required under the Real Estate Settlement Procedures Act (RESPA), including disclosures about yield spread premiums. They stated that the RESPA rules had only recently take effect,[17] and urged the Board to wait until a determination could be made as to whether the disclosures could resolve concerns about originator compensation.

However, industry commenters generally suggested that if the Board chooses to finalize the proposed prohibitions, the Board should permit payments to loan originators based on the principal loan amount. They asserted that prohibiting payments based on the loan amount would disrupt the secondary market. Industry commenters uniformly opposed expanding the proposed prohibitions to HELOCs, citing a lack of abuse in the HELOC market as the principal reason.

In contrast, consumer groups, state and Federal regulators, state attorneys general, and several members of Congress strongly supported the proposed prohibition on loan originator compensation based on the terms or conditions of the transaction. They stated that by removing reliance on loan terms or conditions to set compensation for loan originators, the rule seeks to correct the misaligned incentives that currently exist in the mortgage marketplace between loan originators and consumers. However, some of these commenters did not support allowing compensation based on the principal loan amount. They argued that permitting payments to loan originators based on the loan amount may encourage loan originators to "upsell" the loan amount and discourage others from originating small balance loans. Some commenters, especially consumer advocates, sought additional protections, such as disclosures and prohibitions on creditors paying any compensation to a loan originator unless the creditor's payment covered all fees and charges associated with the loan, not just the compensation paid to the loan originator.

Many of these commenters supported expanding the definition of "loan originator" to include both mortgage brokers and employees of creditors. They stated that overages paid to retail originators are equally harmful to consumers as compensation paid to mortgage brokers; both provide incentives for the loan originator to steer the consumer to a loan that will yield the originator the greatest amount of compensation. In addition, they urged the Board to extend the scope of the proposed prohibition to the entire mortgage market, including HELOCs, to prevent unfair compensation practices from migrating from one market segment to another.

In response to the proposed prohibition on steering, consumer advocates, other Federal banking agencies, members of Congress, state regulators, and state attorneys general expressed support overall. Certain consumer advocates and state officials argued, however, that the proposed safe harbor for steering substantially weakened the proposed prohibitions on compensation practices. These commenters urged the Board to replace the safe harbor with a rebuttable presumption if the transaction's terms or conditions met certain criteria, such as a competitive interest rate and no prepayment penalty.

In contrast, the vast majority of industry commenters opposed the steering prohibition. They argued that the steering prohibition and proposed safe harbor were too vague and would increase litigation risk. They suggested that, at a minimum, the Board provide a broader safe harbor for the steering prohibition to facilitate compliance and lessen litigation risk.

These comments are discussed in further detail throughout this part as applicable.

C. Unfair and Deceptive Acts and Practices Analysis

The Board proposed to use its HOEPA authority to prohibit unfair compensation practices in connection with transactions secured by real property or a dwelling. TILA Section 129(l)(2)(A), 15 U.S.C. 1639(l)(2)(A). TILA Section 129(l)(2) authorizes the Board to prohibit acts or practices in connection with mortgage loans that the Board finds to be unfair or deceptive. As discussed above in part V, in considering whether a practice is unfair or deceptive under TILA Section 129(l)(2), the Board has generally relied on the standards that have been adopted for purposes of Section 5(a) of the FTC Act, 15 U.S.C. 45(a), which also prohibits unfair and deceptive acts and practices. For purposes of the FTC Act, an act or practice is considered unfair when it causes or is likely to cause substantial injury to consumers that is not reasonably avoidable by consumers themselves and not outweighed by countervailing benefits to consumers or to competition.

As explained in further detail below, the Board finds that paying loan originators based on the terms or conditions of the loan, other than the amount of credit extended, or steering consumers to loans that are not in their interest to maximize loan originator compensation, are unfair practices. Furthermore, based on its experience with consumer testing, particularly in connection with the 2008 HOEPA Proposed Rule, the Board believes that disclosure alone is insufficient for most consumers to avoid the harm caused by this practice. Thus, the Board is adopting substantive regulations to prohibit these unfair practices

[17] *See* 73 FR 68204; Nov. 17, 2008.

substantially as proposed. This section discusses (1) the substantial injuries caused to consumers by these unfair compensation practices; (2) the reasons consumers cannot reasonably avoid these injuries; and (3) the basis for the Board concluding that the injuries are not outweighed by the countervailing benefits to consumers or competition when creditors engage in these unfair compensation practices.

Substantial Injury

When loan originators receive compensation based on a transaction's terms and conditions, they have an incentive to provide consumers loans with higher interest rates or other less favorable terms. Yield spread premiums, therefore, present a significant risk of economic injury to consumers. Currently, this injury is common because consumers typically are not aware of the practice or do not understand its implications, and thus cannot effectively limit the practice.

Creditors' payments to mortgage brokers or their own employees that originate loans (loan officers) generally are not transparent to consumers. Brokers may impose a direct fee on the consumer, which may lead consumers to believe that the direct fee is the sole source of the broker's compensation. While consumers expect the creditor to compensate its own loan officers, they do not necessarily understand that the loan originator may have the ability to increase the creditor's interest rate or include certain loan terms for the originator's own gain.

Because consumers generally do not understand the yield spread premium mechanism, they are unable to engage in effective negotiation. Instead they are more likely to rely on the loan originator's advice, and, as a result, may receive a higher rate or other unfavorable terms solely because of greater originator compensation. These consumers suffer substantial injury by incurring greater costs for mortgage credit than they would otherwise be required to pay.

Injury Not Reasonably Avoidable

Yield spread premiums create a conflict of interest between the loan originator and consumer. As noted above, many consumers are not aware of creditor payments to loan originators, especially in the case of mortgage brokers, because these arrangements lack transparency. Although consumers may reasonably expect creditors to compensate their own employees, consumers do not know how the loan officer's compensation is structured or that loan officers can increase the creditor's interest rate or offer certain loan terms to increase their own compensation. Without this understanding, consumers cannot reasonably be expected to appreciate or avoid the risk of financial harm these arrangements represent.

To guard against this practice, a consumer would have to know the lowest interest rate the creditor would have accepted, and ascertain that the offered interest rate includes a rate increase by the loan originator. Most consumers will not know the lowest rate the creditor would be willing to accept. The consumer also would need to understand the dollar amount of the yield spread premium that is generated by the rate increase to determine what portion, if any, is being applied to reduce the consumer's upfront loan charges. HUD recently adopted disclosures in Regulation X (24 CFR Part 3500), which implement RESPA and that could enhance some consumers' understanding of mortgage broker compensation. But the details of the compensation arrangements are complex and the disclosures are limited. Pursuant to Regulation X, a mortgage broker or lender shows the yield spread premium as a credit to the borrower that is applied to cover upfront costs, but also adds the amount of the yield spread premium to the total origination charges being disclosed. This disclosure would not necessarily inform the consumer that the rate has been increased by the originator and that a lower rate with a smaller origination charge may be available. In addition, the Regulation X disclosure concerning yield spread premiums would not apply to compensation paid to a loan originator that is employed by the creditor. Thus, the Regulation X disclosure, while perhaps an improvement over previous rules, is not likely by itself to prevent consumers from incurring substantial injury from the practice.

Yield spread premiums are complex and may be counter-intuitive even to well-informed consumers. Based on the Board's experience with consumer testing, the Board believes that disclosures are insufficient to overcome the gap in consumer comprehension regarding this critical aspect of the transaction. Currently, the required disclosures of originator compensation under Federal and state laws seem to have little, if any, effect on originators' incentive to provide consumers with increased interest rates or other unfavorable loan terms to increase the originators' compensation.[18] The Board's consumer testing indicated that disclosures about yield spread premiums are ineffective. Consumers in these tests did not understand yield spread premiums and how they create an incentive for loan originators to increase consumers' costs.

Consumers' lack of comprehension of yield spread premiums is compounded where the originator imposes a direct charge on the consumer. A mortgage broker may charge the consumer a direct fee for arranging the consumer's mortgage loan. This charge may lead the consumer to infer that the broker accepts the consumer-paid fee to represent the consumer's financial interests. Consumers also may reasonably believe that the fee they pay is the originator's sole compensation. This may lead reasonable consumers erroneously to believe that loan originators are working on their behalf, and are under a legal or ethical obligation to help them obtain the most favorable loan terms and conditions. Consumers may regard loan originators as "trusted advisors" or "hired experts," and consequently rely on originators' advice. Consumers who regard loan originators in this manner are far less likely to shop or negotiate to assure themselves that they are being offered competitive mortgage terms. Even for consumers who shop, the lack of transparency in originator compensation arrangements makes it unlikely that consumers will avoid yield spread premiums that unnecessarily increase the cost of their loan.

Consumers generally lack expertise in complex mortgage transactions because they engage in such mortgage transactions infrequently. Their reliance on loan originators is reasonable in light of originators' greater experience and professional training in the area, the belief that originators are working on their behalf, and the apparent ineffectiveness of disclosures to dispel that belief.

Injury Not Outweighed by Benefits to Consumers or to Competition

Yield spread premiums may benefit consumers in cases where the amount is applied to reduce consumers' upfront closing costs, including originator compensation. A creditor's increase in the interest rate (or the addition of other loan terms) may be used to generate additional income that the creditor uses to compensate the originator, in lieu of adding origination points or fees that

[18] For example, some creditors may be willing to offer a loan with a lower interest rate in return for including a prepayment penalty. A loan originator that offers a loan with a prepayment penalty may not offer the lower rate, however, resulting in a premium interest rate and the payment of a yield spread premium.

the consumer would be required to pay directly from the consumer's preexisting funds or the loan proceeds. This can benefit a consumer who lacks the resources to pay closing costs in cash, or who may have insufficient equity in the property to increase the loan amount to cover these costs.

Without a clear understanding of yield spread premiums, the majority of consumers are not equipped to police the market to ensure that yield spread premiums are in fact applied to reduce their closing costs, especially in the case of loan originator compensation. Such policing would be particularly difficult because consumers are not likely to have any basis for determining a "typical" or "reasonable" amount for originator compensation. Accordingly, the Board is amending Regulation Z to prohibit any person from basing a loan originator's compensation on the loan's terms or conditions, other than the amount of credit extended. However, the final rule still afford creditors the flexibility to structure loan pricing to preserve the potential consumer benefit of compensating an originator, or funding third-party closing costs, through the interest rate.

D. Final Rules Prohibiting Certain Payments to Loan Originators and Steering

The Board proposed in § 226.36(d)(1) to prohibit any person from compensating a loan originator, directly or indirectly, based on the terms or conditions of a loan transaction secured by real property or a dwelling. The prohibition extends to all persons, not just the creditor, to prevent evasion by structuring payments to loan originators through non-creditors, such as secondary market investors. Under the proposal, compensation based on the loan amount would be prohibited as a payment that is based on a term or condition of the loan, but comment was sought on an alternative proposal that would permit such compensation.

The proposed prohibition did not apply to consumers' direct payments to loan originators. However, where the consumer compensated the loan originator directly, proposed § 226.36(d)(2) prohibited the loan originator from also receiving compensation from the creditor or any other person. The proposal applied to all "loan originators," which included employees of the creditor in addition to mortgage brokers, and to all closed-end transactions secured by real property or a dwelling.

The Board also proposed in § 226.36(e)(1) to prohibit a loan originator from steering a consumer to consummate a loan that may not be in the consumer's interest to maximize the loan originator's compensation. Proposed §§ 226.36(e)(2) and (3) provided a safe harbor: No violation of the steering prohibition would occur if, under certain conditions, the consumer was presented with at least three loan options for each type of transaction (fixed-rate or adjustable-rate loan) in which the consumer expressed an interest. Proposed commentary provided additional guidance regarding the prohibition on steering and the safe harbor.

The Board is adopting the prohibition on originator compensation that is based on the terms or conditions of the loan, substantially as proposed. The Board is also adopting the alternative proposal that permits compensation that is based on the amount of credit extended. The Board is revising the proposed commentary to provide further clarification regarding compensation payments that do and do not violate the prohibition, including clarifications concerning the use of credit scores and similar indicators of credit risk. The Board is also adopting the final rule prohibiting steering as proposed, with modifications to the safe harbor and corresponding commentary. These provisions are discussed in further detail below.

Section 226.36 Prohibited Acts or Practices in Connection With Credit Secured by a Dwelling

Definition of "Loan Originator"

As discussed below in more detail, the Board proposed to prohibit certain payments to loan originators based on transaction terms or conditions, and also proposed to prohibit a loan originator from "steering" consumers to transactions that are not in their interest, to increase the loan originator's compensation. Accordingly, the Board proposed in § 226.36(a)(1) to define the term "loan originator" to include persons who are covered by the current definition of "mortgage broker" in § 226.36(a) and employees of the creditor who are not otherwise already considered "mortgage brokers." (Section 226.36(a) currently defines the term "mortgage broker" because a mortgage broker is subject to the prohibition on coercion of appraisers in existing § 226.36(b).) The Board further proposed to clarify under the proposed definition of "loan originator" that a creditor in a "table-funded transaction" that is not funding the transaction at consummation out of its own resources, including drawing on a bona fide warehouse line of credit or out of its deposits, is considered a "mortgage broker." No substantive change was intended other than to adopt the definition of "loan originator." The Board proposed to revise and redesignate the existing definition of "mortgage broker" under § 226.36(a) as new § 226.36(a)(2).

Public Comment. Industry commenters and their trade groups strongly opposed the proposed definition of "loan originator" in § 226.36(a) because they opposed the scope of coverage for the proposed prohibitions on compensation in § 226.36(d). They argued that the rule should not apply to compensation paid by creditors to their employees because creditors have greater capital requirements, face significant oversight and regulation, and are motivated by concern for their reputation, and, therefore, do not engage in unfair compensation practices. Independent mortgage companies and their trade groups further argued that, unlike mortgage brokers, they do not present themselves to consumers as being able to shop loans offered by different creditors, but originate loans exclusively for themselves using their own resources. These commenters argued that this distinction prevents employees of independent mortgage banking companies from engaging in the abuses targeted by the rule, and, therefore, it is unnecessary to extend the rule's prohibitions on compensation to them.

Community banks and their trade groups contended that they should be excluded from the definition of loan originator because such banks and employees have a vested interest in their communities and consumers, and therefore take more time to educate and inform consumers. They noted that they hold most of their loans in portfolio rather than selling them to the secondary market, and have not engaged in the abusive practices targeted by the rule. Similarly, a credit union trade association argued that its members should be excluded from the definition of "loan originator." This commenter stated that loan originator compensation encourages credit union employees to ensure that consumers obtain the loan best suited for them in order to maximize customer satisfaction, because credit union employees share in the profit generated by high loan volumes. Other industry commenters urged the Board to exempt managers, supervisors, and technical or administrative employees from the definition of "loan originator." These commenters said that such employees have little, if any, impact on terms or conditions of individual loans and their

compensation does not rely on originated loans.

Some industry commenters urged the Board to exclude companies and other entities from the proposed definition of "loan originator" and instead adopt the definition of "loan originator" provided for by Congress in the Safe Mortgage Licensing Act (SAFE Act), which covers only natural persons and not entities. Mortgage brokers, together with some other commenters including the Small Business Administration (the SBA), argued that the proposed definition of "loan originator" in Regulation Z would be broader than the SAFE Act definition, without justification. Specifically, the mortgage brokers and the SBA argued the proposal would disproportionately affect small brokerage firms and create an unlevel playing field. They stated that large brokerage firms would be "creditors" who are not subject to the compensation restrictions, because they can and would fund loans out of their own resources, such as by drawing on bona fide warehouse lines of credit. They claimed that the proposal would force small brokerage firms who are unable to fund loans out of their own resources out of the marketplace.

Consumer advocates and state attorneys general supported the proposed definition of loan originator. They noted that, like third-party originators, employees of creditors receive compensation based on loan terms and conditions, a practice that provides incentives to direct consumers to costlier loans.

Discussion. The Board is adopting the definition of loan originator in § 226.36(a)(1) as proposed, with some clarifications. As discussed above, the final rule is aimed at abuses associated with creditors' compensation payments to loan originators for originating loans with interest rates above the creditor's minimum or "par" interest rate or other less favorable terms, such as a prepayment penalty. The final rule applies whether the creditor's payment is made to a natural person, including an employee of the creditor, or a business entity. The rule does not apply to payments received by a creditor when selling the loan to a secondary market investor. When a mortgage brokerage firm originates a loan, it is not exempt under the final rule unless it is also a creditor that funds the loan from its own resources, such as its own line of credit.

Similar to mortgage brokers, creditors' employees have significant discretion over loan pricing, and therefore are able to modify the loan's terms or conditions to increase their own compensation. Ample anecdotal evidence indicates that creditors' loan officers engage in such pricing discretion that directly harms consumers.[19] The Board believes that where loan originators have the capacity to control their own compensation based on the terms or conditions offered to consumers, the incentive to provide consumers with a higher interest rate or other less favorable terms exists. When this unfair practice occurs, it results in direct economic harm to consumers whether the loan originator is a mortgage broker or employed as a loan officer for a bank, credit union, or community bank.

The final rule also defines loan originator under § 226.36(a)(1) as covering both natural persons and mortgage broker companies, including those companies that close loans in their own names but use table funding from a third party. The final rule clarifies that a creditor that funds a transaction is excluded from the rule's definition of a loan originator.

As noted above, a mortgage broker trade group asserted that by treating mortgage broker companies that use table funding as "loan originators," small brokerage firms that do not fund their own loans would be forced out of the marketplace. This commenter argued that mortgage brokers benefit consumers by increasing competition in the mortgage market and lowering mortgage costs, and cited studies for support. One of the studies found that loans obtained through mortgage brokers were less costly to borrowers as compared to loans obtained through lenders.[20] Another study noted that mortgage brokers can simplify the loan shopping experience for consumers and enhance competition.[21] On the other hand, a consumer group cited studies showing that borrowers using mortgage brokers incurred greater costs in connection with their loans, such as fees, interest, and other closing costs.[22] This commenter also cited a study that found that broker-originated loans, as compared to loans originated by creditors' employees (loan officers), cost subprime borrowers more in interest over the life of the loan.[23] Although using a broker can help consumers shop among different lenders and so enhance competition, consumers do not benefit if they are steered by a broker to a higher cost loan to increase the broker's compensation.

The Board has considered these comments and believes the studies are not dispositive of the issues the rule seeks to address. Brokerage entities that do not fund loans out of their own resources operate as retail networks for creditors, particularly in markets where creditors might not have a direct retail presence. The brokers serve to expand the lenders' customer base by bringing loans to creditors that would not be originated by the creditors' own employees. In these cases, mortgage brokers that do not fund loans do not compete directly with creditor entities, but rather with the loan officers of such creditor entities. The final rule, as proposed, applies to mortgage brokers, as well as employees of creditors, that meet the definition of "loan originator." Moreover, as noted above, the rule is intended to address uniformly unfair compensation practices that result in consumers being given loans with less favorable terms, whether the practices involve individual brokers and loan officers or companies that operate as loan originators. The Board believes that providing exemptions for any set of loan originators would facilitate circumvention of the rule and undermine its objective. A rule that covered only natural persons and not brokerage entities would permit evasion, for example, by individual loan originators incorporating as sole proprietorships.

In addition, the Board does not believe the final rule will require small brokerage firms to go out of business.

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[19] For example, the FTC's settlement with Gateway Funding, Inc. in December 2008 illustrates a case where a creditor's loan officers created "overages," although the primary legal theory concerned disparate treatment by race in the imposition of overages. The FTC's complaint and the court's final judgment and order can be found on the FTC's Web site at *http://www.ftc.gov/os/caselist/0623063/index.shtm.* The FTC has since filed a complaint alleging similar patterns of overages in violation of fair lending laws against Golden Empire Mortgage, Inc. The May 2009 complaint can be found at *http://www.ftc.gov/os/caselist/0623061/090511gemcmpt.pdf.* A similar pattern of overages was alleged in legal actions brought by the Department of Justice, which resulted in settlement agreements with Huntington Mortgage Company (1995), available at *http://www.justice.gov/crt/housing/documents/huntingtonsettle.php,* and Fleet Mortgage Corp (1996), available at *http://www.justice.gov/crt/housing/documents/fleetsettle.php.*

[20] Amany El Anshasy, Gregory Elliehausen, & Yoshiaki Shimazaki, *The Pricing of Subprime Mortgages by Mortgage Brokers and Lenders* (July 2005).

[21] Morris Kleiner & Richard Todd, *Mortgage Broker Regulations that Matter: Analyzing Earnings, Employment, and Outcomes for Consumers,* National Bureau of Economic Research Working Paper 13684 (Dec. 2007).

[22] Michael LaCour-Little, *The Pricing of Mortgages by Brokers: An Agency Problem?,* 31 Journal of Real Estate Research 235 (2009); Howell E. Jackson & Jeremy Berry, *Kickbacks or Compensation: The Case of YSPs,* 12 Stan. J. L. Bus. & Fin. 298, 353 (2007); Patricia A. McCoy, *Rethinking Disclosure in a World of Risk-Based Pricing,* 44 Harvard J. on Leg. 123 (2006).

[23] Center for Responsible Lending, *Steered Wrong: Brokers, Borrowers, and Subprime Loans* (Apr. 2008).

Creditors rely upon mortgage brokers as their retail origination network so that they can operate in a greater number of markets with less overhead expense than if they operated direct retail branches and employed loan officers. To the extent that mortgage brokers provide cost savings or other value to creditors as an origination network, the final rule does not prevent creditors from compensating these entities in a manner that reflects such value, so long as the compensation is not based on a transaction's terms or conditions. The Board has provided illustrative examples of permissible compensation for loan originators in the final rule. The final rule prohibits a particular compensation practice that the Board finds to be unfair but does not set a cap on the amount of compensation that a loan originator may receive. This may result in new business models, but the Board does not believe mortgage brokerage firms will no longer be able to compete in the marketplace unless they can continue to engage in compensation practices the Board has found to be unfair.

The Board recognizes, however, that including mortgage brokerage firms in the definition of "loan originator" will capture a significant number of small firms; such firms, on average, tend to be small (*e.g.,* 7 to 10 employees). In addition, extending the definition of "loan originator" to entities that function as mortgage brokers in particular transactions may also cover community banks and credit unions, many of which are small entities. The Board notes that these smaller entities may experience relatively higher costs to implement the final rule because the costs of compliance are fixed and these entities may not achieve similar economies of scale with a smaller loan volume. The Board recognizes the concerns of small entities, but believes for the reasons stated above that the benefits of the prohibition to consumers outweigh the associated compliance costs.

Furthermore, the definition of "loan originator" in § 226.36(a)(1) is consistent with new TILA Section 103(cc)(2), as enacted in Section 1401 of the Reform Act, which defines "mortgage originator" to include employees of a creditor, individual brokers and mortgage brokerage firms, including entities that close loans in their own names that are table funded by a third party. Consistent with Section 1401 of the Reform Act, the Board does not purport to address transactions that occur between creditors and secondary market purchasers, to which consumers are not a direct party, and appropriately does not extend the rule to compensation earned by entities on those transactions.

Existing § 226.36(a) defining mortgage broker is revised and redesignated as new § 226.36(a)(2). Comments 36(a)–1 and –2 regarding the meaning of loan originator and mortgage broker, respectively, are adopted substantially as proposed. However, comment 36(a)–1 regarding the meaning of loan originator is amended to clarify when table funding occurs. For example, a table-funded transaction does not occur if a creditor provides the funds for the transaction at consummation out of its own resources, such as by drawing on a bona fide warehouse line of credit, or out of its deposits. In addition, comment 36(a)-1 is also amended to clarify that the definition of "loan originator" does not apply to a loan servicer when the servicer modifies an existing loan on behalf of the current owner of the loan. This final rule only applies to extensions of consumer credit and does not apply if a modification of an existing obligation's terms does not constitute a refinancing under § 226.20(a).

Under existing § 226.2(a)(17)(i)(B), a person to whom the obligation is initially payable on its face generally is a "creditor." However, as noted, the definition of "loan originator" in § 226.36(a)(1) provides that if a creditor closes a loan transaction in its own name using table funding by a third party, that creditor is also deemed a "loan originator" for purposes of § 226.36. Thus, new comment 36(a)–3 clarifies that for purposes of § 226.36(d) and (e), the provisions that refer to a "creditor" excludes those creditors that are also deemed "loan originators" under § 226.36(a)(1) because they table fund the credit transaction (*i.e.,* do not provide the funds for the transaction at consummation out of their own resources). New comment 36(a)–4 clarifies that for purposes of § 226.36, managers, administrative staff, and similar individuals whose compensation is not based on whether a particular loan is originated are not loan originators.

Covered Transactions

The Board proposed to apply the prohibitions in §§ 226.36(d) and 226.36(e) to closed-end transactions secured by real property or a dwelling regardless of whether they were higher-priced loans under existing § 226.35(a). The Board requested comment on the relative costs and benefits of applying the rule to all segments of the market, whether the costs would outweigh the benefits for loans below the higher-priced threshold, and whether the prohibitions should be extended to HELOCs.

Public Comment. Many creditors and their trade associations urged the Board to limit the prohibitions in §§ 226.36(d) and (e) to higher-priced loans. They argued that unfair and abusive practices relating to loan originator compensation were historically concentrated in the higher-priced loan market. A trade association for independent mortgage banking companies also suggested that the rule protect only vulnerable consumers that have loans with risky features. In addition, most, if not all, industry commenters and their trade groups urged the Board to exclude HELOCs from the proposal's coverage. They cited a lack of evidence that unfairness is associated with loan originator compensation for open-end products.

In contrast, consumers, consumer advocacy groups, and state attorneys general supported extending the prohibitions to the entire market, including HELOCs. They stated that the conflict of interest inherent in rewarding loan originators for offering less favorable loan terms exists regardless of the loan price. They argued that excluding HELOCS or loans below the higher-priced threshold from the rules would simply result in migration of unfair compensation practices to those market segments. Consumer advocates and state attorneys general also noted that failure to cover HELOCs would encourage loan originators to originate "piggyback" HELOCs simultaneously with first-lien loans. These commenters claimed that creditors currently offer financial incentives to loan originators to originate split loan transactions to yield greater return for the creditor, and stated that excluding HELOCs from the prohibitions would allow this unfair practice to continue.

Discussion. The final rule applies to all closed-end consumer credit transactions secured by a dwelling, regardless of price or lien position. *See* §§ 226.1(c) and 226.3(a), and corresponding commentary, regarding extensions of consumer credit subject to TILA. The Board believes covering only transactions above the higher-priced threshold in § 226.35(a) would fail to protect consumers adequately. A consumer can be harmed from a loan originator delivering less favorable loan terms or conditions to maximize compensation whether the loan has an APR that falls above or below the threshold in § 226.35. The Board recognizes that the risk of harm may be lower in the prime segment of the market where consumers historically

have more choices and ability to shop. However, as noted above, the Board's consumer testing showed, and anecdotal evidence demonstrates, that consumers in all segments of the market fail to appreciate the conflict of interest that can arise from originators receiving compensation based on the loan terms or conditions offered. As a result, the Board believes that consumers in all segments of the market are equally susceptible to these unfair compensation practices, and, therefore, equally benefit from the prohibition. Moreover, the Reform Act provisions on originator compensation are not limited to higher-priced mortgage loans.

As discussed above, the Board is adopting this final rule consistent with the proposal, and with the definition of "residential mortgage loan" in the Reform Act. Accordingly, consistent with TILA Section 103(cc)(5), as enacted in section 1401 of the Reform Act, the final rule excludes HELOCs that are subject to § 226.5b and timeshare plans, as described in the Bankruptcy Code, 11 U.S.C. 101(53D). It also does not apply to loans secured by real property that does not include a dwelling. The Board will reconsider these issues in connection with future rulemakings to implement the Reform Act and assess whether broader coverage is necessary, pursuant to its authority in TILA Sections 129(l)(2)(A) and 129B(e).

Section 226.36(d) currently provides that § 226.36 does not apply to HELOCs. Section 226.36(d) is redesignated as § 226.36(f) and revised to clarify that all of § 226.36 does not extend to HELOCs, and § 226.36(d) and (e) do not extend to a loan that is secured by a consumer's interest in a timeshare plan, as described in the Bankruptcy Code, 11 U.S.C. 101(53D).[24] The Board adds new comment 36–1 to clarify that the final rule on loan origination compensation practices covers closed-end consumer credit transactions secured by a dwelling or real property that includes a dwelling, including reverse mortgages that are not HELOCs, and provides a cross reference to additional restrictions set forth in § 226.36(f). In technical revisions, the heading to § 226.36 and corresponding commentary is revised to reflect the expanded scope of that section, and current comment 36–1 is redesignated as comment 36–3. Also in technical revisions, §§ 226.36(d)(1) and (e), which are discussed in detail below, are revised to apply to consumer credit transactions secured by a dwelling. In addition, § 226.1(b) is revised to reflect that the final rule broadens the scope of § 226.36 from transactions secured by the consumer's principal dwelling to all transactions secured by real property or a dwelling. Section 226.1(d)(5) is also revised to reflect the scope of § 226.36.

[24] In the August 2009 Closed-End Proposal, the Board solicited comment on whether §§ 226.36(b) and (c) should apply to HELOCs. The Board will consider whether to extend §§ 226.36(b) and (c) to HELOCs when it finalizes the August 2009 Closed-End Proposal.

Payments Based on Transaction Terms and Conditions

As proposed, § 226.36(d)(1) would prohibit any person from compensating a loan originator, directly or indirectly, based on the terms or conditions of the mortgage. Under the proposal, compensation based on the loan amount would have been prohibited as a payment that is based on a term of the loan. However, the Board sought comment on an alternative that would permit compensation to be based on the amount of credit extended, which is a common practice today.

The prohibition on origination compensation in proposed § 226.36(d)(1) did not apply to consumers' direct payments to loan originators. However, under proposed § 226.36(d)(2), if the consumer compensated the loan originator directly, the originator would be prohibited from also receiving compensation from the creditor or any other person. Proposed § 226.36(d)(3) provided that for purposes of the prohibition on certain compensation practices set forth in §§ 226.36(d)(1) and (d)(2), affiliated entities would be treated as a single "person." *See* § 226.2(a)(22) defining the term "person."

The proposed commentary clarified the types of arrangements considered to be "compensation," and provided examples of compensation based on the transaction's terms or conditions such as payments based on the interest rate, and examples of permissible methods of compensation to loan originators such as payments based on loan volume. The proposed commentary also provided guidance regarding pricing flexibility that creditors would retain and the ability to adjust loan originator compensation periodically to respond to market changes. *See* comments 36(d)(1)–1 through –6.

Public Comment. Consumer advocates, associations of state regulators, state attorneys general, other Federal banking agencies, and members of Congress strongly supported the Board's proposed ban on loan originator compensation that is based on the terms or conditions of a transaction. They stated that these compensation arrangements lack transparency and are unfair and deceptive. They cited various examples of the harm caused to consumers and the economy at large by the practice of compensating loan originators based on a transaction's terms or conditions. These commenters asserted that these compensation arrangements led to significant growth of risky loans for non-prime consumers, increased mortgage costs, and the foreclosure crisis.

In contrast, industry commenters and their trade associations almost uniformly opposed prohibiting loan originator compensation based on the terms or conditions of a transaction. They argued that loan originator compensation provides consumers with the option to cover upfront costs through the interest rate, and generally makes credit more widely available. They further argued that research on the impact of loan originator compensation on consumers is inconclusive, and that existing regulations under RESPA, the SAFE Act, and the MDIA together with market competition are sufficient to protect consumers. Independent mortgage companies and their trade groups also asserted that the Board should consider adopting less restrictive rules as an alternative to the proposal. They also argued that information and views received by the Board during the public comment period should be set forth in a second proposal to permit further public comment.

A mortgage broker trade association argued that TILA does not authorize the Board to regulate private compensation arrangements between employers and employees under TILA. It further asserted that the Board did not adequately demonstrate that the proposed rule satisfied the FTC standards for unfair or deceptive acts or practices, or the rulemaking standards set forth in the Administrative Procedures Act (APA).

The SBA commented that the proposal did not provide sufficient information regarding the rule's economic impact on small entities. In addition to listing the number and type of affected entities, the SBA asserted that the Board should have provided more information about the costs of the rule for small entities. The SBA expressed concern that small entities that originate loans for creditors would be disadvantaged compared to larger entities that are able to fund their own loans, because larger entities would be treated as creditors when selling loans to secondary market investors. The SBA argued that the proposal would require smaller entities to alter their business practices and that some small entities might ultimately leave the marketplace, making it more difficult for consumers

to obtain mortgages. The SBA also said the Board should more fully consider alternatives that would be less burdensome to small entities and reduce or eliminate the economic impact on small entities.

Discussion. The Board is adopting the prohibition on certain compensation practices under § 226.36(d) substantially as proposed, except that the final rule permits compensation based on the amount of credit extended. In addition, for clarity § 226.36(d)(1) is divided into subparts § 226.36(d)(1)(i) through (iii); no other substantive change is intended. For the reasons explained in the proposal, the Board finds that compensating loan originators based on a loan's terms or conditions, other than the amount of credit extended, is an unfair practice that causes substantial injury to consumers. The Board is taking this action pursuant to its authority under TILA Section 129(l)(2) to prohibit acts or practices in connection with mortgage loans that it finds to be unfair or deceptive.

As discussed in greater detail above under part VI.C, compensation payments based on a loan's terms or conditions create incentives for loan originators to provide consumers loans with higher interest rates or other less favorable terms, such as prepayment penalties. There is substantial evidence that compensation based on loan rate or other terms is commonplace throughout the mortgage industry, as reflected in Federal agency settlement orders, congressional hearings, studies, and public proceedings.[25] This evidence demonstrates that market forces, such as competition or liquidity, have not been adequate to prevent the harm to consumers caused by compensation payments that are based on the loan's terms or conditions. Creditors' payments to mortgage brokers or their own employees are neither transparent nor understood by consumers. Accordingly, consumers do not effectively shop or engage in negotiation, and instead often rely on the advice of loan originators. This reliance further compounds the harmful effect of these unfair compensation practices because consumers do not understand that loan originators may have the ability to increase the creditor's interest rate or include costly terms or features to increase their own compensation. The Board's consumer testing conducted in connection with the 2008 HOEPA Proposed Rule further demonstrated consumers' reliance on loan originators and misunderstanding of loan originator compensation. Consequently, these unfair compensation practices cause consumers injuries they often cannot reasonably avoid.

The Board has previously considered other less restrictive alternatives to address concerns about mortgage originator compensation. Under the 2008 HOEPA Proposed Rule, the Board published a disclosure-based approach to the problems presented by yield spread premiums. For the reasons stated in the August 2009 Closed-End Proposal, the Board determined such an approach to be ineffective in redressing the harm caused by these unfair compensation practices.

The Board recognizes that the prohibition on certain compensation practices will require entities, both small and large, to alter their business practices, develop new business models, re-train staff, and reprogram operational systems to ensure compliance with the final rule. For the reasons discussed above, the Board believes that the benefits to consumers provided by the prohibition on certain unfair compensation practices outweigh these associated costs.

Compensation based on the amount of credit extended. As noted above, the Board sought comment on an alternative proposal that would permit loan originator compensation to be based on the amount of credit extended, which is a common practice today. The Board specifically requested comment on whether prohibiting originator compensation based on the amount of credit extended to the consumer was unduly restrictive and necessary to achieve the purpose of the rule.

Consumer advocates and certain Federal banking and state regulators and elected officials opposed the alternative proposal. They argued that it would create an incentive for loan originators to steer consumers to larger loans, thereby increasing consumer risk. They stated that creditors could find another means to compensate brokers and loan officers for additional time spent originating larger loans, and suggested that lenders be permitted to set a minimum loan origination fee to encourage the origination of small loans. Industry commenters and their trade groups strongly supported the alternative and stated that payments based on loan amount do not provide harmful incentives or result in consumer injury. They asserted that a loan originator typically requires compensation in an amount equal to 1 percent of the loan amount in order to cover the costs of origination. Some mortgage industry commenters also recommended permitting originators to receive a higher percentage compensation for smaller loans to ensure that loan originators receive adequate compensation for originating such loans.

The Board is adopting the alternative as proposed with additional clarifications. Under the final rule, the amount of credit extended is deemed not to be a transaction term or condition for purposes of § 226.36(d)(1) provided the compensation payments to loan originators are based on a fixed percentage of the amount of credit extended; however, such compensation may be subject to a minimum or maximum dollar amount. The Board believes that compensation based on the amount of credit extended is less subject to manipulation by the originator than compensation based on terms such as the interest rate or prepayment penalties. For example, a consumer purchasing a home would be unlikely to

[25] *See, e.g.,* affidavits on loan originator compensation filed in Mayor and City Council of *Baltimore* v. *Wells Fargo Bank, N.A., Civil No. JFM 1:08 CV–00062,* Second Amended Complaint (2010); *Iowa* v. *Ameriquest Mortgage Co., et al., Civ. No. CE 53090,* Consent Order (2006), *available at http://www.state.ia.us/government/ag/images/pdfs/Ameriquest_CJ.pdf;* Memorandum from Senator Carl Levin and Senator Tom Coburn to Members of the Permanent Subcommittee on Investigations re: *Wall Street and the Financial Crisis: The Role of High Risk Home Loans,* Exhibit 1a of the Senate Permanent Subcommittee on Investigations Hearing on *Wall Street and the Financial Crisis: The Role of High Risk Home Loans,* 4–5 (Apr. 13, 2010), *available at http://hsgac.senate.gov/public/_files/Financial_Crisis/041310Exhibits.pdf;* Testimony of Michael C. Calhoun, Center for Responsible Lending, Before the U.S. House of Representatives Committee on Financial Services, *Perspectives on the Consumer Financial Protection Agency,* 21 (Sept. 30, 2009), *available at http://www.responsiblelending.org/mortgage-lending/policy-legislation/congress/cfpa-calhoun-testimony.pdf* ; Testimony of Patricia McCoy, Professor of Law, University of Connecticut Law School, Before the U.S. Senate Banking Committee, *Consumer Protections in Financial Services: Past Problems, Future Solutions,* 8, 10 (Mar. 3, 2009), *available at http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&File Store_id=40666635-bc76-4d59-9c25-76daf0784239;* Susan E. Woodward & Robert E. Hall, *Consumer Confusion in the Mortgage Market: Evidence of Less than a Perfectly Transparent and Competitive Market,* American Econ. Rev.: Papers and Proceedings (May 2010), *available at http://pubs.aeaweb.org/doi/pdfplus/10.1257/aer.100.2.511;* Susan Woodward, *A Study of Closing Costs for FHA Mortgages,* HUD Office of Policy Development and Research (May 2008); Howell E. Jackson & Jeremy Berry, *Kickbacks or Compensation: The Case of Yield-Spread Premiums,* 12 Stan. J. L, Bus & Fin. 289 (2007), *available at http://www.law.harvard.edu/faculty/hjackson/pdfs/january_draft.pdf.* Most recently, in March 2010 the Department of Justice and two subsidiaries of American International Group entered into a settlement agreement under which wholesale residential mortgages lenders were responsible for broker fee disparities. The complaint is available at *http://www.justice.gov/crt/housing/documents/aigcomp.pdf,* and the consent order can be found at *http://www.justice.gov/crt/housing/documents/aigsettle.pdf.*

accept an offer for a larger loan amount. Furthermore, a loan originator's ability to steer consumers to larger loans is limited by underwriting criteria such as maximum loan-to-value (LTV) and debt-to-income (DTI) ratios. The Board notes that transaction amount is commonly used throughout the mortgage market to determine the amounts paid to other parties, such as real-estate brokers, mortgage insurers, and various third-party service providers. The Reform Act also specifically permits compensation to loan originators based on the amount of credit extended.[26] For all of the reasons discussed, the Board believes prohibiting originator compensation based on the amount of credit extended would be unduly restrictive and is unnecessary to achieve the purposes of the final rule.

In response to commenters' concerns that the proposal would provide originators with no incentive to originate small loans, the final rule explicitly permits creditors to establish minimum or maximum dollar amounts for loan originator compensation. To prevent circumvention, the commentary clarifies that the minimum or maximum amount may not vary with each credit transaction. Thus, a creditor could choose to pay a loan originator 1 percent of the amount of credit extended for each loan, but no less than $1,000 and no more than $5,000. In this case, the originator is guaranteed payment of a minimum amount for each loan, regardless of the amount of credit extended to the consumer. Using this example, the creditor would pay a loan originator $3,000 on a $300,000 loan (*i.e.,* 1 percent of the amount of credit extended), $1,000 on a $50,000 loan, and $5,000 on a $900,000 loan. However, a creditor may not pay a loan originator 1 percent of the amount of credit extended for amounts greater than $300,000, and 2 percent of the amount of credit extended for amounts that fall between $200,000 and $300,000. In addition, the Board notes that creditors are able to use other compensation methods to provide adequate compensation for smaller loans, such as basing compensation on an hourly rate, or on the number of loans originated in a given time period.

The Board proposed comment 36(d)(1)–10 to clarify that a loan originator may be paid the same fixed percentage of the amount of credit extended for all transactions, subject to a minimum or maximum dollar amount. The Board is adopting the comment, redesignated as comment 36(d)(1)–9, substantially as proposed with additional clarifications. The revisions clarify that a loan originator may be paid compensation based on a fixed percentage that does not vary with the amount of credit extended. Thus, a creditor may pay a loan originator, for example, 1 percent of the amount of credit extended for all loans the originator arranges for the creditor. However, under the final rule a creditor may not pay a loan originator a fixed percentage that varies with different levels or tiers of amounts. The Board believes that permitting compensation to vary in this manner could enable evasion of the rule. For example, some creditors might create tiers and vary the compensation for each tier so that the tiers serve as proxies for other terms or conditions of the transaction. Such a rule might also permit creditors to create tiers with minimal increments, for instance every $10,000, and increase or decrease the percentage of the loan amount paid to the loan originator with each tier. The creditor could pair loan terms, such as prepayment penalties, with some tiers and not others. In this way, a creditor might evade the rule or make enforcement of the prohibition more difficult.

Unlike compensation based on a fixed percentage of the loan amount, underwriting criteria do not serve as a meaningful constraint to the loan originator's ability to steer a consumer from one tier to another where there are minimal increments between loan tiers. It is also unlikely that a consumer would question relatively small differences in loan amounts that might move them from one tier to another tier. Moreover, if compensation could vary in relation to tiers of loan amounts, to prevent potential evasion of the rule, the Board would need to determine reasonable increments between tiers and whether the percentage paid in relation to tiers could increase, decrease, or both. Such an approach would result in an unnecessarily complex rule that would make compliance difficult. Furthermore, to the extent that paying compensation based on tiered loan amounts is meant to ensure fair compensation for some loans and prevent unreasonable compensation for others, the Board believes that permitting loan originators to be paid a minimum and/or maximum compensation amount serves the same purpose.

The meaning of the term "compensation." Some commenters were concerned that the proposed rule would prevent consumers from choosing a higher rate loan to fund amounts that are paid to the originator to cover upfront closing costs. The final rule clarifies that this is not the case. Under the final rule, a consumer may finance upfront costs, such as third-party settlement costs, by increasing or "buying up" the interest rate regardless of whether the consumer pays the loan originator directly or the creditor pays the loan originator's compensation. Thus, the final rule does not prohibit creditors or loan originators from using the interest rate to cover upfront closing costs, as long as any creditor-paid compensation retained by the originator does not vary based on the transaction's terms or conditions.

To address commenters' concerns regarding third-party charges, comment 36(d)(1)–1 is revised to clarify that for purposes of §§ 226.36(d) and (e), the term "compensation" includes amounts retained by the loan originator, but does not include amounts that the loan originator receives as payment for *bona fide* and reasonable third-party charges, such as title insurance or appraisals. Comment 36(d)(1)–1 provides further clarification for certain circumstances where amounts received by the loan originator may exceed the third-party's actual charge imposed in connection with the transaction but would not be deemed compensation for purposes of §§ 226.36(d) and (e). The Board recognizes that, in some cases, loan originators receive payment for third-party charges that may exceed the actual charge because, for example, the loan originator cannot determine with accuracy what the actual charge for the third-party service will be, and, therefore, the originator retains the difference. The difference in amount retained by the originator is not deemed compensation if the third-party charge imposed on the consumer is *bona fide* and reasonable. On the other hand, if the originator marks up the third-party charge (a practice known as "upcharging") and retains the difference between the actual charge and the marked-up charge, the amount retained is compensation for purposes of §§ 226.36(d) and (e).

Comment 36(d)(1)–1 provides the following example: Assume a loan originator charges the consumer a $400 application fee that includes $50 for a credit report and $350 for an appraisal. Assume that $50 is the amount the creditor pays for the credit report. At the time the originator imposes the application fee on the consumer, the originator does not know what the actual cost for the appraisal will be, because the originator may choose from appraisers that charge between $300 to $350 for an appraisal. Later, the cost for the appraisal is determined to be $300

[26] *See* TILA Section 129B(c)(1), as enacted in section 1403 of the Reform Act.

for this consumer's transaction. In this case, the $50 difference between the $400 application fee imposed on the consumer and the actual $350 cost for the credit report and appraisal is not deemed compensation for purposes of §§ 226.36(d) and (e), even though the $50 is retained by the loan originator. The $50 difference would be compensation, however, if the appraisers from whom the originator chooses charge fees between $250 and $300.

The commentary also states that any third-party charge the loan originator imposes on the consumer must comply with state and other applicable law to be deemed *bona fide* and reasonable. For example, if a loan originator uses an "average charge," to be deemed *bona fide* and reasonable under § 226.36, it must also comply with the provisions of HUD's Regulation X, which implements RESPA and addresses the use of "average charges." *See* 12 CFR 3500.8(b).

Comment 36(d)(1)–1 also provides further clarification regarding "amounts retained" by the loan originator that are deemed compensation for purposes of §§ 226.36(d) and (e). For example, if a loan originator imposes a "processing fee" on the consumer in connection with the transaction and retains such fee, it is deemed compensation for purposes of §§ 226.36(d) and (e), whether the originator expends the time to process the consumer's application or uses the fee for other expenses, such as overhead. The remainder of comment 36(d)(1)–1 is adopted as proposed, and clarifies that the term "compensation" includes salaries, commissions, and any financial or similar incentive that is tied to the transaction's terms or conditions, including annual or periodic bonuses, or awards of merchandise or other prizes.

The Board notes that TILA Section 129B(c)(2), as enacted by Section 1403 of the Reform Act, further restricts a loan originator's ability to receive originator compensation from a creditor or other person where a consumer makes any upfront payment to the creditor for points or fees on the loan, other than certain bona fide third-party charges. This restriction was not part of the Board's August 2009 Closed-End Proposal. The Board intends to evaluate this issue and implement this provision as part of a subsequent rulemaking after giving the public notice and opportunity to comment. *See also* § 226.36(d)(2) prohibiting loan originator compensation from dual sources, which is discussed below.

Examples of prohibited compensation. The Board is adopting comment 36(d)(1)–2 substantially as proposed to provide examples of loan originator compensation that are deemed to be based on transaction terms or conditions, such as compensation that is based on the interest rate, annual percentage rate, or the existence of a prepayment penalty. The comment is further revised to provide additional clarification, however, regarding credit scores and similar representations of risk.

As proposed, comment 36(d)(1)–2 stated that a consumer's credit score or similar representation of credit risk is *not* one of the transaction's terms and conditions. However, proposed commentary also provided that "a creditor does not necessarily avoid having based a loan originator's compensation on the interest rate or the annual percentage rate solely because the originator compensation happens to vary with the consumer's credit score as well." A few commenters sought clarification and some urged the Board explicitly to state that compensation could be based on credit scores. In contrast, some other commenters urged the Board expressly to prohibit basing compensation on the credit score or other similar factors of credit risk, such as DTI, to prevent possible circumvention of the rule.

The comment has been revised for clarification. The Board believes credit scores or similar indications of credit risk, such as DTI, are not terms or conditions of the transaction. At the same time, the Board recognizes that they can serve as proxies for a transaction's terms or conditions. For example, credit scores are often used by creditors to assess a consumer's likelihood of default on a loan. If a creditor engages in risk-based pricing, then a lower credit score would yield a higher interest rate loan to reflect the greater risk associated with extending credit to that consumer, while a higher credit score would yield a lower interest rate loan. The Board is concerned that permitting compensation to be based on credit score or other similar factors that serve as proxies for a transaction's terms or conditions would lead to circumvention of the rule. As discussed above, the Board believes that the practice of basing compensation on a transaction's term or condition leads to consumers being given loans with less favorable terms, such as a higher interest rate, which results in harm to consumers that they cannot reasonably avoid, and, therefore, constitutes an unfair practice. Accordingly, the Board believes that permitting compensation based on factors that serve as proxies for a transaction's terms or conditions would provide incentives to originators to place consumers in loans with less favorable terms, which constitutes an unfair practice. Thus, the Board is revising comment 36(d)(1)–2 to address these concerns.

Comment 36(d)(1)–2 clarifies that credit scores or similar indications of credit risk, such as DTI, are *not* terms or conditions of the loan. The comment further provides, however, that the rule prohibits compensation based on a factor that serves as a proxy for a transaction's terms or conditions and provides the following example: Assume consumer A and consumer B receive loans from the same loan originator and the same creditor. Consumer A has a credit score of 650 and is given a loan with a 7 percent interest rate, and consumer B has a credit score of 800 and is given a loan with a 6½ percent interest rate because of his or her different credit score. If the loan originator compensation varies for these transactions in whole or in part based on the credit score so that, for instance, the loan originator receives $1,500 for the loan given to consumer A and $1,000 for the loan given to consumer B, compensation would be based on a transaction's terms or conditions.

The clarification in comment 36(d)(1)–2 acknowledges that credit scores or similar indications of credit risk may, in some instances, serve as proxies for a transaction's terms or conditions, such as the interest rate. The Board believes that this clarification is necessary to prevent evasion of the rule. The Board emphasizes, however, that the final rule does not prohibit risk-based pricing. Risk-based pricing is permissible as long as the loan originator's compensation does not vary based on the transaction's terms or conditions or factors that serve as proxies for the transaction's terms or conditions.

Some industry commenters argued that originators should receive more compensation for loans to borrowers with lower credit scores or blemished credit histories, asserting that these borrowers require more time and effort of the originator. As discussed, under the final rule originators may not receive increased compensation based on credit score or credit history, where credit score and credit history serve as proxies for loan terms and conditions. The Board notes, however, that loan originators may be compensated based on the time actually spent on a transaction, as discussed under comment 36(d)–3 below.

Examples of permissible compensation. Comment 36(d)(1)–3 proposed several examples of

compensation arrangements that would not be based on the transaction's terms or conditions, such as loan volume, long-term performance of an originator's loans, and time spent. Several commenters suggested, however, that the Board provide additional guidance and urged the Board to clarify that compensation could be based, for instance, on the percentage of transactions successfully originated on behalf of the creditor, file quality, and customer satisfaction.

The Board is adopting comment 36(d)(1)–3 largely as proposed, with additional examples of permissible compensation. The comment provides that a payment that is fixed in advance for each originated loan and compensation that accounts for a loan originator's fixed overhead costs are permissible compensation methods. In addition, the comment states that a creditor may pay an originator based on the percentage of loan applications that result in consummated loans and the quality of the loan originator's loan files. The comment also states that compensation based on the amount of credit extended is permissible under the rule, and provides a cross-reference to comment 36(d)(1)–9 for further discussion. The Board believes compensation based on the new examples would not provide originators with incentives that are harmful and unfair to consumers. The comment clarifies, however, that the examples provided in it are illustrative and not exhaustive, and thus a creditor may identify and use other permissible compensation methods.

Compensation that varies from one originator to another. The Board further notes creditors may compensate their own loan officers differently than mortgage brokers. For instance, to account for the fact that mortgage brokers relieve creditors of certain fixed overhead costs associated with loan originations, a creditor may pay mortgage brokers more than its own retail loan officers. For example, a creditor may pay a mortgage broker $2,000 for each loan and pay its loan officers $1,500 for each loan. Alternatively, a creditor may pay its mortgage brokers an amount equal to 2 percent of the amount of credit extended on each loan, and pay its loan officers an amount equal to 1 percent of the amount of credit extended on each loan. Likewise, a creditor may pay one loan officer more than it pays another loan officer. For example, a creditor may pay loan officer A an amount equal to 1 percent of the amount of credit extended for each loan, and loan officer B an amount equal to 1.25 percent of the amount of credit extended for each loan. This is permissible, as long as each loan originator receives compensation that is not based on the terms or conditions of the transactions he or she delivers to the creditor.

Compensation based on loan volume. The final rule does not prohibit a creditor from basing compensation on an originator's loan volume, whether by the total dollar amount of credit extended or the total number of loans originated over a given time period. These arrangements, however, might raise supervisory concerns about whether the creditor has created incentives for originators to deliver loans without proper regard for the credit risks involved. For example, depository institutions and depository institution holding companies (banking organizations) are subject to supervisory guidance that provides for incentive compensation arrangements to take into account credit and other risks in a manner that is consistent with safety and soundness practices.[27] Consistent with this guidance, banking organizations should ensure that incentive compensation arrangements not only comply with the requirements of TILA, but also do not encourage employees to take imprudent risks that are inconsistent with the safety and soundness of the organization.

Compensation based on loan type or program. Some commenters also urged the Board to permit higher compensation for certain loan types, for example, small loans, loans under special programs that assist first-time home-buyers and low- or moderate-income consumers, and loans that satisfy the creditor's obligations under the Community Reinvestment Act (CRA). As discussed above, creditors can encourage originators to make small loans as well as large loans by setting a minimum and maximum payment for each loan if they compensate loan originators a fixed percentage of the amount of credit extended. *See* comment 36(d)(1)–9. The Board believes, however, that allowing compensation to vary with loan type, such as loans eligible for consideration under the CRA, would permit unfair compensation practices to persist in loan programs offered to consumers who may be more vulnerable to such practices.

Compensation that differs based on geography. Proposed comment 36(d)(1)–4 clarified that payment of compensation to a loan originator that differed by geographical area was not prohibited under the proposal, provided that such compensation arrangements complied with other applicable laws such as the Equal Credit Opportunity Act (15 U.S.C. 1691–1691f) and Fair Housing Act (42 U.S.C. 3601–3619). One commenter noted that significant differences exist in geographic areas that can impact loan terms and conditions, such as property value or ranges of income. This commenter urged the Board expressly to provide that creditors can structure originator compensation to account for geographical differences. Other industry commenters also generally suggested that the Board permit compensation to vary based on identified market and geographical factors, in addition to other factors such as charter type and institution size.

The Board is not adopting comment 36(d)(1)–4, and is redesignating 36(d)(1)–5 through 36(d)(1)–10 accordingly. Comment 36(d)(1)–4 was intended to clarify that compensation may take account of differences in the costs of loan origination, such as rent and other overhead expenses. As discussed above, however, the Board has clarified under comment 36(d)(1)–2 that compensation paid to loan originators may account for differences in the costs of origination such as fixed overhead costs, and believes this example is sufficient to address the matter. The Board notes that any compensation arrangement must also comply with all other applicable laws, such as the Equal Credit Opportunity Act and the Fair Housing Act.

Creditors' pricing flexibility. Consumer advocates argued that the Board should only permit loan originators to receive yield spread premiums on "no-cost" loans, meaning loans for which the interest rate is high enough to eliminate all of the consumer's upfront costs including points and third party closing costs. Consumer advocates asserted that when an originator receives a yield spread premium *and* the consumer pays some or all of the other closing costs upfront, the consumer is more susceptible to being over-charged because he or she does not understand the trade-off between upfront closing costs and higher interest rates. Therefore, these commenters argued that the rule should prohibit a yield spread premium and upfront charges on the same transaction.

The Board is not adopting the recommendation to limit compensation paid to loan originators through the rate to no-cost loans. Accordingly, the Board is adopting comment 36(d)(1)–5, redesignated as comment 36(d)(1)–4, as proposed to clarify that the rule does

[27] *See Interagency Guidance on Sound Incentive Compensation Policies,* 75 FR 36395; June 25, 2010.

not affect creditors' flexibility in setting rates or other loan terms. The Board recognizes that some research has suggested that consumers who received no-cost loans paid less for their loans than consumers who received loans where they paid some upfront charges *and* a yield spread premium.[28] The Board's proposal did not restrict yield spread premiums to no-cost loans, however, and therefore the recommendation is outside the scope of the proposed rule. Provisions of the Reform Act address this issue, which will be the subject of a future rulemaking.

In addition, under the rule, creditors may adjust the loan terms it offers to consumers to finance transaction costs the consumer would otherwise be obligated to pay directly in cash or out of the loan proceeds. For example, a creditor could recoup some costs related to the loan transaction by adding an origination point to the loan terms (calculated as one percentage point of the loan amount). However, any adjustment of loan terms must not affect the amount a loan originator receives as compensation for the transaction. Thus, the final rule does not impact creditors' ability to offer a full range of interest rate and fee combinations, so long as the exchange between the loan price and transaction costs has no bearing on loan originator compensation. For example, a creditor could add a constant premium of ¼ of one percent to the interest rates on all transactions to recoup loan originator compensation. *See* comment 36(d)(1)–5.

Effect of modification of loan terms. Under the proposed rule, a loan originator's compensation could neither be increased nor decreased based on the loan terms and conditions. Accordingly, proposed comment 36(d)(1)–6 clarified that if a consumer's request for a lower rate was accepted by the creditor, the creditor would not be permitted to reduce the amount it pays to the loan originator based on the change in loan terms. Similarly, any reduction in origination points paid by the consumer would be a cost borne by the creditor.

Industry commenters opposed prohibiting creditors from reducing loan originator compensation when the loan originator offers a favorable loan term change to a consumer. They argued that unusual circumstances require flexibility, and that loan term concessions help consumers receive better loans. They further stated that fair lending laws adequately provide protection from unlawful discrimination in offering more favorable terms on a prohibited basis.

For the reasons explained in the proposal, the Board is adopting comment 36(d)(1)–6, redesignated as comment 36(d)(1)–5, as proposed. The Board believes that permitting creditors to decrease loan originator compensation because of a change in terms favorable to the consumer would result in loopholes and permit evasions of the final rule. For example, a creditor could agree to set originators' compensation at a high level generally, and then subsequently lower the compensation in selective cases based on the actual loan terms, such as when the consumer obtains another offer with a lower interest rate. This would have the same effect as increasing the originator's compensation for higher rate loans. As noted above, the Board believes such compensation practices are harmful and unfair to consumers.

Thus, under the final rule, when the creditor offers to extend a loan with specified terms and conditions (such as rate and points), the amount of the originator's compensation for that transaction is not subject to change, based on either an increase or a decrease in the consumer's loan cost or any other change in the loan terms. The Board recognizes that in some cases a creditor may be unable to offer the consumer a lower cost and more competitively-priced loan without also reducing the creditor's own origination costs. Creditors finding themselves in this situation frequently, however, will be able to adjust their pricing and compensation arrangements to be more competitive with other creditors in the market.

Periodic changes in loan originator compensation. The Board proposed comment 36(d)(1)–7 to provide guidance on how creditors may periodically revise the compensation they pay a loan originator without violating the rule. The Board is adopting the comment, redesignated as comment 36(d)(1)–6, as proposed. The revised compensation arrangement must result in payments to the loan originator that are not based on the terms or conditions of a transaction. Thus, a creditor may periodically review factors such as loan performance, loan volume, and current market conditions for originator compensation, and prospectively revise the compensation it will pay the loan originator for future transactions.

Compensation received directly from the consumer. The Board proposed comment 36(d)(1)–8 to indicate that the prohibition in § 226.36(d)(1) did not apply to transactions in which the loan originator received compensation directly from the consumer, and to clarify that in such cases no other person could pay the loan originator in connection with the particular transaction pursuant to § 226.36(d)(2). *See* § 226.36(d)(2) and corresponding commentary below discussing the prohibition on compensation from both the consumer and another source. Proposed comment 36(d)(1)–8 also provided guidance regarding what constitutes compensation received directly from the consumer.

The Board is adopting the comment, redesignated as comment 36(d)(1)–7, substantially as proposed with clarifications. Comment 36(d)(1)–7 provides that loan originator compensation may be paid directly by the consumer whether it is paid in cash or out of the loan proceeds. However, payments by the creditor to the loan originator that are derived from an increased interest rate are not considered compensation received directly from the consumer. Comment 36(d)(1)–7 further clarifies that origination points charged by a creditor are not compensation paid directly by a consumer to a loan originator whether they are paid in cash or out of loan proceeds. If a creditor pays compensation to the loan originator out of points, the loan originator may not also collect compensation directly from the consumer. To facilitate compliance, comment 36(d)(1)–7 provides a cross reference to 36(d)(1)–1, which discusses compensation.

Prohibition of Compensation From Both the Consumer and Another Source

The Board proposed § 226.36(d)(2) to provide that, if a loan originator is compensated directly by the consumer on a transaction, no other person may pay any compensation to the originator for that transaction. Direct compensation paid by a consumer to a loan originator is not limited to "origination fees," "broker fees," or similarly labeled charges. Rather, compensation for this purpose includes any payment by the consumer that is retained by the loan originator. Thus, a creditor that is a loan originator by virtue of making a table-funded transaction is subject to this prohibition if it imposes and retains any direct charge on the consumer for the transaction. *See* comment 36(d)(1)–1 for further discussion of amounts retained by a loan originator for bona fide third-

[28] *See, e.g.,* Susan E. Woodward & Robert E. Hall, *Consumer Confusion in the Mortgage Market: Evidence of Less than a Perfectly Transparent and Competitive* Market, 513–15, *American Econ. Rev.: Papers and Proceedings* (May 2010), *available at http://pubs.aeaweb.org/doi/pdfplus/10.1257/aer.100.2.511;* Susan Woodward, *A Study of Closing Costs for FHA Mortgages,* HUD Office of Policy Development and Research (May 2008).

party charges that are and are not deemed compensation.

Industry commenters and their trade associations opposed the proposed restriction on loan originator compensation from more than one source. These commenters argued that the proposed rule would give consumers fewer options for paying closing costs, including broker compensation. Some commenters recommended permitting loan originators to receive payments from both a creditor and a consumer if the total compensation does not exceed an agreed-upon amount and is reasonable. For example, a trade association suggested that reasonable compensation would not exceed 2 percent of the loan amount, subject to minimum of $500.

On the other hand, consumer advocates and a Federal banking agency urged the Board to adopt § 226.36(d)(2) as proposed. Consumer advocates asserted that allowing loan originators to receive compensation from different sources would enable loan originators to evade the prohibition on loan originator compensation based on the terms and conditions of a transaction. Consumer advocates concurred with the rationale stated in the Board's proposal, that consumers may reasonably believe that their direct payments are the only compensation the loan originator receives. They stated that consumers generally are less able to keep track of points paid on a loan and of the total amount of originator compensation paid, when loan originators receive compensation from multiple sources.

The Board is adopting § 226.36(d)(2) as proposed with some clarifications. The Board believes this provision is necessary to ensure that the protections in § 226.36(d)(1) are effective and that loan originators do not increase a consumer's interest rate or points to increase the originator's own compensation. Allowing the originator to receive compensation directly from the consumer while also accepting payment from the creditor in the form of a yield spread premium would enable the originator to evade the prohibition in § 226.36(d)(1). An originator that increases the consumer's interest rate to generate a larger yield spread premium can apply the excess creditor payment to third-party closing costs and thereby reduce the amount of consumer funds needed to cover upfront fees. Without § 226.36(d)(2), the originator could then impose a direct fee on the consumer in the same amount, to retain the benefit of the larger yield spread premium.

For example, suppose that for a loan with a 5 percent interest rate, the originator will receive a payment of $1,000 from the creditor as compensation, and for a loan with a 6 percent interest rate, a yield spread premium of $3,000 will be generated. Under § 226.36(d)(1), the originator must apply the additional $2,000 to cover the consumer's other closing costs. Without § 226.36(d)(2), instead of reducing the consumer's total upfront payment, the originator could also impose a $2,000 origination fee directly on the consumer, essentially retaining the benefit of the larger yield spread premium.

As discussed above, consumers generally are not aware of creditor payments to originators and reasonably may believe that when they pay a loan originator directly, that amount is the only compensation the loan originator will receive. Even if a consumer were aware of such creditor payments to loan originators, the consumer could reasonably expect that making a direct payment to an originator would reduce or eliminate the need for the creditor to fund the originator's compensation through the consumer's interest rate. Because yield spread premiums are not transparent to consumers, however, consumers cannot effectively negotiate the originator's compensation. In fact, if consumers pay loan originators directly and creditors also pay originators through higher rates, consumers may be injured by unwittingly paying originators more in total compensation (directly and through the rate) than consumers believe they agreed to pay.

The Board does not believe that § 226.36(d)(2) will significantly limit consumer choice, as consumers may still use a rate increase to cover upfront closing costs that are charged by third parties, as long as loan originators receive their compensation from only one party. Section 226.36(d)(2) will, however, increase transparency for consumers by reducing the total number of loan pricing variables with which consumers must contend. The increased transparency is consistent with TILA's purpose of promoting the informed use of consumer credit.[29] *See* TILA Section 102(a), 15 U.S.C. 1601(a). Consistent with TILA Section 129B(c)(2), as enacted in section 1403 of the Reform Act, the final rule permits loan originators to receive payment from a person other than the consumer only if the originator does not also receive any compensation directly from the consumer. As noted above, TILA Section 129B(c)(2) further restricts a loan originator's ability to receive compensation from a person other than a consumer where a consumer pays upfront points or fees on the transaction, other than certain bona fide third-party charges. *See* comment 36(d)(1)–1 discussing the term "compensation." The Board intends to address this issue as part of a subsequent rulemaking after giving the public notice and opportunity to comment.

The Board is also adopting comment 36(d)(2)–1 substantially as proposed with some clarifications. Comment 36(d)(2)–1 clarifies circumstances when a person is or is not deemed to provide compensation to a loan originator in connection with a particular credit transaction. Comment 36(d)(2)–1 explains that payment of a salary or hourly wage to a loan originator does not violate the prohibition in § 226.36(d)(2) even if the loan originator also receives direct compensation from a consumer in connection with that consumer's transaction. However, the final rule also clarifies that, in this instance, if any loan originator receives compensation directly from the consumer in connection with a specific credit transaction, no other loan originator, such as the mortgage broker company or another employee of the mortgage broker company, can receive compensation from the creditor in connection with that particular credit transaction.

The Board proposed in comment 36(d)(2)–2 to clarify that yield spread premiums, even if disclosed as "credits" in accordance with HUD's Regulation X, which implements RESPA, are not considered compensation received by the loan originator directly from the consumer for purposes of this rule. Under Regulation X, a yield spread premium paid by a creditor to the loan originator may be characterized on the RESPA disclosures as a "credit" that will be applied to reduce the consumer's total settlement charges, including origination fees. A mortgage broker trade association opposed the clarification in proposed comment 36(d)(2)–2 and urged the Board to treat yield spread premiums as payments made directly from the consumer to the loan originator under Regulation Z. By contrast, as discussed above, consumer advocates and a Federal banking agency urged the Board to adopt § 226.36(d)(2) as proposed.

The Board is adopting comment 36(d)(2)–2, as proposed. If the rule were to treat yield spread premiums as payments made directly by the consumer, loan originators could accept

[29] *See, e.g.,* Susan E. Woodward, *A Study of Closing Costs for FHA Mortgages* 70–73, Urban Institute and U.S. Department of Housing and Urban Development (2008), *available at http://www.urban.org/UploadedPDF/411682_fha_mortgages.pdf.*

both a yield spread premium from the creditor as well as a payment from the consumer, which would undermine the purpose of the rule. For the reasons stated above, the Board believes that permitting compensation from different sources would enable originators to evade the prohibition on receiving compensation based on the loan terms and conditions. Comment 36(d)(2)–2 clarifies that for purposes of this final rule, payments made by creditors to loan originators are not payments made *directly* by the consumer, regardless of how they might be disclosed under HUD's Regulation X.

Affiliated Entities

The Board is adopting the definition of "affiliates" under § 226.36(d)(3), as proposed with some clarifications. Section 226.36(d)(3) clarifies that affiliates must be treated as a single "person" for purposes of § 226.36(d), and comment 36(d)(3)–1 provides a cross-reference to the definition of "affiliates" in § 226.32(b)(2). Commenters did not address this aspect of the proposed rule. The Board believes that defining the term "affiliates" as a single person for purposes of § 226.36(d) is necessary to prevent circumvention of the final rule. For example, circumvention would occur if a parent company with multiple subsidiaries could structure its business to evade the prohibition on certain compensation practices. To illustrate, the rule would be circumvented if a parent company that has two mortgage lending subsidiaries could arrange to pay a loan originator greater compensation on higher rate loans offered by subsidiary "A" than the compensation it would pay the same originator for a lower rate loan made by subsidiary "B." To address this issue, the Board treats such subsidiaries of the parent company as a single person, so that if a loan originator is able to deliver loans to both subsidiaries, they must compensate the loan originator in the same manner. Accordingly, if a loan originator delivers a loan to subsidiary "B" and the interest rate is 8 percent, the originator must receive the same compensation that would have been paid by subsidiary "A" for a loan with a rate of either 7 or 8 percent. The Board is also adopting comment 36(d)(3)–1, as proposed.

Record Retention Requirements

Currently, creditors are required by § 226.25(a) to retain evidence of compliance with Regulation Z for two years. Under the proposal, comment 25(a)–5 clarified that a creditor must retain at least two types of records to demonstrate compliance with § 226.36(d)(1): A record of the compensation agreement with the loan originator that was in effect on the date the transaction's rate was set, and a record of the actual amount of compensation it paid to a loan originator in connection with each covered transaction. The proposed comment explained that for loans involving mortgage brokers, the creditor may retain the HUD–1 settlement statement required under RESPA as a record of the actual amount of loan originator compensation paid. The Board sought comment on whether other records should be subject to the retention requirements; whether some time other than the date the transaction rate is set would be more appropriate; whether the two-year retention requirement was adequate; and the relative costs and benefits of requiring persons, other than creditors, to retain records concerning originator compensation.

Industry commenters and their trade associations opposed expanding the record retention requirements to persons other than creditors, citing cost and burden as reasons. A credit union trade association affirmed that systems currently used by credit unions to track loan originator compensation should be deemed sufficient. This commenter also stated that credit union compensation records indicating that loan originator compensation was provided in the form of salary without being directly attributable to a particular transaction should satisfy the record retention requirements.

Associations of state regulators urged the Board to require the retention of records for longer than two years. Consumer advocates recommended that the Board require retention of records by all parties making payments to loan originators for five years. They asserted that detection of violations of the rule would be unlikely within the two-year period. These commenters also noted that that the HUD–1 settlement statement is often inaccurate, and so should not be considered a record of the actual amount of loan originator compensation paid, but did not offer other alternatives.

The Board is adopting comment 25(a)–5 substantially as proposed. Accordingly, the final rule does not extend the record retention requirement to persons other than the creditor that pays loan originator compensation. At the time the Board issued this proposal and comments were submitted, TILA did not subject non-creditors to civil liability. As a result, the comments did not take into account such liability in their analysis of the costs and benefits of recordkeeping by non-creditors. On July 21, 2010, Congress enacted the Reform Act, which amended TILA to provide civil liability for loan originators.[30] The Board will request additional comment on this matter in connection with subsequent rulemakings to implement provisions of the Reform Act.

Under the final rule, any creditor who pays loan originator compensation, and, therefore, is subject to § 226.36(d), is required to retain records pursuant to § 226.25(a). The Board believes record retention requirements are necessary to ensure that the loan originator compensation rules in §§ 226.36(d) and (e) are enforceable. Comment 25(a)–5 is being revised to remove reference to the HUD–1 settlement statement which does not currently itemize loan originator compensation. Comment 25(a)–5 is also revised to provide that where a loan originator is a mortgage broker, a disclosure or agreement required by applicable state law that complies with § 226.25 is presumed to be a record of the amount actually paid to the loan originator in connection with the transaction.

The final rule does not extend the record retention requirement for origination compensation beyond two years. This is the same time period that applies for records of compliance with other provisions of Regulation Z. The Board weighed the potential benefits of a longer timeframe against the increased costs, and believes that the benefits of a longer time period do not clearly outweigh the costs. To facilitate compliance, the Board adopts proposed comment 36(d)(1)–9, redesignated as comment 36(d)(1)–8, to provide a cross-reference to the record retention requirement.

Alternatives and Exemptions Not Adopted

Disclosures. Industry commenters and their trade associations urged the Board to implement disclosure requirements to address unfair compensation practices, instead of directly prohibiting loan originator compensation based on terms or conditions of the transaction under § 226.36(d)(1). In particular, the SBA and a mortgage broker trade association recommended that the Board replace the proposed prohibition on certain compensation practices with a requirement that creditors disclose the lowest interest rate they would accept for a given loan. A Federal banking agency suggested that, in addition to prohibiting loan originator

[30] *See* TILA Section 129B(d), as enacted in Section 1404 of the Reform Act.

compensation based on the terms or conditions of a transaction, the Board develop and require uniform mortgage broker disclosures that specify the mortgage broker's role and fees. This commenter argued that such disclosures would help consumers understand the role of brokers, and would indirectly reform loan originator compensation practices.

For the reasons discussed in the proposal, the Board is not adopting disclosure requirements as an alternative to the proposed prohibitions on certain compensation practices. In connection with its proposal of a disclosure-based approach to originator compensation, the Board conducted consumer testing of the disclosures and based on the results of such testing, and other concerns, withdrew the rule in its 2008 HOEPA Final Rule. For the reasons stated therein and reiterated in its August 2009 Closed-End Proposal, the Board believed that disclosure of loan originator compensation would not address the injury to consumers. The Board was concerned that after reading the disclosures consumers often concluded, not necessarily correctly, that mortgage brokers are more expensive than creditors. Many consumers also believed that mortgage brokers would serve their best interests notwithstanding disclosure of the conflict of interest resulting from the relationship between interest rates and broker compensation.

The Board's consumer testing also suggests that few consumers shop for mortgages, and often rely on one broker or lender because of their trust in the relationship, and because they do not know that brokers and lenders have discretion over the loan terms offered. Moreover, even when originator compensation is disclosed, consumers typically do not understand its complexities or how it relates to the mechanics of loan pricing. Consumers do not understand how a creditor payment to a loan originator can result in a higher interest rate for consumers. Without that knowledge, consumers cannot take steps to protect their own interests, for example by negotiating for a smaller direct payment, a lower rate, or both.

Further, HUD and some states have required certain disclosures of mortgage broker fees for years. In spite of these disclosures, concerns continue to be raised about abuses associated with yield spread premiums and similar compensation for loan officers. For these reasons, the Board believes that disclosures are ineffective at addressing unfair originator compensation.

Caps. Some industry commenters and trade associations recommended the Board adopt a cap on loan originator compensation, for example at two percent of the loan amount, while allowing compensation to vary from transaction to transaction based on the loan's terms. The Board is not imposing a cap on the amount of loan originator compensation that can be paid in a particular transaction. Although a cap might prohibit the most egregious compensation practices, it would not adequately address the consumer injury that the final rule is designed to address. A cap would merely create an upper limit on an originator's compensation; it would not prevent a loan originator from increasing the consumer's rate or points to increase the originator's own compensation. In addition, a cap would require the Board to determine an upper limit that is appropriate for all loans. It is unclear how, or on what basis, the Board would determine the appropriate cap for all loans, and, therefore, such a cap might prove arbitrary. In some cases originators might not be fully compensated for their work, and in other cases they might receive compensation that exceeds the value of their services. Some loan originators would simply charge up to the cap in all cases. For all of these reasons, the final rule does not apply a cap to originator compensation.

Prohibition on Steering

The Board requested comment on a proposal under § 226.36(e)(1) that would prohibit loan originators from directing or "steering" consumers to loans based on the fact that the originator will receive additional compensation, when that loan may not be in the consumer's interest. The proposed rule was intended to prevent circumvention of the prohibition in § 226.36(d)(1), which could occur if the loan originator steered the consumer to a loan with a higher interest rate or higher points to increase the originator's compensation. To facilitate compliance with this anti-steering rule, the Board also proposed a safe harbor in §§ 226.36(e)(2) and (3). Under the safe harbor, a loan originator would be deemed to comply with the anti-steering rule if, under certain specified conditions, the consumer is presented with a choice of loan options that include (1) the lowest interest rate, (2) the second lowest interest rate, and (3) the lowest total dollar amount for origination points or fees and discount points. Proposed commentary provided additional guidance regarding the prohibition on steering and the safe harbor.

The Board specifically sought comment on whether the steering prohibition would be effective in achieving its stated purpose, as well as the feasibility and practicality of such a rule, its enforceability, and any unintended adverse effects the rule might have. As discussed in further detail below, the Board is adopting the anti-steering rule under § 226.36(e)(1) as proposed, with a modification to the safe harbor provided under §§ 226.36(e)(2) and (3).

Public Comment. Industry commenters and their trade associations generally asserted that the anti-steering prohibition, as well as the safe harbor, were too vague and would increase compliance costs and litigation risk. They asserted that these costs would, in turn, be passed on to consumers. Some commenters argued that the anti-steering rule would interfere with the loan originator's ability to communicate with consumers. They claimed that the prohibition would cause loan originators not to advise their consumers fully about possible loan options. These commenters urged the Board to provide a safe harbor for various disclosures instead of the anti-steering rule.[31] A credit union trade association suggested a safe harbor for consumers who know what loan type they want, and for smaller entities that may offer only one or two types of loans.

Consumer advocates, other Federal banking agencies, members of Congress, and state officials generally supported the anti-steering proposal, although some noted concerns with the safe harbor and associated record-keeping requirements. These commenters stated that the practice of steering consumers to loans with less favorable terms increases consumers' costs and risk, increases the risk to the market as a whole, and has the potential to result in illegal discrimination. For example, one commenter stated that originator compensation led to many borrowers who qualified for prime loans being steered to subprime loans. This commenter also asserted that the compensation practices addressed by the rule caused subprime borrowers to have reduced access to loans with lower interest rates and no risky features, and contributed significantly to foreclosures in minority neighborhoods.

With respect to the safe harbor, consumer advocates, state officials, and

[31] A mortgage broker trade association suggested that the Board look to a House-passed bill that preceded the Reform Act for guidance on its anti-steering rule. For the reasons discussed above, the Board's rule is consistent with the Reform Act as enacted.

a Federal banking agency expressed concern that the proposed safe harbor would undermine the effectiveness of the prohibition on certain compensation payments under § 226.36(d). These commenters stated that the safe harbor was too broad and would permit circumvention of the rule under § 226.36(d)(1). They argued that the safe harbor would create incentives for "pro forma" compliance, and weaken consumers' access to effective remedies. These commenters urged the Board to eliminate the safe harbor entirely so that compliance with the steering prohibition could be determined case-by-case, based on whether the loan originator could have offered the consumer a loan transaction with lower costs. Alternatively, they recommended that the Board replace the safe harbor with a rebuttable presumption of compliance that would only be available in those instances where the loan originator offered, and the consumer chose, a "plain vanilla loan" (*e.g.,* a loan with a rate that is fixed for at least 5 years with a competitive interest rate, points and fees equal to 2 points or less, no prepayment penalty, fully amortizing payments, and that is underwritten with full documentation of the consumer's ability to repay).

Discussion. The Board is adopting the anti-steering rule under § 226.36(e)(1) as proposed, with some clarifications to corresponding comments 36(e)(1)–1 through –3. The Board believes an anti-steering rule is appropriate and necessary to prevent the harm that results if loan originators steer consumers to a particular transaction based on the amount of compensation paid to the originator when that loan is not in the consumer's interest. In addition, the Board believes the rule is necessary to prevent circumvention of the prohibition in § 226.36(d)(1). Section 226.36(d)(1) does not prevent a loan originator from directing a consumer to transactions from a single creditor that offer greater compensation to the originator, while ignoring possible transactions having lower interest rates that are available from other creditors. Consumers generally are unaware of yield spread premiums and are unable to appreciate the incentives such compensation creates regarding the loan options a loan originator may choose to present to consumers. Unaware of these financial incentives, consumers are unable to engage in effective negotiation with loan originators. Rather, consumers are more likely to rely on a loan originator's advice regarding which loan transaction will be in their interest. Consequently, these consumers may pay more for mortgage credit than they would otherwise be required to pay. As discussed above in part VI.C, the Board finds such a practice to be unfair.

The final rule under § 226.36(e)(1) prohibits loan originators from directing or "steering" a consumer to consummate a dwelling-secured loan based on the fact that the originator will receive greater compensation from the creditor in that transaction than in other transactions the originator offered or could have offered to the consumer, unless the consummated transaction is in the consumer's interest. The rule is intended to preserve consumer choice by ensuring that consumers have loan options that reflect considerations other than the maximum amount of compensation that will be paid to the originator. Thus, originators could violate the anti-steering prohibition if, for instance, they direct a consumer to a fixed-rate loan option from a creditor that maximizes the originator's compensation without providing the consumer with an opportunity to choose from other available loans that have lower fixed interest rates with the equivalent amount in origination and discount points.

Commenters expressed concern that a prohibition on steering could negatively impact the relationship between loan originators and consumers, for example by causing loan originators not fully to advise consumers on available loan options. The Board believes, however, that the anti-steering rule is sufficiently flexible to allow the loan originator and consumer to continue to discuss and determine which terms and conditions of the loan transaction, in addition to other factors such as length of time until closing, will serve the consumer's interest. For example, comment 36(e)(1)–2(ii) makes clear that the final rule does not require a loan originator to direct a consumer to consummate the transaction that will result in the least amount of compensation being paid to the originator by the creditor. However, if the loan originator reviews possible loan offers available from a significant number of the creditors with which the originator regularly does business, and the originator directs the consumer to the transaction that will result in the least amount of creditor-paid compensation, the requirements of § 226.36(e) would be deemed to be satisfied.

Comment 36(e)(1)–2 is also revised to provide additional clarification that where a loan originator directs a consumer to a transaction that will result in a greater amount of creditor-paid compensation for the loan originator, § 226.36(e)(1) is not violated if the terms and conditions on that transaction are the same as other possible loan offers available through the originator, and for which the consumer likely qualifies. Comment 36(e)–1 is adopted as proposed to provide guidance on compensation that is subject to the anti-steering rule. Comments 36(e)(1)–1 and –3 are adopted as proposed to provide further guidance regarding what it means to "direct" or "steer" a consumer, and examples of conduct that is prohibited under the anti-steering rule, respectively.

As discussed above under the definition of a "loan originator," employees of a creditor are prohibited under § 226.36(d)(1) from receiving compensation that is based on the terms or conditions of the loan. Thus, when originating loans for the employer-creditor, the originator may not steer the consumer to a particular loan offered by the employer to increase compensation. Accordingly, in these cases, compliance with § 226.36(d)(1) is deemed to satisfy the requirements of § 226.36(e)(1). At the same time, the Board recognizes that a creditor's employee may occasionally act as a broker by forwarding a consumer's application to a creditor other than the loan originator's employer, such as when the employer does not offer any loan products for which the consumer would qualify. If the loan originator is compensated for arranging the loan with the other creditor, the originator is not an employee of the creditor in that transaction and is subject to § 226.36(e)(1). *See* comment 36(e)(1)–2.ii.

Safe Harbor; Loan Options Presented

As noted above, to facilitate compliance with the anti-steering rule, the Board proposed to create a safe harbor in §§ 226.36(e)(2) and (3). Under the proposal, a loan originator would be deemed to comply with the anti-steering rule if, under certain conditions, the consumer is presented with a choice of loan options that include (1) the lowest interest rate, (2) the second lowest interest rate, and (3) the lowest total dollar amount for origination points or fees and discount points. For the reasons discussed below, the Board is adopting the proposed safe harbor, with technical clarifications and a modification to the set of loan options that a loan originator must present to the consumer to qualify for the safe harbor.

Under the final rule, a loan originator is deemed to have complied with the anti-steering rule in § 226.36(e)(1) if it

satisfies each of three requirements: (1) For each type of transaction in which the consumer expressed an interest (*i.e.,* a fixed-rate, adjustable-rate, or a reverse mortgage), the consumer is presented with and able to choose from loan options that include a loan with the lowest interest rate, a loan with the lowest total dollar amount for origination points or fees and discount points, and a loan with the lowest rate with no risky features, such as a prepayment penalty or negative amortization; (2) the loan options presented to the consumer are obtained by the loan originator from a significant number of the creditors with whom the loan originator regularly does business; and (3) the loan originator believes in good faith that the consumer likely qualifies for the loan options presented to the consumer. The loan originator need only evaluate loan offers that are available from creditors with whom the loan originator regularly does business. *See* §§ 226.36(e)(2)(i)–(iii), 226.36(e)(3)(i)(A)–(C), and 226.36(e)(3)(ii) and corresponding commentary.

The safe harbor is intended to provide loan originators with clear guidance to ensure that they can comply with the anti-steering rule in § 226.36(e). At the same time, the Board believes the safe harbor must be sufficiently flexible to ensure consumers are not unduly restricted from considering various loan options. There is no uniform method available for determining which loans may be in the consumer's interest. Consumers and loan originators generally consider various terms and conditions in relation to other external factors, such as how long the consumer expects to hold the loan or the creditor's reputation for delivering loans within a promised timeframe. Thus, some consumers may reasonably determine that the financial risk created by a certain loan feature, for example shared equity, is acceptable in light of the loan's lower interest rate, while other consumers may prefer to accept a higher rate to avoid the risk associated with a shared equity feature (*e.g.,* potential loss of future equity). The Board believes that consumer advocates' suggestion for narrowing the safe harbor to permit only one type of loan option would unduly restrict consumer choice and access to credit.

The Board believes, however, that there is merit in limiting the safe harbor to circumstances where the loan originator offers a loan option without certain risk features. Such a requirement may serve to deter loan originators from steering consumers to loans with riskier features than they would otherwise choose simply to earn greater compensation. In addition, requiring loan originators to present a loan option with the lowest rate and without certain risky features to obtain the benefit of the safe harbor should place consumers in a better position to compare more traditional loans to loans with riskier features and might result in more consumers opting for "traditional" loans. To this end, such a requirement serves TILA's purpose of avoiding the uninformed use of credit. *See* TILA Section 102(a), 15 U.S.C. 1601(a).

For these reasons, the final rule modifies the safe harbor to require that, in addition to loan options with the lowest rate and the lowest total dollar amount for origination points or fees and discount points, one of the loan options presented to a consumer be a loan with the lowest interest rate that is without any of the following features: Negative amortization; a prepayment penalty; a balloon payment in the first 7 years; a demand feature; shared equity; or shared appreciation. The final rule also provides that if the consumer expresses an interest in a reverse mortgage, a loan without a prepayment penalty, or a shared-equity or shared-appreciation feature must be presented. *See* § 226.36(e)(3)(i)(B). This loan option requirement replaces the requirement under the proposal to offer the consumer a loan option with the second lowest rate. In technical revisions, §§ 226.36(e)(2) and (e)(3)(i) are further clarified that to obtain the safe harbor, loan originators must present loan options to the consumer that include the loan options identified in § 226.36(e)(3)(i); no substantive change is intended. In addition, comments 36(e)–1 through –4 are adopted as proposed to provide guidance on the application of the rule.

The Board believes that requiring loan originators to present loan offers with the lowest interest rate and the lowest total dollar amount for origination points or fees and discount points to avail themselves of the safe harbor will prevent the most egregious practices of originators steering consumers to more expensive loans. Such a requirement may also help to ensure that consumers are able to choose from low-cost alternatives. The Board is not adopting the recommendation by some commenters to provide a rebuttable presumption rather than a safe harbor. As noted above, consumers may choose loans for a variety of reasons, depending on their individual circumstances and preferences. The anti-steering rule is intended to deter the most egregious practices of steering consumers to more expensive loans simply to earn greater compensation, while at the same time preserving consumers' credit options. The Board believes that a presumption of compliance would not serve this purpose as well as a safe harbor, because creditors could incur greater risk by offering more loan options to consumers. *See* comment 36(e)(2)–1, adopted as proposed, clarifying that there is no presumption regarding the loan originator's compliance or noncompliance with § 226.36(e)(1) where a loan originator does not satisfy § 226.36(e)(2).

Comment 36(e)(1)–2.i, adopted substantially as proposed, clarifies that in determining whether a transaction is in the consumer's interest, the loan originator must compare that transaction to other possible loan offers available through the originator, and for which the loan originator in good faith believes the consumer is likely to qualify, at the time that transaction was offered to the consumer. The loan originator need only evaluate those loan offers that are available from creditors with whom the loan originator regularly does business. That is, the final rule does not require a loan originator to establish a new business relationship with any creditor.

The Board is also adopting § 226.36(e)(3)(iii), as proposed, which provides that if a loan originator presents more than three loans to the consumer for each type of transaction in which the consumer expresses an interest, the loan originator must highlight the three loans that satisfy the criteria of the safe harbor, as discussed above.

Some commenters expressed concern, however, that the safe harbor would unnecessarily require loan originators to present consumers with a minimum of three loan options where one or two loan options satisfied the criteria set forth in § 226.36(e)(3)(i). To address these commenters' concerns, the final rule includes new § 226.36(e)(4) to provide that if a single loan fulfills the criteria of all loan options listed in § 226.36(e)(3)(i), loan originators satisfy the requirements of the safe harbor by presenting that loan to the consumer. Thus, loan originators can present fewer than three loans and satisfy §§ 226.36(e)(2) and (e)(3)(i) if the loans presented meet the criteria of the options set forth in § 226.36(e)(3). Furthermore, comment 36(e)(2)–2, which is adopted substantially as proposed, provides additional clarification that presenting more than four loans for each transaction type in which the consumer expressed an interest and for which the consumer likely qualifies would not likely help

consumers make a meaningful choice. As noted above, if a loan originator presents more than three loans to a consumer, the loan originator must highlight the three loans that satisfy the criteria set out in the final rule.

Alternatives not adopted. A Federal banking agency recommended offering a safe harbor if the loan originator completed a trade-off table in the RESPA Good Faith Estimate (GFE). The Board is not adopting the recommendation to provide a safe harbor for a completed trade-off table in the RESPA GFE. The trade-off table is designed to help consumers understand the trade-off between interest rates and points. While understanding this trade-off is beneficial, it is not sufficient, by itself, to protect consumers against steering. For example, the trade-off table would not highlight that a loan has a prepayment penalty or other risky feature. Moreover, for adjustable-rate products, the trade-off table reflects only the initial interest rate and not the rate at first adjustment or the maximum possible interest rate. In some cases, a trade-off table might lead a consumer to choose an adjustable rate mortgage because of a low initial rate, without the consumer realizing that the rate could rapidly and significantly increase.

VII. Mandatory Compliance Dates; Effective Dates

The Board requested comment on the length of time necessary for creditors to implement the proposed rule. Industry commenters and their trade associations requested an implementation period of at least 18 to 24 months. The SBA recommended that the Board delay implementation for at least 18 months for small entities. Many of these commenters explained that the proposed rule involved extensive revisions to current business practices regarding loan originator compensation. In contrast, consumer advocates asked that the proposed rule become effective immediately or at least very quickly in light of the substantial consumer injury resulting from loan originator compensation.

Under TILA Section 105(d), certain of the Board's disclosure regulations are to have an effective date of that October 1 which follows by at least six months the date of promulgation. 15 U.S.C. 1604(d). However, the Board may at its discretion lengthen the implementation period for creditors to adjust their forms to accommodate new requirements, or shorten the period where the Board finds that such action is necessary to prevent unfair or deceptive disclosure practices. No similar effective date requirement exists for non-disclosure regulations. The Riegle Community Development and Regulatory Improvement Act of 1994, however, requires that agency regulations which impose additional reporting, disclosure and other requirements on insured depository institutions take effect on the first day of a calendar quarter following publication in final form. 12 U.S.C. 4802(b).

Compliance with the final rule will be mandatory on April 1, 2011. *See* comment 36–2. Thus, the final rule applies to loan originator compensation for transactions subject to § 226.36(d) and (e), for which creditors receive applications on or after April 1, 2011. The Board believes that this will provide sufficient time for creditors and loan originators to make the necessary adjustments to their compensation agreements and practices to conform to the final rule. A longer compliance time such as the 18 to 24 months suggested by creditors is not necessary, given that the rule does not require changes to the timing, content and format of mortgage disclosure forms.

Compliance with the provisions of the final rule is not required before the effective date. Thus, the final rule and the Board's accompanying analysis should have no bearing on whether the acts and practices that are restricted or prohibited under this final rule are deemed to be unfair or deceptive if they occur before the effective date of this rule. Unfair acts or practices can be addressed through case-by-case enforcement actions against specific institutions or individuals, through regulations applying to all institutions and individuals, or both. An enforcement action concerns a specific institution's or individual's conduct and is based on all of the facts and circumstances surrounding that conduct. By contrast, a regulation is prospective and applies to the market as a whole, drawing bright lines that distinguish broad categories of conduct.

Because broad regulations, such as those in the final rule, can require large numbers of institutions and individuals to make major adjustments to their practices, there could be more harm to consumers than benefit if the regulations were effective earlier than the effective date. If institutions and individuals were not provided a reasonable time to make changes to their operations and systems to comply with the final rule, they would either incur excessively large expenses, which would be passed on to consumers, or cease engaging in the regulated activity altogether, to the detriment of consumers. And because an act or practice is unfair only when the harm outweighs the benefits to consumers or to competition, the implementation period preceding the effective date set forth in the final rule is integral to the Board's decision to restrict or prohibit certain acts or practices by regulation.

For these reasons, acts or practices occurring before the effective date of this final rule will be judged on the totality of the circumstances under applicable laws or regulations. Similarly, acts or practices occurring after this final rule's effective date that are not governed by these rules will continue to be judged on the totality of the circumstances under applicable laws or regulations.

VIII. Paperwork Reduction Act

In accordance with the Paperwork Reduction Act of 1995, 44 U.S.C. 3506; 5 CFR 1320 Appendix A.1, the Board has reviewed the final rule under authority delegated to the Board by the Office of Management and Budget. The final rule contains no new collections of information and proposes no substantive changes to existing collections of information pursuant to the Paperwork Reduction Act.

As discussed above, on August 26, 2009 the Board published in the **Federal Register** a notice of proposed rulemaking to amend Regulation Z. 74 FR 43232. The comment period for this notice expired on December 24, 2009. The Board is continuing to review all of the comments and is in the process of developing several final rules.

The Board has a continuing interest in the public's opinions of its collections of information. At any time, comments regarding the burden estimate or any other information, including suggestions for reducing the burden may be sent to: Secretary, Board of Governors of the Federal Reserve System, 20th and C Streets, NW., Washington, DC 20551; and to the Office of Management and Budget, Paperwork Reduction Project (7100–0199), Washington, DC 20503.

IX. Final Regulatory Flexibility Analysis

In accordance with section 4(a) of the Regulatory Flexibility Act (RFA), 5 U.S.C. §§ 601–612, the Board is publishing a final regulatory flexibility analysis for the amendments to Regulation Z. The RFA requires an agency either to provide a final regulatory flexibility analysis with a final rule or to certify that the final rule will not have a significant economic impact on a substantial number of small entities. Under regulations issued by the SBA, an entity is considered "small" if it has $175 million or less in assets for banks and other depository institutions;

and $7 million or less in revenues for non-bank mortgage lenders and mortgage brokers.[32]

The Board received a large number of comments contending that the proposed rule would have a significant impact on various businesses. Based on public comment, the Board's own analysis, and for the reasons stated below, the Board believes that this final rule will have a significant economic impact on a substantial number of small entities.

A. Statement of Need for, and Objectives of, the Final Rule

Congress enacted TILA based on findings that economic stability would be enhanced and competition among consumer credit providers would be strengthened by the informed use of credit resulting from consumers' awareness of the cost of credit. One of the stated purposes of TILA is to provide a meaningful disclosure of credit terms to enable consumers to compare credit terms available in the marketplace more readily and avoid the uninformed use of credit. TILA also contains procedural and substantive protections for consumers. TILA directs the Board to prescribe regulations to carry out the purposes of the statute. The Board's Regulation Z implements TILA.

Congress enacted HOEPA in 1994 as an amendment to TILA. HOEPA imposed additional substantive protections on certain high-cost mortgage transactions. HOEPA also charged the Board with prohibiting acts or practices in connection with mortgage loans that are unfair, deceptive, or designed to evade the purposes of HOEPA, and acts or practices in connection with refinancing of mortgage loans that are associated with abusive lending practices or are otherwise not in the interest of borrowers.

The final rule restricts certain loan originator compensation practices to address problems that have been observed in the mortgage market. These restrictions are proposed pursuant to the Board's statutory responsibility to prohibit unfair and deceptive acts and practices in connection with mortgage loans.

B. Summary of Issues Raised by Comments in Response to the Initial Regulatory Flexibility Analysis

In accordance with section 3(a) of the RFA, 5 U.S.C 603(a), the Board prepared an initial regulatory flexibility analysis (IRFA) in connection with the proposed rule, and acknowledged that the projected reporting, recordkeeping, and other compliance requirements of the proposed rule would have a significant economic impact on a substantial number of small entities. In addition, the Board recognized that the precise compliance costs would be difficult to ascertain because they would depend on a number of unknown factors, including, among other things, the specifications of the current systems used by small entities to administer and maintain accounts, the complexity of the terms of credit products that they offer, and the range of such product offerings. The Board sought information and comment on any costs, compliance requirements, or changes in operating procedures arising from the application of the proposed rule to small entities.

The Board reviewed comments submitted by various entities in order to ascertain the economic impact of the proposed rule on small entities. A number of financial institutions and mortgage brokers expressed concern that the Board had underestimated the costs of compliance. In addition, the SBA submitted a comment on the Board's IRFA. Executive Order 13272 directs Federal agencies to respond in a final rule to written comments submitted by the SBA on a proposed rule, unless the agency certifies that the public interest is not served by doing so. The Board's response to the SBA's comment letter is below.[33]

Response to the SBA. The SBA expressed concern that the Board's IRFA did not adequately assess the impact of the proposed rule on small entities as required by the RFA. The SBA urged the Board to issue a new proposal containing a revised IRFA. For the reasons stated below, the Board believes that its IRFA complied with the requirements of the RFA and the Board is proceeding with a final rule.

The SBA suggested that the Board failed to provide sufficient information about the economic impact of the proposed rule and that the Board's request for public comment on the costs to small entities of the proposed rule was not appropriate. Section 3(a) of the RFA requires agencies to publish for comment an IRFA which shall describe the impact of the proposed rule on small entities. 5 U.S.C. 603(a). In addition, section 3(b) requires the IRFA to contain certain information including a description of the projected reporting, recordkeeping and other compliance requirements of the proposed rule, including an estimate of the classes of small entities which will be subject to the requirement and the type of professional skills necessary for preparation of the report or record. 5 U.S.C. 603(b).

The Board's IRFA complied with the requirements of the RFA. The IRFA procedure is "intended to evoke commentary from small businesses about the effect of the rule on their activities, and to require agencies to consider the effect of a regulation on those entities." *Cement Kiln Recycling Coalition* v. *EPA,* 255 F.3d 855, 868 (D.C. Cir. 2001). The RFA does not require that the Board be able to project the specific dollar amount that a rule will cost small entities in order to implement the rule; rather it requires a description of the projected impact of the rule on small entities and of reporting, recordkeeping, or compliance requirements. 5 U.S.C. 603(a), 603(b)(4). Accordingly, the Board described the projected impact of the proposed rule and sought comments from small entities themselves on the effect the proposed rule would have on their activities. First, the Board described the impact of the proposed rule on small entities by describing the rule's proposed requirements in detail throughout the supplementary information for the proposed rule. Second, the Board described the projected compliance requirements of the rule in its IRFA, noting the need for small entities to comply with recordkeeping requirements, and update systems and loan origination practices.[34]

The SBA also commented that the Board failed to provide sufficient information about the number of small mortgage brokers that may be impacted by the rule. Section 3(b)(3) of the RFA requires the IRFA to contain a description of and, *where feasible,* an estimate of the number of small entities to which the proposed rule will apply. 5 U.S.C. 603(b)(3) (emphasis added). The Board provided a description of the small entities to which the proposed rule would apply and provided an estimate of the number of small depository institutions to which the proposed rule would apply.[35] The Board also provided an estimate of the total number of mortgage broker entities and estimated that most of these were

[32] 13 CFR 121.201.

[33] Advocacy commented on all of the provisions in the Board's August 2009 Closed-End Proposal. The Board is responding in this final rule only to Advocacy's comments that relate to this final rule regarding loan originator compensation. The Board will respond to Advocacy's comments on other proposed provisions when any final rules on those provisions are issued.

[34] 74 FR 43232, 43320; Aug. 26, 2009.

[35] *Id.* at 43319–43320.

small entities.[36] The Board stated that it was not aware of a reliable source for the total number of small entities likely to be affected by the proposal.[37] Thus, the Board did not find it feasible to estimate their number. The Board has previously requested information on the number of small entities, including small mortgage broker entities, in its 2008 proposed rule under HOEPA.[38] Comment letters received by the Board on both the current and the 2008 proposals, including the SBA's comment letters, have not provided additional sources of information about the number of small entities affected.

The SBA also suggested that the Board's IRFA did not sufficiently address alternatives to the proposed rule, especially as they relate to small entities. Section 3(c) of the RFA requires that an IRFA contain a description of any significant alternatives to the proposed rule which *accomplish the stated objectives of applicable statutes* and which minimize any significant economic impact of the proposed rule on small entities. 5 U.S.C. 603(c) (emphasis added). However, the Board's IRFA discusses the alternative of improved disclosures and requests comment on other alternatives.[39]

The SBA's comment letter recommended that the Board replace the proposed substantive rule restricting originator practices with a requirement that creditors disclose the lowest interest rate they would accept for a given loan. However, the Board's IRFA discussion of the disclosure alternative indicates why the Board does not believe that such a disclosure alternative would accomplish the stated objectives of applicable statutes.[40] The Board has extensively considered whether additional disclosures, including disclosing the loan originator's compensation, would achieve the statutory objectives of HOEPA, and even proposed such a disclosure requirement in the 2008 HOEPA Proposed Rule.[41] However, public comment on that proposal, and consumer testing conducted for the Board, provided strong evidence that additional disclosures would not accomplish the goal of HOEPA and the Board's proposal to prevent unfair or deceptive origination practices, which led the Board to withdraw the proposal.[42] The SBA's comment letter asserts that the disclosure alternative should be sufficient to accomplish the Board's regulatory goals, yet it fails to mention the public comment or consumer testing findings relating to the Board's withdrawn 2008 proposal.

The SBA also suggested that, according to a mortgage broker industry trade group, the proposed definition of "loan originator" would limit the flexibility and loan pricing and product options that small business entities can offer. The SBA urged the Board to give full consideration to the trade group's comments. As discussed in the **SUPPLEMENTARY INFORMATION** above, the Board has carefully considered these comments. The final rule is intended to uniformly address the harm that can result from unfair compensation practices, and the Board believes that providing exemptions for any set of loan originators would facilitate circumvention of the rule and undermine its objective. Furthermore, as discussed in the **SUPPLEMENTARY INFORMATION** above, the final rule still affords creditors the flexibility to structure loan pricing to preserve the potential consumer benefit of compensating an originator, or funding third-party closing costs, through the interest rate.

As the SBA notes, the Board requested comment in the supplementary information to the proposal on an alternative that would permit compensation based on loan amount. The Board is adopting this alternative in the final rule.

Other comments. In addition to the SBA's comment letter, a number of industry commenters expressed concerns that the rule, as proposed, would be costly to implement, would not provide enough flexibility, and would not adequately respond to the needs or nature of their business. Mortgage brokers argued that the Board should consider alternatives that would exempt small entities from the proposed rule or mitigate the application of the proposed rule on small entities. As discussed above, the Board concluded that these suggestions do not represent significant alternatives to the proposed rule because they would not meet the objectives of the rule. Many of the issues raised by commenters do not apply uniquely to small entities and are addressed above in other parts of the **SUPPLEMENTARY INFORMATION.**

C. Description of Small Entities to Which the Final Rule Will Apply

The final rule will apply to all institutions and entities that engage in originating or extending closed-end, home-secured credit. The Board is not aware of a reliable source for the total number of small entities likely to be affected by the final rule, and the credit provisions of TILA and Regulation Z have broad applicability to individuals and businesses that originate, extend and service even small numbers of home-secured credit. *See* § 226.1(c)(1).[43] All small entities that originate or extend closed-end loans secured by real property or a dwelling potentially could be subject to at least some aspects of the final rule.

The Board can, however, identify through data from Reports of Condition and Income (call reports) approximate numbers of small depository institutions that will be subject to the final rule. According to March 2010 Call Report data, approximately 8,848 small depository institutions will be subject to the rule. Approximately 15,899 depository institutions in the United States filed Call Report data, approximately 11,218 of which had total domestic assets of $175 million or less and thus were considered small entities for purposes of the RFA. Of the 3,898 banks, 523 thrifts, 6,727 credit unions, and 70 branches of foreign banks that filed Call Report data and were considered small entities, 3,776 banks, 496 thrifts, 4,573 credit unions, and 3 branches of foreign banks, totaling 8,848 institutions, extended mortgage credit. For purposes of this Call Report analysis, thrifts include savings banks, savings and loan entities, co-operative banks and industrial banks.

The Board cannot identify with certainty the number of small non-depository institutions that will be subject to the final rule. Home Mortgage Disclosure Act (HMDA) data indicate that 1,507 non-depository institutions (independent mortgage companies, subsidiaries of a depository institution, or affiliates of a bank holding company) filed HMDA reports in 2009 for 2008 lending activities. Based on the small volume of lending activity reported by these institutions, most are likely to be small.

[36] *Id.*

[37] *Id.* at 43319.

[38] 73 FR 1672, 1720; Jan. 9, 2008.

[39] Section 5(a) of the RFA permits an agency to perform the IRFA analysis (among others) in conjunction with or as part of any other analysis required by any other law if such other analysis satisfies the provisions of the RFA. 5 U.S.C. 605(a). Other alternatives were discussed throughout the supplementary information to the Board's proposal.

[40] 74 FR 43232, 43320; Aug. 26, 2009.

[41] 73 FR 1672; Jan. 9, 2008.

[42] 73 FR 44522; July 30, 2008.

[43] Regulation Z generally applies to "each individual or business that offers or extends credit when four conditions are met: (i) The credit is offered or extended to consumers; (ii) the offering or extension of credit is done regularly; (iii) the credit is subject to a finance charge or is payable by a written agreement in more than four installments, and (iv) the credit is primarily for personal, family, or household purposes." § 226.1(c)(1).

The final rule will apply to mortgage brokers. Loan originators other than mortgage brokers that will be affected by the final rule are employees of creditors (or of brokers) and, as such, are not business entities in their own right. In its 2008 proposed rule under HOEPA, 73 FR 1672, 1720; Jan. 9, 2008, the Board noted that, according to the National Association of Mortgage Brokers (NAMB), there were 53,000 mortgage brokerage companies in 2004 that employed an estimated 418,700 people.[44] The Board estimated that most of these companies are small entities. On the other hand, the U.S. Census Bureau's 2002 Economic Census indicates that there were only 17,041 "mortgage and nonmortgage loan brokers" in the United States at that time.[45]

D. Reporting, Recordkeeping, and Other Compliance Requirements

The compliance requirements of the final rule are described in the SUPPLEMENTARY INFORMATION. Some small entities will be required, among other things, to alter certain business practices, develop new business models, re-train staff, and reprogram operational systems to ensure compliance with the final rule. In addition, Regulation Z currently requires creditors to retain evidence of compliance with Regulation Z for two years. As described in the SUPPLEMENTARY INFORMATION, the final rule clarifies the types of records that creditors must retain to demonstrate compliance with the rule. The effect of the final rule on small entities is unknown. The final rule could affect how loan originators are compensated and will impose certain related recordkeeping requirements on creditors. The precise costs that the final rule will impose on mortgage creditors and loan originators are difficult to ascertain. As discussed above, the Board has requested information about the impact of the rule on small entities but has not received additional sources of information about the number of small entities affected or the costs to small entities. Nevertheless, the Board believes that these costs will have a significant economic effect on small entities, including small mortgage creditors and brokers.

[44] *http://www.namb.org/namb/Industry_Facts.asp?SnID=719224934.* This page of the NAMB Web site, however, no longer provides an estimate of the number of mortgage brokerage companies.

[45] *http://www.census.gov/prod/ec02/ec0252a1us.pdf* (NAICS code 522310).

E. Steps Taken To Minimize the Economic Impact on Small Entities

The steps the Board has taken to minimize the economic impact and compliance burden on small entities, including the factual, policy, and legal reasons for selecting the alternatives adopted and why each one of the other significant alternatives was not accepted, are described above in the SUPPLEMENTARY INFORMATION and in the summary of issues raised by the public comments in response to the proposal's IRFA. For example, the Board has adopted an alternative that permits loan originator compensation to be based on loan amount. The SBA and small entity commenters stated that this alternative would be less burdensome and would provide more flexibility to small entity loan originators. In addition, the final rule does not apply to open-end credit or timeshare plans, and the final rule does not extend the record retention requirement to persons other than the creditor who pays loan originator compensation. The Board believes that these provisions minimize the significant economic impact on small entities while still meeting the stated objectives of HOEPA and TILA.

List of Subjects in 12 CFR Part 226

Advertising, Consumer protection, Federal Reserve System, Mortgages, Reporting and recordkeeping requirements, Truth in lending.

Authority and Issuance

■ For the reasons set forth in the preamble, the Board amends Regulation Z, 12 CFR part 226, as set forth below:

PART 226—TRUTH IN LENDING (REGULATION Z)

■ 1. The authority citation for part 226 continues to read as follows:

Authority: 12 U.S.C. 3806; 15 U.S.C. 1604, 1637(c)(5), and 1639(l); Pub L. 111–24 § 2, 123 Stat. 1734.

Subpart A—General

■ 2. Section 226.1 is amended by revising paragraphs (b) and (d)(5) to read as follows:

§ 226.1 Authority, purpose, coverage, organization, enforcement, and liability.

* * * * *

(b) *Purpose.* The purpose of this regulation is to promote the informed use of consumer credit by requiring disclosures about its terms and cost. The regulation also includes substantive protections. It gives consumers the right to cancel certain credit transactions that involve a lien on a consumer's principal dwelling, regulates certain credit card practices, and provides a means for fair and timely resolution of credit billing disputes. The regulation does not generally govern charges for consumer credit, except that several provisions in Subpart G set forth special rules addressing certain charges applicable to credit card accounts under an open-end (not home-secured) consumer credit plan. The regulation requires a maximum interest rate to be stated in variable-rate contracts secured by the consumer's dwelling. It also imposes limitations on home-equity plans that are subject to the requirements of § 226.5b and mortgages that are subject to the requirements of § 226.32. The regulation prohibits certain acts or practices in connection with credit secured by a dwelling in § 226.36, and credit secured by a consumer's principal dwelling in § 226.35. The regulation also regulates certain practices of creditors who extend private education loans as defined in § 226.46(b)(5).

* * * * *

(d) * * *

(5) Subpart E contains special rules for mortgage transactions. Section 226.32 requires certain disclosures and provides limitations for closed-end loans that have rates or fees above specified amounts. Section 226.33 requires special disclosures, including the total annual loan cost rate, for reverse mortgage transactions. Section 226.34 prohibits specific acts and practices in connection with closed-end mortgage transactions that are subject to § 226.32. Section 226.35 prohibits specific acts and practices in connection with closed-end higher-priced mortgage loans, as defined in § 226.35(a). Section 226.36 prohibits specific acts and practices in connection with an extension of credit secured by a dwelling.

* * * * *

Subpart E—Special Rules for Certain Home Mortgage Transactions

■ 3. Section 226.36 is amended by:
■ A. Revising the section heading;
■ B. Revising paragraph (a);
■ C. Redesignating paragraph (d) as paragraph (f) and revising it; and
■ D. Adding new paragraphs (d) and (e).

The additions and revisions read as follows:

§ 226.36 Prohibited acts or practices in connection with credit secured by a dwelling.

(a) *Loan originator and mortgage broker defined.* (1) *Loan originator.* For purposes of this section, the term "loan originator" means with respect to a

particular transaction, a person who for compensation or other monetary gain, or in expectation of compensation or other monetary gain, arranges, negotiates, or otherwise obtains an extension of consumer credit for another person. The term "loan originator" includes an employee of the creditor if the employee meets this definition. The term "loan originator" includes the creditor only if the creditor does not provide the funds for the transaction at consummation out of the creditor's own resources, including drawing on a *bona fide* warehouse line of credit, or out of deposits held by the creditor.

(2) *Mortgage broker.* For purposes of this section, a mortgage broker with respect to a particular transaction is any loan originator that is not an employee of the creditor.

* * * * *

(d) *Prohibited payments to loan originators.* (1) *Payments based on transaction terms or conditions.* (i) In connection with a consumer credit transaction secured by a dwelling, no loan originator shall receive and no person shall pay to a loan originator, directly or indirectly, compensation in an amount that is based on any of the transaction's terms or conditions.

(ii) For purposes of this paragraph (d)(1), the amount of credit extended is not deemed to be a transaction term or condition, provided compensation received by or paid to a loan originator, directly or indirectly, is based on a fixed percentage of the amount of credit extended; however, such compensation may be subject to a minimum or maximum dollar amount.

(iii) This paragraph (d)(1) shall not apply to any transaction in which paragraph (d)(2) of this section applies.

(2) *Payments by persons other than consumer.* If any loan originator receives compensation directly from a consumer in a consumer credit transaction secured by a dwelling:

(i) No loan originator shall receive compensation, directly or indirectly, from any person other than the consumer in connection with the transaction; and

(ii) No person who knows or has reason to know of the consumer-paid compensation to the loan originator (other than the consumer) shall pay any compensation to a loan originator, directly or indirectly, in connection with the transaction.

(3) *Affiliates.* For purposes of this paragraph (d), affiliates shall be treated as a single "person."

(e) *Prohibition on steering.* (1) *General.* In connection with a consumer credit transaction secured by a dwelling, a loan originator shall not direct or "steer" a consumer to consummate a transaction based on the fact that the originator will receive greater compensation from the creditor in that transaction than in other transactions the originator offered or could have offered to the consumer, unless the consummated transaction is in the consumer's interest.

(2) *Permissible transactions.* A transaction does not violate paragraph (e)(1) of this section if the consumer is presented with loan options that meet the conditions in paragraph (e)(3) of this section for each type of transaction in which the consumer expressed an interest. For purposes of paragraph (e) of this section, the term "type of transaction" refers to whether:

(i) A loan has an annual percentage rate that cannot increase after consummation;

(ii) A loan has an annual percentage rate that may increase after consummation; or

(iii) A loan is a reverse mortgage.

(3) *Loan options presented.* A transaction satisfies paragraph (e)(2) of this section only if the loan originator presents the loan options required by that paragraph and all of the following conditions are met:

(i) The loan originator must obtain loan options from a significant number of the creditors with which the originator regularly does business and, for each type of transaction in which the consumer expressed an interest, must present the consumer with loan options that include:

(A) The loan with the lowest interest rate;

(B) The loan with the lowest interest rate without negative amortization, a prepayment penalty, interest-only payments, a balloon payment in the first 7 years of the life of the loan, a demand feature, shared equity, or shared appreciation; or, in the case of a reverse mortgage, a loan without a prepayment penalty, or shared equity or shared appreciation; and

(C) The loan with the lowest total dollar amount for origination points or fees and discount points.

(ii) The loan originator must have a good faith belief that the options presented to the consumer pursuant to paragraph (e)(3)(i) of this section are loans for which the consumer likely qualifies.

(iii) For each type of transaction, if the originator presents to the consumer more than three loans, the originator must highlight the loans that satisfy the criteria specified in paragraph (e)(3)(i) of this section.

(4) *Number of loan options presented.* The loan originator can present fewer than three loans and satisfy paragraphs (e)(2) and (e)(3)(i) of this section if the loan(s) presented to the consumer satisfy the criteria of the options in paragraph (e)(3)(i) of this section and the provisions of paragraph (e)(3) of this section are otherwise met.

(f) This section does not apply to a home-equity line of credit subject to § 226.5b. Section 226.36(d) and (e) do not apply to a loan that is secured by a consumer's interest in a timeshare plan described in 11 U.S.C. 101(53D).

■ 4. In Supplement I to Part 226:

■ A. Under *Section 226.25—Record Retention, 25(a) General rule,* new paragraph 5 is added.

■ B. Under *Section 226.36—Prohibited Acts or Practices in Connection With Credit Secured by a Dwelling* ,

■ 1. Revise the heading;

■ 2. Redesignate paragraph 1 as paragraph 3;

■ 3. Add paragraphs 1 and 2;

■ 4. Under *36(a) Mortgage broker defined,* revise the heading, revise paragraph 1, and add paragraphs 2, 3, and 4; and

■ 5. Add entries for *36(d) Prohibited payments to loan originators* and *36(e) Prohibition on steering.*

The additions and revisions read as follows:

Supplement I To Part 226—Official Staff Interpretations

* * * * *

Subpart D—Miscellaneous

* * * * *

Section 226.25—Record Retention

25(a) General rule.

* * * * *

5. *Prohibited payments to loan originators.* For each transaction subject to the loan originator compensation provisions in § 226.36(d)(1), a creditor should maintain records of the compensation it provided to the loan originator for the transaction as well as the compensation agreement in effect on the date the interest rate was set for the transaction. See § 226.35(a) and comment 35(a)(2)(iii)–3 for additional guidance on when a transaction's rate is set. For example, where a loan originator is a mortgage broker, a disclosure of compensation or other broker agreement required by applicable state law that complies with § 226.25 would be presumed to be a record of the amount actually paid to the loan originator in connection with the transaction.

* * * * *

Subpart E—Special Rules for Certain Home Mortgage Transactions

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Section 226.36—Prohibited Acts or Practices in Connection with Credit Secured by a Dwelling

1. *Scope of coverage.* Sections 226.36(b) and (c) apply to closed-end consumer credit transactions secured by a consumer's principal dwelling. Sections 226.36(d) and (e) apply to closed-end consumer credit transactions secured by a dwelling. Sections 226.36(d) and (e) apply to closed-end loans secured by first or subordinate liens, and reverse mortgages that are not home-equity lines of credit under § 226.5b. *See* § 226.36(f) for additional restrictions on the scope of this section, and §§ 226.1(c) and 226.3(a) and corresponding commentary for further discussion of extensions of credit subject to Regulation Z.

2. *Mandatory compliance date for §§ 226.36(d) and (e).* The final rules on loan originator compensation in § 226.36 apply to transactions for which the creditor receives an application on or after April 1, 2011. For example, assume a mortgage broker takes an application on March 10, 2011, which the creditor receives on March 25, 2011. This transaction is not covered. If, however, the creditor does not receive the application until April 5, 2011, the transaction is covered.

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36(a) Loan originator and mortgage broker defined.

1. *Meaning of loan originator.* i. *General.* Section 226.36(a) provides that a loan originator is any person who for compensation or other monetary gain arranges, negotiates, or otherwise obtains an extension of consumer credit for another person. Thus, the term "loan originator" includes employees of a creditor as well as employees of a mortgage broker that satisfy this definition. In addition, the definition of loan originator expressly includes any creditor that satisfies the definition of loan originator but makes use of "table funding" by a third party. *See* comment 36(a)–1.ii below discussing table funding. Although consumers may sometimes arrange, negotiate, or otherwise obtain extensions of consumer credit on their own behalf, in such cases they do not do so for another person or for compensation or other monetary gain, and therefore are not loan originators under this section. (Under § 226.2(a)(22), the term "person" means a natural person or an organization.)

ii. *Table funding.* Table funding occurs when the creditor does not provide the funds for the transaction at consummation out of the creditor's own resources, including drawing on a *bona fide* warehouse line of credit, or out of deposits held by the creditor. Accordingly, a table-funded transaction is consummated with the debt obligation initially payable by its terms to one person, but another person provides the funds for the transaction at consummation and receives an immediate assignment of the note, loan contract, or other evidence of the debt obligation. Although § 226.2(a)(17)(i)(B) provides that a person to whom a debt obligation is initially payable on its face generally is a creditor, § 226.36(a)(1) provides that, solely for the purposes of § 226.36, such a person is also considered a loan originator. The creditor is not considered a loan originator unless table funding occurs. For example, if a person closes a loan in its own name but does not fund the loan from its own resources or deposits held by it because it assigns the loan at consummation, it is considered a creditor for purposes of Regulation Z and also a loan originator for purposes of § 226.36. However, if a person closes a loan in its own name and draws on a *bona fide* warehouse line of credit to make the loan at consummation, it is considered a creditor, not a loan originator, for purposes of Regulation Z, including § 226.36.

iii. *Servicing.* The definition of "loan originator" does not apply to a loan servicer when the servicer modifies an existing loan on behalf of the current owner of the loan. The rule only applies to extensions of consumer credit and does not apply if a modification of an existing obligation's terms does not constitute a refinancing under § 226.20(a).

2. *Meaning of mortgage broker.* For purposes of § 226.36, with respect to a particular transaction, the term "mortgage broker" refers to a loan originator who is not an employee of the creditor. Accordingly, the term "mortgage broker" includes companies that engage in the activities described in § 226.36(a) and also includes employees of such companies that engage in these activities. Section 226.36(d) prohibits certain payments to a loan originator. These prohibitions apply to payments made to all loan originators, including payments made to mortgage brokers, and payments made by a company acting as a mortgage broker to its employees who are loan originators.

3. *Meaning of creditor.* For purposes of § 226.36(d) and (e), a creditor means a creditor that is not deemed to be a loan originator on the transaction under this section. Thus, a person that closes a loan in its own name (but another person provides the funds for the transaction at consummation and receives an immediate assignment of the note, loan contract, or other evidence of the debt obligation) is deemed a loan originator, not a creditor, for purposes of § 226.36. However, that person is still a creditor for all other purposes of Regulation Z.

4. *Managers and administrative staff.* For purposes of § 226.36, managers, administrative staff, and similar individuals who are employed by a creditor or loan originator but do not arrange, negotiate, or otherwise obtain an extension of credit for a consumer, and whose compensation is not based on whether any particular loan is originated, are not loan originators.

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36(d) Prohibited payments to loan originators.

1. *Persons covered.* Section 226.36(d) prohibits any person (including the creditor) from paying compensation to a loan originator in connection with a covered credit transaction, if the amount of the payment is based on any of the transaction's terms or conditions. For example, a person that purchases a loan from the creditor may not compensate the loan originator in a manner that violates § 226.36(d).

2. *Mortgage brokers.* The payments made by a company acting as a mortgage broker to its employees who are loan originators are subject to the section's prohibitions. For example, a mortgage broker may not pay its employee more for a transaction with a 7 percent interest rate than for a transaction with a 6 percent interest rate.

36(d)(1) Payments based on transaction terms and conditions.

1. *Compensation.* i. *General.* For purposes of § 226.36(d) and (e), the term "compensation" includes salaries, commissions, and any financial or similar incentive provided to a loan originator that is based on any of the terms or conditions of the loan originator's transactions. See comment 36(d)(1)–3 for examples of types of compensation that are not covered by § 226.36(d) and (e). For example, the term "compensation" includes:

A. An annual or other periodic bonus; or

B. Awards of merchandise, services, trips, or similar prizes.

ii. *Name of fee.* Compensation includes amounts the loan originator retains and is not dependent on the label or name of any fee imposed in connection with the transaction. For example, if a loan originator imposes a "processing fee" in connection with the transaction and retains such fee, it is deemed compensation for purposes of § 226.36(d) and (e), whether the originator expends the time to process the consumer's application or uses the fee for other expenses, such as overhead.

iii. *Amounts for third-party charges.* Compensation includes amounts the loan originator retains, but does not include amounts the originator receives as payment for *bona fide* and reasonable third-party charges, such as title insurance or appraisals. In some cases, amounts received for payment for third-party charges may exceed the actual charge because, for example, the originator cannot determine with accuracy what the actual charge will be before consummation. In such a case, the difference retained by the originator is not deemed compensation if the third-party charge imposed on the consumer was *bona fide* and reasonable, and also complies with state and other applicable law. On the other hand, if the originator marks up a third-party charge (a practice known as "upcharging"), and the originator retains the difference between the actual charge and the marked-up charge, the amount retained is compensation for purposes of § 226.36(d) and (e). For example:

A. Assume a loan originator charges the consumer a $400 application fee that includes $50 for a credit report and $350 for an appraisal. Assume that $50 is the amount the creditor pays for the credit report. At the time the loan originator imposes the application fee on the consumer, the loan originator is uncertain of the cost of the appraisal because the originator may choose from appraisers that charge between $300 to $350 for appraisals. Later, the cost for the appraisal is determined to be $300 for this consumer's transaction. In this case, the $50 difference between the $400 application fee imposed on the consumer and the actual $350 cost for the credit report and appraisal is not deemed compensation for purposes of § 226.36(d) and (e), even though the $50 is retained by the loan originator.

B. Using the same example in comment 36(d)(1)–1.iii.A above, the $50 difference would be compensation for purposes of § 226.36(d) and (e) if the appraisers from whom the originator chooses charge fees between $250 and $300.

2. *Examples of compensation that is based on transaction terms or conditions.* Section 226.36(d)(1) prohibits loan originator compensation that is based on the terms or conditions of the loan originator's transactions. For example, the rule prohibits compensation to a loan originator for a transaction based on that transaction's interest rate, annual percentage rate, loan-to-value ratio, or the existence of a prepayment penalty. The rule also prohibits compensation based on a factor that is a proxy for a transaction's terms or conditions. For example, a consumer's credit score or similar representation of credit risk, such as the consumer's debt-to-income ratio, is not one of the transaction's terms or conditions. However, if a loan originator's compensation varies in whole or in part with a factor that serves as a proxy for loan terms or conditions, then the originator's compensation is based on a transaction's terms or conditions. To illustrate, assume that consumer A and consumer B receive loans from the same loan originator and the same creditor. Consumer A has a credit score of 650, and consumer B has a credit score of 800. Consumer A's loan has a 7 percent interest rate, and consumer B's loan has a 6½ percent interest rate because of the consumers' different credit scores. If the creditor pays the loan originator $1,500 in compensation for consumer A's loan and $1,000 in compensation for consumer B's loan because the creditor varies compensation payments in whole or in part with a consumer's credit score, the originator's compensation would be based on the transactions' terms or conditions.

3. *Examples of compensation not based on transaction terms or conditions.* The following are only illustrative examples of compensation methods that are permissible (unless otherwise prohibited by applicable law), and not an exhaustive list. Compensation is not based on the transaction's terms or conditions if it is based on, for example:

i. The loan originator's overall loan volume (*i.e.,* total dollar amount of credit extended or total number of loans originated), delivered to the creditor.

ii. The long-term performance of the originator's loans.

iii. An hourly rate of pay to compensate the originator for the actual number of hours worked.

iv. Whether the consumer is an existing customer of the creditor or a new customer.

v. A payment that is fixed in advance for every loan the originator arranges for the creditor (*e.g.,* $600 for every loan arranged for the creditor, or $1,000 for the first 1,000 loans arranged and $500 for each additional loan arranged).

vi. The percentage of applications submitted by the loan originator to the creditor that result in consummated transactions.

vii. The quality of the loan originator's loan files (*e.g.,* accuracy and completeness of the loan documentation) submitted to the creditor.

viii. A legitimate business expense, such as fixed overhead costs.

ix. Compensation that is based on the amount of credit extended, as permitted by § 226.36(d)(1)(ii). *See* comment 36(d)(1)–9 discussing compensation based on the amount of credit extended.

4. *Creditor's flexibility in setting loan terms.* Section 226.36(d)(1) does not limit a creditor's ability to offer a higher interest rate in a transaction as a means for the consumer to finance the payment of the loan originator's compensation or other costs that the consumer would otherwise be required to pay directly (either in cash or out of the loan proceeds). Thus, a creditor may charge a higher interest rate to a consumer who will pay fewer of the costs of the transaction directly, or it may offer the consumer a lower rate if the consumer pays more of the costs directly. For example, if the consumer pays half of the transaction costs directly, a creditor may charge an interest rate of 6 percent but, if the consumer pays none of the transaction costs directly, the creditor may charge an interest rate of 6.5 percent. Section 226.36(d)(1) also does not limit a creditor from offering or providing different loan terms to the consumer based on the creditor's assessment of the credit and other transactional risks involved. A creditor could also offer different consumers varying interest rates that include a constant interest rate premium to recoup the loan originator's compensation through increased interest paid by the consumer (such as by adding a constant 0.25 percent to the interest rate on each loan).

5. *Effect of modification of loan terms.* Under § 226.36(d)(1), a loan originator's compensation may not vary based on any of a credit transaction's terms or conditions. Thus, a creditor and originator may not agree to set the originator's compensation at a certain level and then subsequently lower it in selective cases (such as where the consumer is able to obtain a lower rate from another creditor). When the creditor offers to extend a loan with specified terms and conditions (such as the rate and points), the amount of the originator's compensation for that transaction is not subject to change (increase or decrease) based on whether different loan terms are negotiated. For example, if the creditor agrees to lower the rate that was initially offered, the new offer may not be accompanied by a reduction in the loan originator's compensation.

6. *Periodic changes in loan originator compensation and transactions' terms and conditions.* This section does not limit a creditor or other person from periodically revising the compensation it agrees to pay a loan originator. However, the revised compensation arrangement must result in payments to the loan originator that do not vary based on the terms or conditions of a credit transaction. A creditor or other person might periodically review factors such as loan performance, transaction volume, as well as current market conditions for originator compensation, and prospectively revise the compensation it agrees to pay to a loan originator. For example, assume that during the first 6 months of the year, a creditor pays $3,000 to a particular loan originator for each loan delivered, regardless of the loan terms or conditions. After considering the volume of business produced by that originator, the creditor could decide that as of July 1, it will pay $3,250 for each loan delivered by that particular originator, regardless of the loan terms or conditions. No violation occurs even if the loans made by the creditor after July 1 generally carry a higher interest rate than loans made before that date, to reflect the higher compensation.

7. *Compensation received directly from the consumer.* The prohibition in § 226.36(d)(1) does not apply to transactions in which any loan originator receives compensation directly from the consumer, in which case no other person may provide any compensation to a loan originator, directly or indirectly, in connection with that particular transaction pursuant to § 226.36(d)(2). Payments to a loan originator made out of loan proceeds are considered compensation received directly from the consumer, while payments derived from an increased interest rate are not considered compensation received directly from the consumer. However, points paid on the loan by the consumer to the creditor are not considered payments received directly from the consumer whether they are paid in cash or out of the loan proceeds. That is, if the consumer pays origination points to the creditor and the creditor compensates the loan originator, the loan originator may not also receive compensation directly from the consumer. Compensation includes amounts retained by the loan originator, but does not include amounts the loan originator receives as payment for *bona fide* and reasonable third-party charges, such as title insurance or appraisals. *See* comment 36(d)(1)–1.

8. *Record retention.* See comment 25(a)–5 for guidance on complying with the record retention requirements of § 226.25(a) as they apply to § 226.36(d)(1).

9. *Amount of credit extended.* A loan originator's compensation may be based on the amount of credit extended, subject to certain conditions. Section 226.36(d)(1) does not prohibit an arrangement under which a loan originator is paid compensation based on a percentage of the amount of credit extended, provided the percentage is fixed and does not vary with the amount of credit extended. However, compensation that is based on a fixed percentage of the amount of credit extended may be subject to a minimum and/or maximum dollar amount, as long as the minimum and maximum dollar amounts do not vary with each credit transaction. For example:

i. A creditor may offer a loan originator 1 percent of the amount of credit extended for all loans the originator arranges for the creditor, but not less than $1,000 or greater than $5,000 for each loan.

ii. A creditor may *not* offer a loan originator 1 percent of the amount of credit extended for loans of $300,000 or more, 2 percent of the amount of credit extended for loans between $200,000 and $300,000, and 3 percent of the amount of credit extended for loans of $200,000 or less.

36(d)(2) Payments by persons other than consumer.

1. *Compensation in connection with a particular transaction.* Under § 226.36(d)(2), if any loan originator receives compensation directly from a consumer in a transaction, no other person may provide any compensation to a loan originator, directly or indirectly, in connection with that particular credit transaction. *See* comment 36(d)(1)–7 discussing compensation received directly from the consumer. The restrictions imposed under § 226.36(d)(2) relate only to payments, such as commissions, that are specific to, and paid solely in connection with, the transaction in which the consumer has paid compensation directly to a loan originator. Thus, payments by a mortgage broker company to an employee in the form of a salary or hourly wage, which is not tied to a specific transaction, do not violate § 226.36(d)(2) even if the consumer directly pays a loan originator a fee in connection with a specific credit transaction. However, if any loan originator receives compensation directly from the consumer in connection with a specific credit transaction, neither the mortgage broker company nor an employee of the mortgage broker company can receive compensation from the creditor in connection with that particular credit transaction.

2. *Compensation received directly from a consumer.* Under Regulation X, which implements the Real Estate Settlement Procedures Act (RESPA), a yield spread premium paid by a creditor to the loan originator may be characterized on the RESPA disclosures as a "credit" that will be applied to reduce the consumer's settlement charges, including origination fees. A yield spread premium disclosed in this manner is not considered to be received by the loan originator directly from the consumer for purposes of § 226.36(d)(2).

36(d)(3) Affiliates.

1. For purposes of § 226.36(d), affiliates are treated as a single "person." The term "affiliate" is defined in § 226.32(b)(2). For example, assume a parent company has two mortgage lending subsidiaries. Under § 226.36(d)(1), subsidiary "A" could not pay a loan originator greater compensation for a loan with an interest rate of 8 percent than it would pay for a loan with an interest rate of 7 percent. If the loan originator may deliver loans to both subsidiaries, they must compensate the loan originator in the same manner. Accordingly, if the loan originator delivers the loan to subsidiary "B" and the interest rate is 8 percent, the originator must receive the same compensation that would have been paid by subsidiary A for a loan with a rate of either 7 or 8 percent.

36(e) Prohibition on steering.

1. *Compensation.* See comment 36(d)(1)–1 for guidance on compensation that is subject to § 226.36(e).

Paragraph 36(e)(1).

1. *Steering.* For purposes of § 226.36(e), directing or "steering" a consumer to consummate a particular credit transaction means advising, counseling, or otherwise influencing a consumer to accept that transaction. For such actions to constitute steering, the consumer must actually consummate the transaction in question. Thus, § 226.36(e)(1) does not address the actions of a loan originator if the consumer does not actually obtain a loan through that loan originator.

2. *Prohibited conduct.* Under § 226.36(e)(1), a loan originator may not direct or steer a consumer to consummate a transaction based on the fact that the loan originator would increase the amount of compensation that the loan originator would receive for that transaction compared to other transactions, unless the consummated transaction is in the consumer's interest.

i. In determining whether a consummated transaction is in the consumer's interest, that transaction must be compared to other possible loan offers available through the originator, if any, and for which the consumer was likely to qualify, at the time that transaction was offered to the consumer. Possible loan offers are available through the loan originator if they could be obtained from a creditor with which the loan originator regularly does business. Section 226.36(e)(1) does not require a loan originator to establish a business relationship with any creditor with which the loan originator does not already do business. To be considered a possible loan offer available through the loan originator, an offer need not be extended by the creditor; it need only be an offer that the creditor likely would extend upon receiving an application from the applicant, based on the creditor's current credit standards and its current rate sheets or other similar means of communicating its current credit terms to the loan originator. An originator need not inform the consumer about a potential transaction if the originator makes a good faith determination that the consumer is not likely to qualify for it.

ii. Section 226.36(e)(1) does not require a loan originator to direct a consumer to the transaction that will result in a creditor paying the least amount of compensation to the originator. However, if the loan originator reviews possible loan offers available from a significant number of the creditors with which the originator regularly does business, and the originator directs the consumer to the transaction that will result in the least amount of creditor-paid compensation for the loan originator, the requirements of § 226.36(e)(1) are deemed to be satisfied. In the case where a loan originator directs the consumer to the transaction that will result in a greater amount of creditor-paid compensation for the loan originator, § 226.36(e)(1) is not violated if the terms and conditions on that transaction compared to the other possible loan offers available through the originator, and for which the consumer likely qualifies, are the same. A loan originator who is an employee of the creditor on a transaction may not obtain compensation that is based on the transaction's terms or conditions pursuant to § 226.36(d)(1), and compliance with that provision by such a loan originator also satisfies the requirements of § 226.36(e)(1) for that transaction with the creditor. However, if a creditor's employee acts as a broker by forwarding a consumer's application to a creditor *other than* the loan originator's employer, such as when the employer does not offer any loan products for which the consumer would qualify, the loan originator is not an employee of the creditor in that transaction and is subject to § 226.36(e)(1) if the originator is compensated for arranging the loan with the other creditor.

iii. See the commentary under § 226.36(e)(3) for additional guidance on what constitutes a "significant number of creditors with which a loan originator regularly does business" and guidance on the determination about transactions for which "the consumer likely qualifies."

3. *Examples.* Assume a loan originator determines that a consumer likely qualifies for a loan from Creditor A that has a fixed interest rate of 7 percent, but the loan originator directs the consumer to a loan from Creditor B having a rate of 7.5 percent. If the loan originator receives more in compensation from Creditor B than the amount that would have been paid by Creditor A, the prohibition in § 226.36(e) is violated unless the higher-rate loan is in the consumer's interest. For example, a higher-rate loan might be in the consumer's interest if the lower-rate loan has a prepayment penalty, or if the lower-rate loan requires the consumer to pay more in up-front charges that the consumer is unable or unwilling to pay or finance as part of the loan amount.

36(e)(2) Permissible transactions.

1. *Safe harbors.* A loan originator that satisfies § 226.36(e)(2) is deemed to comply with § 226.36(e)(1). A loan originator that does not satisfy § 226.36(e)(2) is not subject to any presumption regarding the originator's compliance or noncompliance with § 226.36(e)(1).

2. *Minimum number of loan options.* To obtain the safe harbor, § 226.36(e)(2) requires that the loan originator present loan options that meet the criteria in § 226.36(e)(3)(i) for each type of transaction in which the consumer expressed an interest. As required by § 226.36(e)(3)(ii), the loan originator must have a good faith belief that the options presented are loans for which the consumer likely qualifies. If the loan originator is not able to form such a good faith belief for loan options that meet the criteria in § 226.36(e)(3)(i) for a given type of transaction, the loan originator may satisfy § 226.36(e)(2) by presenting all loans for which the consumer likely qualifies and that meet the other requirements in § 226.36(e)(3) for that given type of transaction. A loan originator may present to the consumer any number of loan options, but presenting a consumer more than four loan options for each type of transaction in which the consumer expressed an interest and for which the consumer likely qualifies would not likely help the consumer make a meaningful choice.

36(e)(3) Loan options presented.

1. *Significant number of creditors.* A significant number of the creditors with which a loan originator regularly does business is three or more of those creditors. If the loan originator regularly does business with fewer than three creditors, the originator is deemed to comply by obtaining loan options from all the creditors with which it regularly does business. Under § 226.36(e)(3)(i), the loan originator must obtain loan options from a significant number of creditors with which the loan

originator regularly does business, but the loan originator need not present loan options from all such creditors to the consumer. For example, if three loans available from one of the creditors with which the loan originator regularly does business satisfy the criteria in § 226.36(e)(3)(i), presenting those and no options from any other creditor satisfies that section.

2. *Creditors with which loan originator regularly does business.* To qualify for the safe harbor in § 226.36(e)(2), the loan originator must obtain and review loan options from a significant number of the creditors with which the loan originator regularly does business. For this purpose, a loan originator regularly does business with a creditor if:

i. There is a written agreement between the originator and the creditor governing the originator's submission of mortgage loan applications to the creditor;

ii. The creditor has extended credit secured by a dwelling to one or more consumers during the current or previous calendar month based on an application submitted by the loan originator; or

iii. The creditor has extended credit secured by a dwelling twenty-five or more times during the previous twelve calendar months based on applications submitted by the loan originator. For this purpose, the previous twelve calendar months begin with the calendar month that precedes the month in which the loan originator accepted the consumer's application.

3. *Lowest interest rate.* To qualify under the safe harbor in § 226.36(e)(2), for each type of transaction in which the consumer has expressed an interest, the loan originator must present the consumer with loan options that meet the criteria in § 226.36(e)(3)(i). The criteria are: The loan with the lowest interest rate; the loan with the lowest total dollar amount for discount points and origination points or fees; and a loan with the lowest interest rate without negative amortization, a prepayment penalty, a balloon payment in the first seven years of the loan term, shared equity, or shared appreciation, or, in the case of a reverse mortgage, a loan without a prepayment penalty, shared equity, or shared appreciation. To identify the loan with the lowest interest rate, for any loan that has an initial rate that is fixed for at least five years, the loan originator shall use the initial rate that would be in effect at consummation. For a loan with an initial rate that is not fixed for at least five years:

i. If the interest rate varies based on changes to an index, the originator shall use the fully-indexed rate that would be in effect at consummation without regard to any initial discount or premium.

ii. For a step-rate loan, the originator shall use the highest rate that would apply during the first five years.

4. *Transactions for which the consumer likely qualifies.* To qualify under the safe harbor in § 226.36(e)(2), the loan originator must have a good faith belief that the loan options presented to the consumer pursuant to § 226.36(e)(3) are transactions for which the consumer likely qualifies. The loan originator's belief that the consumer likely qualifies should be based on information reasonably available to the loan originator at the time the loan options are presented. In making this determination, the loan originator may rely on information provided by the consumer, even if it subsequently is determined to be inaccurate. For purposes of § 226.36(e)(3), a loan originator is not expected to know all aspects of each creditor's underwriting criteria. But pricing or other information that is routinely communicated by creditors to loan originators is considered to be reasonably available to the loan originator, for example, rate sheets showing creditors' current pricing and the required minimum credit score or other eligibility criteria.

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By order of the Board of Governors of the Federal Reserve System, September 1, 2010.

Jennifer J. Johnson,

Secretary of the Board.

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