Community Mortgage Banking Project

December 23, 2009

Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, DC 20551

Dear Ms. Johnson:

The Community Mortgage Banking Project (CMPB) is pleased to offer our comments on the Regulation Z (Truth in Lending) proposed regulations and specifically the regulations pertaining to loan officer and mortgage broker compensation proposed under the Federal Reserve Board's (FRB) HOEPA authority. The CMBP is an organization of independent mortgage banking companies that provide stable, affordable residential mortgage loans to consumers across the US. As an industry segment, independent mortgage banking companies originate approximately one-third of all residential mortgages in the US and about half of all FHA-insured mortgages.

Macro Economic Considerations

The sustainability of the economic recovery underway in the US today depends on the recovery of our housing market, particularly the stabilization, and eventual recovery, in home values. The stabilization and recovery in home values requires a continued strong flow of mortgage funds to finance purchase and sale activity by consumers. Community-based mortgage banking companies play a key role in this financing flow and we are very focused on any regulatory changes that may impact the availability and cost of mortgage credit to consumers.

As such, we are very concerned that the FRB's effort to address what it considers to be unfair and/or deceptive acts or practices caused by the way loan officers and brokers are compensated for their origination activities may produce market responses that will severely curtail consumer's choices of lenders and significantly increase the cost of mortgage credit to across the board. At the same time we believe, as we will detail in this letter, that those creditors and brokers who choose to, will find ways to circumvent the FRB regulation, to the disadvantage of those creditors and brokers who honor both the spirit and the letter of the regulation.

Asymmetrical Information

We understand that the FRB is attempting to address the issue of consumer interaction with loan officers and mortgage brokers, where the loan officers and mortgage brokers possess significantly superior information regarding loan pricing, terms and conditions compared to the average consumer. Further we understand that the FRB is concerned that currently a loan officer/mortgage broker's compensation varies according to the terms and conditions of the loan the consumer agrees to accept, and that loan officers/mortgage brokers may use their superior knowledge to persuade consumers to accept loan terms and conditions that are not necessarily in the best interest of the consumer, but will maximize the loan officer/mortgage broker's compensation from the loan transaction.

We also understand that it is the FRB's belief that while many consumers know and understand that they should shop for the best loan terms and conditions most consumers do not know/understand that this need to shop does not stop with the selection of a mortgage broker or mortgage banking company for their home financing. Further the FRB believes that many consumers do not know/understand that the loan terms and conditions, particularly the pricing of the loan, are negotiable and consequently most consumers do not negotiate. Therefore the outcome, in the FRB's view, is that in many instances consumers do not obtain the best terms and conditions, specifically the best pricing, that could be available on their loans, and that loan officers and brokers are able to enhance their compensation due to this lack of consumer knowledge/understanding.

In order to address this situation, the FRB proposes to prohibit a loan officer and mortgage broker's compensation from varying based on the "terms and conditions" of the loan. The FRB has offered two alternatives in the proposed rule – one where the principal balance of the mortgage is considered a term and condition and the second where the principal balance is not considered a term and condition of the loan. The latter alternative would permit a loan officer and broker's compensation to be set as a percentage of the principal balance of the loan.

The collective experience of our member companies is different from what we understand is the FRB's view on the extent of negotiations that take place between consumers and creditors over the rate and terms of residential mortgage loans. In our experience a significant proportion of consumers understand and exercise their option to negotiate the rate and terms of mortgage financing they are seeking. We see this in our retail lending operations every day. We believe this activity, and the ability of independent mortgage banking companies to interact with consumers to match or beat competitive terms in the market, will be adversely affected by the FRB's proposed rule as we detail in this letter.

Industry Business Models

A key point in assessing the impact of this proposed rule is a knowledge and understanding of the different business models employed by the two major creditor groups in the mortgage industry – large bank-owned creditors and community-based mortgage banking companies. (The phrase community-based mortgage banking companies is intended to encompass all those community-based mortgage creditors that employ the originate-to-sell business model in serving the home loan needs of consumers).

Both large bank-owned creditors and community-based mortgage banking companies have very similar total costs per loan produced. However there are key differences in the composition of the total costs per loan produced between bank-owned creditors and community-based mortgage banking companies.
Large bank-owned creditors devote a higher proportion of cost per loan to creating and maintaining their brand name through marketing campaigns that are centered on consumer advertising. They rely upon the brand name they create and maintain to attract consumers that are seeking many financial products including mortgages. Because the brand name plays such a large part in business development for large bank-owned creditors, they do not seek, and do not pay for, strong business development skills in their loan officers because their business model does not require those skills.

Community-based mortgage banking companies, on the other hand, with a virtually identical **total cost structure as large bank-owned creditors**, allocate their costs differently. To compete against the brand names of the large bank-owned creditors, these community-based companies hire loan officers with superior business development skills to seek out consumers who are in the market for a mortgage and persuade those consumers to obtain their financing from a community-based mortgage banking company. Individuals with these types of business development skills command higher levels of compensation in the marketplace. The loan officer compensation structures of community-based companies reflect the fact that these companies rely upon the business development skills of their loan officers to compete with the brand name recognition of the large bank-owned companies.

Thus costs of loan officer compensation are lower for the large bank-owned creditors, compared to community-based mortgage banking companies. In turn the fact that loan officer compensation is a smaller portion of total loan origination costs for the large bank owned companies means that there will be a disproportionate impact from the FRB proposal upon community-based mortgage banking companies than their large bank owned competitors. We will explain this impact more fully below.

Consumer and Market Impacts

In addition, while CMBP understands and appreciates the FRB's viewpoint and reasoning for the regulation we believe there will be additional, significant unintended consequences that will flow from this regulation that will reduce competitive lender choices for consumers, increase the cost of mortgage finance and disrupt the efficient functioning of the mortgage market, to the ultimate detriment of consumers. We believe these unintended consequences will occur as the mortgage market participants adjust their operations to comply with the FRB rule to maintain profitable operations or devise ways to circumvent the requirements of the rule. We will highlight these unintended market consequences in some detail, and then suggest an alternative that we believe will safeguard consumers' interests by focusing on the conflict of interest or "moral hazard" concerns about the marketplace, without creating the unintended consequences we detail below.

Unintended Consequences

There are nine unintended consequences that CMBP has identified that we believe would flow from the FRB's loan officer/broker compensation proposal that would negatively impact either consumers and/or the mortgage market. These unintended consequences would be as follows:

1. **Higher mortgage costs to consumers** – in terms of importance, this is the primary unintended consequence. We believe the FRB proposal will not only directly increase costs, but also indirectly, through the other unintended consequences listed below. By prohibiting creditors from varying the compensation of their loan officers according to the terms and conditions of the mortgages they originate, the creditor is forced into a position where a variable cost – the loan officer commission – is artificially forced to become a fixed cost.

   From a financial management standpoint the only way for the creditor to compensate for the shift of a cost from variable to fixed is to fix the revenue side of the equation, i.e. the amount earned at origination on the loans. This will result in increased costs to most consumers, since creditors will feel pressure to raise rates and fees to consumers across the board in order to compensate for the uncertainty caused by the inability to match variable revenues and costs at the loan level.

   However, market competition requires creditors to respond to consumers seeking lower rates from the quoted rate, as a result of market information (e.g., news that rates have declined) or competitors quotes (borrowers have been shopping with other lenders). Consumer negotiation is a reality of today's market place. Creditors currently compensate for such negotiations by reducing the loan officer's compensation equal or proportional to the reduction in loan pricing that the loan officer negotiates with the consumer. Since this compensation reduction option will no longer be available under the FRB proposal, creditors will be forced to recover the cost of discounting by raising loan prices across the board.

2. **Disadvantaging lower balance mortgages -** under the first alternative proposed by the FRB lower balance mortgages would be disadvantaged when compared to higher balance mortgages. If creditors are required to pay loan officers a fixed commission amount per loan, that amount will represent a larger percentage of the balance of a smaller loan than a larger loan. The creditor would seek to recapture that larger cost on a percentage basis, by a corresponding higher cost to the low balance loan consumer.

   For example look at a $50,000 loan under the fixed commission alternative proposed in the rule. A reasonable per loan commission under such a rule would be $1,500 per loan. A $1500 commission for a $50,000 loan would be 3% of the principal balance, clearly a significant commission amount in percentage terms, for a loan of that size. The response of creditors to this rule will be to increase fees and costs to consumers, many of whom have modest financial means, who are seeking low balance mortgages. We do not believe this is a result that the FRB intends to achieve with this proposed regulation.

3. **Creation of an unlevel playing field among mortgage competitors –** Large bank-owned creditors will be greatly advantaged under the FRB's compensation proposal versus mid-sized and small mortgage banking companies. The reason for this lies in the **composition** of the cost structure of large bank-owned creditors versus the composition of the cost structure of community-based mortgage banking companies, and the way the rule will severely hamper the ability of community-based mortgage banking companies to compete with the cost of capital advantage enjoyed by the large, bank-owned companies.

   Because loan officer compensation is a smaller portion of the cost structure of large bank-owned companies, as explained above, the compensation adjustments they will have to make to comply with the FRB rule will be smaller and have less of an impact on their operations. In turn the competitive advantages enjoyed by the large, bank-owned lenders will remain intact – a significantly lower cost of capital thanks to federal deposit insurance and name brand recognition to attract consumers as borrowers.

   By restricting the flexibility of creditors to tailor their compensation structures to serve the needs of consumers and achieve their business objectives, the community-based mortgage banking companies that depend upon the business development skills of their loan officers to counteract the name brand recognition of their large bank-owned competitors will be severely disadvantaged while the competitive advantages of the bank-owned companies—name brand recognition and lower cost of capital--will remain intact.

In addition community-based companies will be severely hampered in their ability to compete on a loan-by-loan basis with the large bank-owned companies, due to the FRB rule. Large bank-owned creditors are able to utilize their lower cost of capital today to compete on aggregate loan pricing. **Community-based companies today can compete effectively, to the benefit of consumers, by matching the prices of the large bank-owned companies on a loan-by-loan basis**. Community-based companies can do that because a large component of their cost structure – loan officer compensation-- is variable and can be adjusted downward as pricing is moved lower to match the pricing of the large bank-owned companies. Thus community-based companies are able to compete and the consumer is the beneficiary of that competition.

If the FRB rule is promulgated as proposed, community-based companies will no longer have the ability to adjust loan officer compensation downward in order to capture business, and thus will be placed at a competitive disadvantage, to the detriment of consumers who will have fewer lender choices. If and when a large number of community-based companies are driven from business because they can no longer compete with the large bank owned creditors, consumers will be further disadvantaged because with reduced competition the market share of large bank owned companies will grow, their marketplace power will grow and their need to compete on price with independents will be reduced, leading inevitably to higher costs for consumers. In the third quarter of 2009 three large bank-owned creditors accounted for over 50% of the U.S. mortgage market. This market concentration is already reaching uncomfortable levels even with full competition, how much higher will it be driven if this rule goes into effect as proposed? Can U.S. consumers afford the costs of this unintended consequence?

4. **Intertwined role of branch manager who is also an originator –** Among community-based mortgage banking companies it is typical that branch managers are also mortgage originators. Based upon industry information and our own surveys, we estimate that approximately 90-95% of all branch managers also originate loans. It is also typical that branch manager/originators will be compensated for the mortgages they originate in a manner similar to other originators and that they are also compensated for their branch management activities on the basis of the profitability of the branch. The profitability of the branch in turn, is driven by revenue less costs. Obviously a branch's revenue depends upon the volume and nature of the loans being originated, and costs are determined by compensation levels and fixed charges for equipment, rent, etc.

As we read the proposed FRB alternatives, compensation paid to branch managers for their management activity, as opposed to their loan origination activity, is exempt from the compensation restrictions. As such, companies could designate their best mortgage originators as a branch of "one". If they have to manage a person in order to be deemed a "branch manager", then the branch can consist of the originator and the processor that works with the originator. Thus the originator can be compensated for his/her origination activities in conformance with the FRB rule, and compensated for their branch manager activities in conformance with a compensation structured devised by the creditor to achieve their business objectives. We believe this is a market work-around that will not produce the results the Fed intends with the proposed rule.

If this interpretation is not what the FRB intends, then this rule should be re-proposed with provisions that make it clear that the compensation restrictions extend to all compensation paid to branch managers that are also loan originators.

5 **Encouragement of one-person broker operations -** If either alternative of the FRB mortgage originator compensation rule becomes effective, mortgage brokers will be free to seek out and sell to those creditors that provide them with the highest compensation per loan. Mortgage brokers will be able to do this in full compliance with the anti-steering rule proposed in 226.36(e) by doing business regularly only with creditors that pay high compensation. They will be able to utilize the trust relationship established with the consumer to convince the consumer they are obtaining them the best rate and terms possible. In reality of course, the mortgage broker will be offering the consumer the best rate and terms among the *creditors that the broker regularly does business with,* and not necessarily the best rate and terms available in the wider marketplace. Since loan officers are employed by mortgage creditors, these loan officers will not have a similar opportunity for selective placement of the loan, thus they will be at a competitive disadvantage to mortgage brokers in terms of discounting to meet consumer requirements and their own compensation opportunities. As such, many loan officers may decide to terminate their employment with creditors and become brokers. As brokers they will be free to pick and choose to create business relationships only with the highest compensating wholesalers and utilize their trust relationship with consumers to convince them they are getting them the best deal available, while achieving the highest compensation possible.

6. **Having consumers pay originators directly is not a solution -** the FRB proposed rule exempts from the compensation restrictions those loan transactions where the loan originator receives compensation directly and solely from the consumer. This exemption creates a significant loophole that can be exploited by mortgage brokers in particular. With this exemption it

will be a simple matter for a mortgage broker to obtain a consumer's approval for a significant fee that will vary according to the loan's term and conditions by promising the consumer that they will receive a credit from the creditor at the loan closing in an amount equal to the amount the consumer will pay the mortgage broker. Thus there will be no cash out of pocket for the consumer. The mortgage broker will be in compliance with the FRB rule, and still be able to adjust their compensation to meet competition.

7. **Different price sheets** – Under the FRB proposal creditors who deal with mortgage brokers and retail mortgage bankers alike will be encouraged to create different price sheets for each mortgage broker/loan officer that takes into account the types, and profitability, of the loans being produced by each originator. These price sheets will, of course, produce different loan pricing among the consumers being served by these originators. These price sheets will also be revised from time to time, taking into account the terms and conditions of the loans being originated by the broker/loan officer and how those terms and conditions affect the creditor's profitability.
8. **Difficult to regulate** – the FRB indicates concern in the commentary to the regulation about the enforceability of this proposal. As we have pointed out in previous sections of this letter, the ability to circumvent this proposed regulation will be significant, the number of compensation structures created among market participants will be considerable and varied and the ability to police all this will require vast increases in manpower and resources. We believe that the scope of enforcement requirements will lead to a situation where primary enforcement of the regulation is carried out by private litigation. The threat of lawsuits, the costs of actual litigation and the potential for significant monetary awards, which may drive settlements even where there has been no regulatory violations, will inevitably be reflected in the costs of mortgage credit to consumers as well as a resulting degradation in the efficiency of the mortgage market.
9. **Products with fixed prices** – some loan products have fixed origination fees that are lower than the fees a creditor would typically charge, thus creditors will be discouraged from originating these products if the FRB proposal is promulgated as proposed. These programs have higher origination costs associated with them and currently creditors deal with this by reducing their costs through lower commissions paid to loan officers on these loans. Examples of this type of product are mortgages originated under the auspices of state housing finance agencies and reverse mortgages.

<u>A More Targeted Solution</u>

As can be seen from the listing of these 9 unintended consequences, the direct and indirect impacts on consumers will be adverse and widespread. The CMBP proposes a modification to the FRB proposal **that will apply its principles to all loans** in a way that will permit the unintended consequences to be largely, if not entirely, be avoided. For stable, affordable mortgages the essential ability for creditors to provide discounts to consumers will be preserved.

CMBP Proposal on Loan Officer/Broker Compensation

The CMBP proposes that Section 226.36(d)(1) be modified to read as follows:
(d) Payments to loan originators. (1) Limitations on payments. In connection with a consumer credit transaction secured by real property or 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, if the transaction:

(i) has an annual percentage rate that *exceeds* the FFIEC Average Prime Offer Rate by more than 1.5 percentage points for a comparable transaction as of the date the interest rate is set; or

(ii) is deemed a 'non-traditional' mortgage under guidance, advisories, or regulations prescribed by the Federal Banking Agencies.

For purposes of this paragraph, the principal amount of credit extended is not deemed a transaction term or condition.

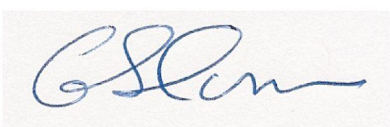
Explanation of Proposed Language

The CMBP proposal affects directly or indirectly all loans. It focuses compensation restrictions, and the FRB energy, resources and enforcement efforts on those situations adverse to consumers, and will produce a better result for consumers. Most importantly the 9 unintended consequences detailed previously in this letter should be largely, if not entirely, avoided.

Under the CMBP proposal the cost of loan officer compensation, for most mortgages, will retain the flexibility to allow the discounting necessary for community-based creditors to remain competitive. Therefore the negative impact of an increase in the cost of mortgages to consumers will be avoided. Lower loan balances will not be disadvantaged due to restrictions on loan officer compensation because today's flexibility on this important cost will be retained. The competitive playing field will also remain level, as independent mortgage banking companies will be free to dedicate the resources they believe necessary to achieve their business objectives by employing loan officers that possess superior business development skills, and thus preserve their competitive position versus the large bank-owned companies who deploy their resources to establishment and maintenance of their brand name. With the CMBP proposal the potential development of "one person" branches, a proliferation of mortgage brokers and potential abuses under the "consumers pays the costs" exception will also be avoided, since the financial incentives will not have been created under a more targeted and focused regulation. The same will be true for the creation of a different rate sheet for each originator. The enforcement difficulty, while not eliminated, should be greatly reduced with the more specific targeting of the rule and finally the problems with specific programs that limit origination fees should be completely eliminated.

We urge the FRB to give serious consideration to our proposal. We would be pleased to act as a resource to the FRB as it continues its deliberative process of considering these regulations. Whatever decision the FRB makes on these regulations we believe that it will be extremely important that the final regulations address in detail how the 9 unintended consequences set forth in this letter will be avoided.

Sincerely,



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