California Association of Mortgage Brokers

December 21, 2009

Board of Governors of the Federal Reserve System
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Re: Docket No. R - 1366

On August 26, 2009, the Federal Reserve ("the Board") proposed an amendment to Regulation Z. The Board is inviting public comment on the proposal until December 24, 2009, after which it will determine if the amendment should be adopted, altered, or withdrawn. The California Association of Mortgage Brokers ("CAMB") believes the amendment, although well intentioned, will not translate well into practice.

CAMB's concern with the amendment is with its intention to regulate loan originator compensation by requiring compensation agreements between lenders and loan originators. This requirement as proposed would lead to increased consumer costs driven by reduced competition, fewer consumer choices, and an increased risk of improper steering. CAMB requests that this section of the rule be withdrawn for the reasons explained below. (For the purpose of the following discussion, the term mortgage broker is used to represent all loan originators.)

I. Compensation Agreements

The proposed amendment requires that the lender execute a compensation agreement with the mortgage broker before the lender can contribute to the broker's compensation from funds that did not originate from the borrower. Compensation is defined as any fee retained by the broker (non-3rd party fees.) Almost exclusively, the non-borrower source of compensation paid by lenders is the additional present value of a loan with an above par rate commonly known as a yield spread premium ("YSP".)

A separate agreement would be required between the broker and every lender from whom the broker wished to receive YSP. The purpose of the agreement is to establish a consistent broker payment method whenever YSP is used for compensation. In their request for comment, the Board offers two options to accomplish this goal: the first would mandate that the payment method is not related to <u>any</u> of the terms of the loan i.e., the amount of payment cannot change because the loan size, type, rate, term or any other parameter changes. The second option would allow loan amount to be used to calculate the payment, i.e., a consistent percentage could be used. Under both offered options, whenever any of the broker's compensation is paid through YSP, the broker is barred from concurrently collecting any origination fee from the borrower.

a. Option A

Under Option A, CAMB believes the most likely arrangement that would be adopted by the industry is a "flat-fee."

A flat-fee is a fixed and consistent dollar amount paid on each closed loan regardless of loan terms. The lender would need to calculate the appropriate interest rate bump from the par rate in order to generate the flat fee though YSP.

b. Option B

Under Option B, loan amount could be used to calculate the fixed payment made to the broker.

The flat fee (Option A) or percentage of loan amount (Option B) chosen is specific to the two parties to the agreement; if a broker worked with 10 creditors, the broker could have 10 agreements, all with different flat fees or percentages amounts. Likewise, if a creditor worked with 100 brokers, the creditor could have agreements for 100 different amounts. There is no minimum or maximum on the dollar amount of the flat fee or percentage. If adopted, whenever a broker receives compensation from YSP, the agreement in place with the creditor offering the YSP would dictate the payment amount.

Option A would be a dramatic departure from the industry standard of using loan amount to calculate commissions. CAMB believes that such a departure, in addition to the negative impact of the rule in general, would further elevate costs to clients who have less expensive properties and smaller loans, and would complicate long standing procedures such as the deductibility of "points" (*see Revenue Procedure 92-12.*) Although Option B appears more palatable than Option A, the same core problems identified below remain.

<u>II. What the Board Hopes to Accomplish through the Required Fee Agreement</u>

The Board's goal is to eradicate incentives to provide consumers loans with higher interest rates or other less favorable terms:

> "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, such injury is common because consumers typically are not aware of the practice or do not understand its implications and cannot effectively negotiate its use." (*Federal Register / Vol. 74, No. 164 / Wednesday, August 26, 2009 / Proposed Rules, 43281.*)

The Board claims its authority for this type of regulation under TILA:

> "PROHIBITIONS.--The Board, by regulation or order, shall prohibit acts or practices in connection with-- (A) mortgage loans that the Board finds to be unfair, deceptive, or designed to evade the provisions of this section……."(*TILA Section 129(l)*)

<u>III. The Risks Associated With the Current Proposal</u>

A. Improper Steering

As indicated above, the proposed rule would require brokers to create compensation agreements with many different lenders. There could be different "flat-fees" (Option A) or percentages (Option B) associated with each of these agreements. A higher flat fee or percentage would require a greater rate bump, ergo a higher final rate to the consumer. The proposed plan would create an environment where loan originators have a financial incentive to send the loan to the lender who will pay them the highest fee (regardless of loan product.) If not further regulated, this scenario would inevitably result in higher borrower interest rates - one of the enumerated occurrences the Board is trying to curtail.

In recognition of the steering incentive the proposed rule would create, the Board requests comment on enlarging the rule to include an anti-steering clause:

> "2. Prohibited conduct. Under § 226.36(e)(1), a loan originator may not direct or steer a consumer to a loan to increase the amount of compensation that the originator will receive for the transaction unless the loan is in the consumer's interest." (*Federal Register / Vol. 74, No. 164 / Wednesday, August 26, 2009 / Proposed Rules, 43409.*)

In order for the broker to determine if a loan is in the consumer's best interest, the broker must compare (and defensively paper-trail) the loan offered to the consumer with other possible loans offered by the broker. To be included in this comparison, the broker must have a good faith belief the consumer is likely to qualify for the loan. To complete this process, multiple loans from multiple lenders must be compared in complex mixture of interest rate contexts:

> "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 at least three loans that include the loan with the lowest interest rate, the loan with the second lowest rate, and the loan with the lowest total dollar amount for discount points and origination points." (*Federal Register / Vol. 74, No. 164 / Wednesday, August 26, 2009 / Proposed Rules, 43410.*)

Should this complex interplay between mandatory compensation agreements and anti-steering language be adopted, CAMB envisions two outcomes – the "bad" broker will work the system while the "good" broker will be driven away.

The few unscrupulous broker for whom these and other rules continue to be devised will use compensation agreements to their advantage without too much fear of repercussions. Consumers will not have any information that a compensation agreement exists, let alone that several other more advantageous ones also exist. <u>Who is in a position to monitor the unscrupulous broker?</u> Funding lenders will not be privy to other compensation agreements the broker may have with other lenders. As such, they cannot be called upon to police and theoretically they cannot be later indicted in a steering scheme. <u>How can the new steering regulation be enforced</u>?

The Truth in Lending Act provides for three methods of enforcement: administrative agency enforcement, criminal penalties, and private civil liability, the latter of which has become the dominant mode at least as measured by the number of lawsuits. Criminal sanctions have been rarely invoked, and for the most part administrative enforcement has been sporadic. (*See Rohner, Truth in Lending, American Bar Association (2000) pages 885,886.*) Under the proposed rule, private attorney generals who seek the attorney's fee awards allowed by Truth in Lending will attack brokers who use YSP as part of their "forensic review" process, hoping to get lucky. The Board's proposed rule will be enforced after-the-fact through private lawsuits.

Honest brokers will become targets while the unscrupulous minority will work the unsupervised system until targeted by a civil lawsuit, at which time they will disappear.

B. Less Competition Because Broker's Liability Skyrockets

The great majority of brokers who currently use YSP to their customers' advantage will find the complex process through which the Board requires brokers to defend and paper-trail their loan offerings too expensive and too risky. Query: under the rule would it be appropriate for a broker to choose a lender who can fund in 10 days and who pays a higher compensation instead of a second who will take 30 days to fund but pays the broker a few hundred dollars less? If the broker determines the former is in "the consumer's best interest" should they risk their business to an expensive lawsuit? In practice, brokers will need to be cognizant of ever increasing liability, and accordingly restrict their product offerings (to their customers' disadvantage) or close up shop.

C. Less Competition Because Lenders Choose Not to Participate

Because of the steering opportunity created for the small minority of unscrupulous brokers, and the subsequent legal actions described above and their unknown outcomes, third party originations (TPO) will become less attractive to investors. This will translate into increased costs for lenders who produce TPO loans, who, if they stay loyal to the channel, will then need to raise prices or punitively clamp down on all their broker relationships. This clamp down will likely include substantial reductions in YSP loan offerings, resulting in less and less competition in the marketplace. The reduction in competition will be further exacerbated as lenders choose to avoid a multitude of complex compensation agreements that may carry liability that will remain unforeseen until private attorney generals motivated by attorney fee clauses begin the process of peeling the onion.

IV. Better Alternatives

As mentioned earlier, the Boards' stated goal in developing its compensation related rules is "to eradicate incentives to provide consumer's loans with higher interest rates or other less favorable terms." As the above illustrates, this proposal will effectively do the opposite. Unscrupulous steering that cannot be monitored except through civil lawsuits will be promoted. Furthermore, the prohibition on merging borrower paid origination and YSP, although well intentioned, will severely harm borrower's ability to fine tune the parameters of their loan to their individual situation. Often market conditions create opportunities where such an option represents best execution.

The majority of brokers who perform a tremendous service in communities where others won't visit will at best be able to offer a substantially curtailed product line, as they seek to avoid liability and as lenders withhold product options due to complexity, cost, and unknown future liability. At worst, these small business owners will themselves become victims.

The Board is familiar with HUD's attempt to address these same issues in Regulation X. Per the Board:

> "Although HUD recently adopted disclosures in Regulation X, implementing RESPA, that could enhance some consumers' understanding of mortgage broker compensation, the details of the compensation arrangements are complex and the disclosures are limited.
> A creditor may show the yield spread premium as a credit to the borrower that is applied to cover upfront costs, but is also permitted to add the amount of the yield spread to the total origination charges being disclosed. This 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 was also available. In addition, the Regulation X disclosure concerning yield spread premiums would not apply to overages

> occurring when the loan originator 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." (*Federal Register / Vol. 74, No. 164 / Wednesday, August 26, 2009 / Proposed Rules, 43281.*)

It appears HUD would disagree that its RESPA rule change is "not likely by itself to prevent consumers from incurring substantial injury:"

> "Brian Montgomery, HUD's Assistant Secretary of Housing, Federal Housing Commissioner, said, "We have carefully considered the concerns expressed from every corner of the mortgage market in developing this rule. I am convinced that we successfully balanced the needs of consumers with those in the business of homeownership. None of us can lose sight of the fact that millions of Americans simply don't understand all the fine print of their mortgages and this, in many respects, is at the heart of today's mortgage crisis." Since 1974, little has changed about the process Americans endure when they buy and refinance their homes. <u>Now, HUD's final reform will improve disclosure of the key loan terms and closing costs consumers pay when they buy or refinance their home</u>." (*HUD New Release, November 12, 2008, underline added.*)

CAMB agrees with the Board that it is problematic that the Regulation X disclosure concerning yield spread premiums does not currently apply to overages charged the loan originator is employed by the creditor. <u>A simple fix would be to make it apply to all originators</u> (a position CAMB has always maintained regarding this issue.) This would make all originators equally transparent, ultimately benefitting the consumer. However, the Board seems to categorically discount the batteries of testing HUD performed to validate the impact of its new Good faith estimate on consumers.

HUD's approach, although arguably less than perfect, is more in line with our fair market system where two parties are free to negotiate in good faith. *The new GFE demands that every dollar from all sources be disclosed, and that the broker declare its compensation clearly in a fixed dollar amount.* This good faith disclosure of personal compensation is well beyond that required of almost any other party to a business transaction. If the retail loan officer was required to do the same, the consumer would be armed with all available information; there could be no secret retail overages.

Yet the Board instead chooses to press forward with a much more complex system of multi-faceted agreements and remedies instead of giving the much simpler GFE a chance, as if there were a clear and present danger the GFE cannot address. This emergency preemption might be understandable if there was evidence that loan originators were *today* steering consumers into the time-bomb products like those that existed a few years ago, such as option ARMs, simply to line their own pockets. But no such emergency exists today, as no such products exist today. Granted, the new GFE will not insure that a retail loan originator will not charge an overage, but, at least in the case of the broker, it insures the consumer clearly sees all fees and is in the position to decide if the transaction warrants its cost.

The Board has not offered any evidence, admissible or anecdotal, that there is such an exigent need for a rule change that the Board cannot wait to measure the impact of the new GFE. If the Board is concerned that the new GFE fails to curtail the ability of the retail loan officer of a lender to quote an overage without any form of disclosure, then the Board should introduce a rule that focuses on this issue, or work with HUD to extend the disclosure requirements of the new GFE to all originators.

The California Association of Mortgage Brokers ("CAMB") believes this amendment will lead to increased consumer costs driven by reduced competition, fewer consumer choices, and an increased risk of improper steering. CAMB requests the Board place the above discussed portion of the proposed rule on hold until the impact of the new GFE is adequately measured.

Furthermore, CAMB requests that in its review, the Board reassess the real potential for steering the proposed rule creates, as well as the negative impacts that would flow from enforcement through civil liability.

We appreciate your consideration of our comments.

Sincerely,

Ed Smith, Jr.
President
California Association of Mortgage Brokers