Consumer Finance Monitor (Season 3, Episode 22): The CFPB's Loan Originator Rule's Compensation Provisions: Assessing Compliance Risk

Speakers: Chris Willis and Rich Andreano, Jr.

Chris Willis:

Welcome to the Consumer Finance Monitor podcast, where we explore important new developments in the world of consumer financial services and what they mean for your business, your customers, and the industry. I'm your host, Chris Willis and I'm the practice group leader of Ballard Spahr's consumer financial services litigation group, and I'll be moderating today's program. For those of you who want even more information, don't forget about our blog, ConsumerFinanceMonitor.com. We've hosted the blog since 2011, so there's a lot of relevant industry content there. We also have a mortgage banking update which is of particular relevance to today's subject matter, and we regularly host webinars on subjects of interest to those of us in the industry.

Chris Willis:

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Chris Willis:

Today I'm very happy to be joined by my partner, Rich Andreano, who's one of the practice group leaders of our mortgage banking regulatory practice in Washington, DC. Rich, welcome to the podcast.

Rich Andreano:

Thank you, Chris.

Chris Willis:

Now, Rich, I understand that the loan originator compensation provisions in Regulation Z have recently become one of the main areas of focus of the mortgage industry. Why is that?

Rich Andreano:

Indeed. As you might expect that mortgage lenders are highly dependent on their loan originators to bring in business. They are the sales force for the mortgage industry, so clearly how a lender compensates its loan originators is important in both recruiting and retaining good loan originators. Now what the rule does is it basically prohibits what had been prior market practice of compensating originators in some way relative to the type of loan and the pricing of the loan. The rule basically says, originator may not be compensated based on a loan term or any factor that would serve as a proxy for a loan term. So, industry members today spend a lot of time in trying to recruit and retain loan originators by developing plans that are both competitive as to compensation yet still compliant with the rule.

Chris Willis:

So what is going on currently in the market regarding loan originator compensation?

Rich Andreano:

What I'm observing is a move towards very aggressive conduct that may not only push to the edge of the envelope, but perhaps even beyond. Number of industry members have contacted me and asked, "Has the rule been amended to liberalize some of the restrictions?" And in fact, I say no and ask, "Why do you ask that?" And they advise that they are aware of conduct and they've confirmed themselves that it does exist that have people paying compensation in ways that would appear to violate the rule, and that that is beginning to happen more and more frequently. So what we're seeing is a lot of aggressive conduct out there based on the belief that frankly people think there will not be any enforcement.

Chris Willis:

It's interesting that there's this belief in the market based on your conversations that the CFPB won't be interested in this subject, either in examinations or enforcement, and therefore these loan originator compensation practices that you're talking about won't be subject to scrutiny. Do you think that's an accurate assumption?

Rich Andreano:

I do not. I understand how some people could have gone down the path. The last public enforcement action, and I emphasize public because what the Bureau does privately in an examination we don't know about, so all we know about is when they either reach a consent order with someone, or they can't reach a consent order and they decide to move forward and they file a lawsuit.

Rich Andreano:

The last public enforcement action actually occurred back in June of 2015, and that was under Director Cordray. Now, remember, Director Cordray didn't leave til around Thanksgiving of 2017, so you had almost two and a half years at the end of his tenure where there was no public enforcement action, and there has been none since. That, coupled with the belief that under the current administration the Bureau will be less aggressive with enforcement, has caused people to get very aggressive. I don't think however that that is a good way to look at things. In fact, a few weeks ago, and you can go on our website and get this. We did a webinar on Bureau enforcement and indicated this very point that we believe that the Bureau in fact will enforce, and that the common belief that they'll be very lax is not only wrong, but quite dangerous.

Chris Willis:

Yeah, and I can say from my own experience in dealing with the Bureau in a number of open enforcement investigations now, and in a lot of examinations as well, I don't see any support for the concept that the Bureau is lax on enforcement now. In fact, quite the opposite. I think the enforcement activity, as you noted Rich, is picking up and there's no way that there seems to be a mood in the Bureau for ignoring sort of black letter law that's there in a statute or regulation on any subject, including loan originator compensation. So Rich, what do you think the considerations are for companies in the mortgage origination market if they're thinking about pushing the envelope with respect to loan originator compensation practices?

Rich Andreano:

The loan originator compensation rule is one of the standard items that the CFPB looks at in an exam. Now, as with many newer rules, the initial exams often are relatively basic and I would categorize the initial exams with the loan originator compensation rule to fit in that category. But as typically develops, over time the examiners as they become more comfortable with the rule and how it works and understand it better, will dig deeper looking for issues and I think we're going to see that moving forward.

Rich Andreano:

The other thing in addition to the Bureau looking at it in exams has been the rise of whistleblower complaints, and in fact the Bureau indicates a lot of enforcement actions or investigations were triggered by whistleblower complaints that had very detailed information on conduct that appeared to violate the law. And who might be a whistleblower? Well, your own

employees if they're disgruntled. Former employees who are disgruntled. Believe it or not, I know of cases where significant others of companies' personnel were the whistleblower, and a trend I'm seeing more and more now is competitors.

Rich Andreano:

Competitors it used to be were reluctant to make complaints, but I'm finding more and more that they are doing so particularly when they view market conduct as placing them at a competitive disadvantage. In other words, some people are not following a rule that the company is following the rule and placed at a competitive disadvantage. So, I think we're going to see more of that going forward, and then when you focus on the liability under the loan originator compensation rule, that's quite significant.

Rich Andreano:

First, unlike the typical truth in lending requirement which has a one-year statute of limitations, this has a three-year statute of limitations and that's important when you look at what you can be liable for, and that's all finance charges and fees paid by the consumer plus court costs and attorney's fees, which of course love to draw the attorneys into the action. But think of that. Well, finance charges. So, how much interest accrues on a loan during its first three years? That's a pretty big number and that would attract a lot of people to think about making a claim.

Rich Andreano:

Another important factor here is loan originators themselves, including individual loan officers, also are liable under the rule. It's capped at either the amount of compensation they earned on the loan, or actual damages plus court costs and attorney's fees. So it's important factor I often pass on to people. When your loan originators come to you and ask you to do something very aggressive, note to them that when you don't do it, you're not only protecting the company, you're actually also protecting them.

Rich Andreano:

There's also this so-called defense to foreclosure provision that applies to this rule, as well as the ability to repay rule. Once you get past the three-year statute of limitations, there still is liability, believe it or not. If the creditor goes to enforce the loan, the borrower can raise a violation of the rule as basically an attempt to offset the debt owed, so all we're going to need is a bump in the economy to increase default rates and we may see people in fact making these claims, and as we know with the coronavirus and what it's doing to financial markets and the economy, that may be the bump in the road that is on the horizon.

Rich Andreano:

Last but not least, the rule can be enforced directly by state attorney generals. Dodd-Frank put that into the Truth in Lending Act, and as we know, because of a perception which Chris and I don't agree with that the Bureau will be lax in enforcement, a lot of states have stepped up and in fact are forming their own mini Consumer Financial Protection Bureaus and so we think they will be players with this rule as well.

Chris Willis:

You know, Rich, when I counsel clients on regulatory risks, I try to think about it in terms of likelihood of discovery, in terms of how likely is it that a regulator or an adversary will discover something, and then if it is discovered what the degree of impact is. And I think what you've just told us, and tell me if I'm right or not, is that first of all, there's a high likelihood of discovery, because LO comp is a standard thing that the Bureau looks at in all mortgage origination examinations, and that even absent an examination, there are multiple whistleblower avenues for discovery of this issue as well.

Chris Willis:

So there's a high likelihood of it being discovered at some point in the future, and then if it is discovered, the potential impact is very large because you could not only have a significant size regulatory enforcement action or consent order, but the then public existence of that could bring a lot of private individual or class action cases to be brought, and there wouldn't really be much I don't think from the standpoint of individual issues to get in the way of class certification, and of course there's no arbitration clauses in the mortgage industry, so the addition of private litigation could actually be a very significant one in connection with this issue. Do you think I'm basically getting it right in terms of trying to quantify the level of risk here?

Rich Andreano:

Yeah, I do. Because if you're doing something across the board generally with loan originator compensation that would violate the rule, you tend to be repeating that violation with all of your loan originators or some significant subset of your loan originators, so I do think class action is certainly a risk there and some of this can be easily discoverable. What happens when the Bureau comes in is, who do they talk to? They talk to HR, the payroll people, and those people share a lot of information and in fact, what they do is hand me your compensation plans and give me your payroll records, and they line them up. And where they've often found issues is, well, wait a minute. There seems to be some payments here that we can't necessarily tie to the comp plan.

Rich Andreano:

So even if people were trying to hide what they were doing, once you follow the money and you realize it's not tied to the comp plan, they started digging in and they found there were these unwritten comp plans that violated the rule, and not only were the companies in trouble for that, but a separate violation is not having all your compensation terms in writing, so that in and of itself is a violation of the rule. So I think there is significant potential, and when we do see an enforcement action or a private lawsuit, I think a lot of people in the industry are going to become very nervous.

Chris Willis:

Rich, let me ask you a related question to what you were talking about with respect to the defense to foreclosure, and the fact that the LO comp issue could be raised many years in the future in a defensive action if a foreclosure is sought on the borrower's property. Would that have any impact on loans that are placed with the secondary market, placed in securitizations or with GSEs or other entities like that?

Rich Andreano:

It certainly does, which is where another factor here are the investors and in the investors, I've seen them ask for representations and warranties in fact that loan originator compensation plans are compliant. If we do see private lawsuits develop more, I think investors will impose even greater scrutiny in this area because of that, and the thing is here, well as people always say, "Well, it's hard to have assignee liability because the investor may not know what was occurring." I said, well, that depends how you define assignee liability. Can they bring the claim directly against the investor? May be difficult, but if they can make a claim and offset part of the debt, well, that is assignee liability if you look at it in that standpoint, similar to the right to rescind also. So I view it as this is an area where investors also may become effectively private enforcers by really taking a close look at what people are doing.

Chris Willis:

So I think it's obvious and should be obvious to everyone listening that the loan originator compensation rules need careful attention and represent a high risk area for mortgage originators. Now, the CFPB has indicated that it plans to revisit the subject of loan originator compensation. Rich, what is the Bureau planning specifically in that regard?

Rich Andreano:

This is a response to an effort by the Mortgage Bankers Association. It polled its membership, and basically asked, "What are the top three asks after the rule?" There were a lot of asks, but what are the top three? And the top three were to allow an

originator to reduce their compensation in order to provide better pricing to meet competition. That's something that both the Fed when it adopted the original rule and the Bureau when it adopted the revised rule addressed in the preambles. It made pretty clear that's conduct they don't want to occur, but there were also two other asks. One with housing finance agency loans to allow a company to actually pay lower compensation with those loans, and two, when an originator makes an error to allow the company to basically dock their commission for that error, and this would typically be an error that has some financial implications such as they forget to disclose a fee, or they under-disclose a fee. This was commonly done before the rule was adopted, but not since then.

Rich Andreano:

Well, in the latest rulemaking agenda, the Bureau has indicated the housing finance agency loan ask and the error ask are things that it plans to address. Important here with housing finance agency loans. When the Bureau was considering the ability to repay rule, it decided that these housing finance agency programs, also called bond loan programs, were so protective of consumers there was no need to overlay the federal ability to repay requirements, so they expressly exempted those loans from the ability to repay rule. At the time I pointed out to the Bureau, "Understand what you did. That made sense, but because there's no similar exemption under the loan originator compensation rule, you're frustrating the ability of creditors to make these loans because the margins are thin on these loans and if they have to pay standard loan originator compensation, it makes it an economically challenging loan often for a creditor to make." Bureau we think now does understand that and they're sensitive to that issue, so they've made clear that they do intend to address that.

Rich Andreano:

The one we were unsure about was the error. An employee makes an error, because when we discussed that with the Bureau in the past, they would say, "Yeah, but an originator can intentionally make an error just to try to do indirectly what they can't do directly, such as lowering their comp to provide a low price. They could just forget to disclose a fee." And said, "Acknowledge the potential for that, but if a creditor or a loan originator's doing that, you can detect that in the supervisory process and handle it that way, than just by saying no." I get no's easy, but it's not necessarily a good policy result.

Rich Andreano:

So it looks like they do intend to address that. They will be concerned about the potential for deliberate errors to try to circumvent the rule, but I think that's something they'll address in the rulemaking process and again, I think the best way to deal with that is through the supervisory process and not through a restrictive rule. They didn't put any timeframe on these actions, so it's not that I'm looking for a proposed rule even this year, but I think within the next couple years we will see proposals in this area.

Chris Willis:

Okay. Well, thank you Rich for your very insightful and frankly quite sobering comments on this very serious issue of loan originator compensation, and thank you to all of our listeners for downloading and listening to today's podcast. Make sure to visit our website, BallardSpahr.com, where you can subscribe to our podcast in Apple Podcasts, Google Play, Spotify, or your favorite podcast platform. Don't forget to check out our blog, ConsumerFinanceMonitor.com for daily insights about the financial services industry, and our mortgage banking update. If you have any questions or suggestions for the show, please email us at podcast@BallardSpahr.com, and stay tuned each Thursday for a great new episode of our podcast. Thank you all for listening.