DRAFT/DELIBERATIVE: Template for Reviewing Regulatory Analyses.

Title: Loan Originator Compensation Requirements Under the Truth in Lending Act

RIN: 3170-AA13

Publication Date: Feb. 15, 2013

Summary of Major Provisions of rule: (Copied from Regulations.gov)

Prohibition Against Compensation Based on a Term of a Transaction or Proxy for a Term of a Transaction. Regulation Z already prohibits basing a loan originator's compensation on "any of the transaction's terms or conditions." The Dodd-Frank Act codifies this prohibition. The final rule implements the Dodd-Frank Act and clarifies the scope of the rule as follows:

- The final rule defines "a term of a transaction" as "any right or obligation of the parties to a credit transaction." This means, for example, that a mortgage broker cannot receive compensation based on the interest rate of a loan or on the fact that the loan officer steered a consumer to purchase required title insurance from an affiliate of the broker, since the consumer is obligated to pay interest and the required title insurance in connection with the loan.
- To prevent evasion, the final rule prohibits compensation based on a "proxy" for a term of a transaction. The rule also further clarifies the definition of a proxy to focus on whether: (1) The factor consistently varies with a transaction term over a significant number of transactions; and (2) the loan originator has the ability, directly or indirectly, to add, drop, or change the factor in originating the transaction.
- To prevent evasion, the final rule generally prohibits loan originator compensation from being reduced to offset the cost of a change in transaction terms (often called a "pricing concession"). However, the final rule allows loan originators to reduce their compensation to defray certain unexpected increases in estimated settlement costs.
- To prevent incentives to "up-charge" consumers on their loans, the final rule generally prohibits loan originator compensation based upon the profitability of a transaction or a pool of transactions. However, subject to certain restrictions, the final rule permits certain bonuses and retirement and profit-sharing plans to be based on the terms of multiple loan originators' transactions. Specifically, the funds can be used for: (1) Contributions to or benefits under certain designated tax-advantaged retirement plans, such as 401(k) plans and certain pension plans; (2) bonuses and other types of non-deferred profits-based compensation if the individual loan originator originated ten or fewer mortgage transactions during the preceding 12 months; and (3) bonuses and other types of non-deferred profits-based compensation that does not exceed 10 percent of the individual loan originator's total compensation.

Prohibition Against Dual Compensation. Regulation Z already provides that where a loan originator receives compensation directly from a consumer in connection with a mortgage loan, no loan originator may receive compensation from another person in connection with the same transaction. The Dodd-Frank Act codifies this prohibition, which was designed to address consumer confusion over mortgage broker loyalties where the brokers were receiving payments both from the consumer and the creditor. The final rule implements this restriction but provides an exception to allow mortgage brokers to pay their employees or contractors commissions, although the commissions cannot be based on the terms of the loans that they originate.

No Prohibition on Consumer Payment of Upfront Points and Fees. Section 1403 of the Dodd-Frank Act contains a section that would generally have prohibited consumers from paying upfront points or fees on transactions in which the loan originator compensation is paid by a person other than the consumer (either to the creditor's own employee or to a mortgage broker). However, the Dodd-Frank Act also authorizes the Bureau to waive or create exemptions from the prohibition on upfront points and fees if the Bureau determines that doing so would be in the interest of consumers and in the public interest.

Commented [RR(1]: Almost all critical elements of a cost-benefit analysis are missing from this analysis. The statement of the problem and market failure analysis is incomplete. There is no identification of alternatives, there are no quantified or monetized benefits or costs, limited discussion of effectiveness (except to concede the rule may not be effective), etc. Very few claims of benefits and costs are supported by evidence. In some cases, the bureau does not distinguish between transfers and benefits/costs. The analysis is not useful for decision-making, and provides only modest contributions to transparency. Relative to the Bureau's first major rulemaking (HMDA), this rule is a considerable step back in CBA completeness.

I'm not an attorney, but I would be surprised if the Bureau's analysis didn't present APA related risks.

Commented [RR(2]: Many provisions listed here aren't analyzed in the 1022 section.

DRAFT/DELIBERATIVE: Template for Reviewing Regulatory Analyses.

Sec. 1022 (and GIPRA):

1. ***Universe*** **–** Does the analysis assess the costs and benefits to persons identified by the Act, including consumers, covered persons, 1026 covered persons, and consumers in rural areas?

   Yes.

2. ***Content*** **–** Does the analysis assess the potential loss of access to consumer financial products and services?

   Yes, though assess may be too generous a word.

Cost-benefit analysis best practices (based on OMB Circular A-4):

3. ***Is there a clear statement of the problem the rule is intended to address?***

   No. There is no section that clearly specifies the problem the rule is intended to address.

4. ***Does the analysis identify a market failure?***

   Exemption from ban on points – No, but that's why they provided an exemption.

   Compensation based on terms to the transaction – Moral hazard: the footnote argues that moral hazard is fundamentally about how mortgage originators have more information about loan products than consumers – including about the cost of mortgage products.

   Qualification Requirements for loan originators – No.

5. ***Does the analysis present evidence of a market failure?***

   Exemption from ban on points – No, but that's why they provided an exemption.

   Compensation based on terms to the transaction (moral hazard) – Yes. It provided a single citation to a non-scholarly work that is no longer active at the cited URL. I found a copy of the article on msu.edu, and it is a single-page qualitative essay.[1]

   Qualification Requirements for loan originators – No.

6. ***Does the analysis define an appropriate baseline? Does it use the baseline consistently?***

Commented [RR(3]: Aside: Author uses term adverse selection often, but it isn't clear the term is being applied correctly. I do not consider this repeated use of the term "identification of a market failure."

Commented [RR(4]: This is really a continuation of the baseline. So it isn't discussed at length in other sections in the template.

Commented [RR(5]: Moral hazard in this space is a concern and an important subject to explore. However, the final rule does not go into detail about the degree and nature of the potential problem. It does not assess the extent to which competition and shopping erodes the consequences of moral hazard. The final rule accepts as given that some loan products may be more profitable than others, which creates a moral hazard problem and does not analyze whether the observed profits reflect something other than economic profits (such as return on risk).

The analysis concedes the possibility that prohibition on profits-based compensation may not have benefits marginal to existing prohibition – that's the type of question you would want to test empirically.

[1] [HYPERLINK "https://msu.edu/~conlinmi/teaching/PIM821/bailoutmoralhazard2.pdf"]

Yes. Pre-statute baseline – except for exemption from ban on discount points.

7. ***Does the analysis define an appropriate time horizon?***

No. The Bureau didn't quantify anything, so no need to define a time horizon.

8. ***Does the analysis identify a range of regulatory alternatives, including potential alternatives to regulation? What alternatives to regulation were identified (such as additional enforcement)?***

Compensation based on terms - No. None.

Qualification Requirements for loan originators – No. None.

9. ***Are benefits connected to market failure?***

Compensation based on terms of the transaction – yes. The benefits discussed are connected to the market failure identified (moral hazard).

Loan originator qualification – No.

10. ***Does the analysis assess the potential effectiveness of the regulation?***

No for all provisions.

11. ***Does the analysis correctly identify and account for costs, benefits, and transfers for each alternative? Does it explicitly identify and account for impacts on credit access and availability?***

Benefits for exemption from ban on points: consumer choice, more information in market place (signals consumer likely to stay in mortgage for longer), better management of prepayment risk.

Costs for exemption from ban on points: There is some discussion that discount points may lead to "consumer harm" if people pay their mortgages back quicker.

Benefits and costs to consumers from ban on compensation based on terms: Reduction in moral hazard, but rule concedes benefits are not established and could be zero. No costs are identified.

Benefits and costs to covered persons from ban on compensation based on terms: "may impose adjustment costs or make it more costly to attract or retain qualified loan originators.

Benefits and Costs to consumers for loan originator qualifications – Reduce "harm" to consumers without discussing the types of harm they are referring to. Reduce "adverse

Commented [RR(6]: This is particularly problematic with this rule. There are loads of alternatives to banning incentive pay – like disclosure, standards of care, higher degrees of enforcement of fraud protections, etc.

Same with qualification requirements, which can serve as a barrier to entry and increase costs and are generally difficult to prove are effective. Despite extensive study, DOT has trouble justifying basic driver qualifications with empirical evidence.

Commented [RR(7]: This is very irresponsible in this instance. The rule bans certain methods of compensation to originators but does not (to my knowledge) establish a standard of behavior that originators must adhere to. Banks can just increase the salary of their most profitable originators and the incentives structure and moral hazard is identical. If you think that, in a reasonably competitive labor market, that originators that make more money for a firm aren't going to be higher paid, I have a bridge I want to sell you.

(Update: analysis later mentions that loan originators must comply with prudential standard. No discussion of benefits relative to prudential discussion alone.)

Bureau concedes: "The Bureau, however, notes that the current state of academic research has not provided an unequivocal answer to the question of whether any given profit-based compensation arrangement will produce incentives sufficiently strong for individual loan originators to engage in consumer steering. The Bureau also notes that this research, whether based on theoretical or empirical methods, shows that the potential for any profit-sharing plan to create adverse incentives are acutely sensitive to the specific features of the working environment and the means by which such profits are distributed to the relevant individual loan originators. [177] Finally, the Bureau notes that any potential reduction in the strength of these incentives is almost surely insufficient, under all realistic circumstances, to eliminate them entirely. [178]"

Commented [RR(8]: Bureau concedes, "The Bureau, however, notes that the current state of academic research has not provided an unequivocal answer to the question of whether any given profit-based compensation arrangement will produce incentives sufficiently strong for individual loan originators to engage in steering."

Commented [RR(9]: Reductions in moral hazard theoretically shift consumers from lower margin to higher margin products. This would likely involve a transfer rectangle and a deadweight loss triangle. Transfers not identified. That no other costs are identified is a glaring omission – incentive pay in a competitive market should improve service, information through advertising, and maybe even lower costs if it incentivizes more aggressive competition.

selection" in loan originators without any explanation of what they mean. "Increase economic efficiency in the market and allow more mutually beneficial loan transactions to occur."

Commented [RR(10]: Completely unfounded statement.

Benefits and Costs to Covered persons for loan originator qualifications – "Increased consumer confidence," "reduced liability;" increased recruitment, training, and related costs. "Level playing field with depository institutions – refers to as "adverse selection."

Commented [RR(11]: Banks are profit maximizers free to heighten employment standards if in their best interest.

Issues of access are dismissed, rather than analyzed.

12. ***Are costs, benefits, and transfers quantified for each alternative? Does it explicitly identify and account for impacts on credit access and availability?***

    No.

13. ***Are costs, benefits, and transfers monetized for each alternative? Does it explicitly identify and account for impacts on credit access and availability?***

    No.

14. ***Are future costs and benefits discounted to present value using appropriate rates?***

    Nothing to discount.

15. ***Does the analysis identify key sources of uncertainty?***

    Compensation based on terms – Yes. The analysis suggests there is no consensus on effectiveness and the extent and nature of the problem.

16. ***Does the analysis conduct sensitivity analyses for sources of uncertainty?***

    No.

17. ***Was the analysis put out for public comment prior to finalizing?***

    Yes.

18. ***The following questions should be included in a thorough evaluation, but are more difficult, time-consuming, and/or less-objective: Is the analysis transparent and reproducible? Is it transparent in its assumptions? Does it rely on the best available science and evidence? Does it comply with data quality standards?***