The Return of the Wholesale Mortgage Broker

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Who Should Read This?
Residential mortgage lenders that maintain, or may develop, a wholesale lending model, as well as residential mortgage brokers

The prevalence of wholesale mortgage brokers has fluctuated dramatically in the past two decades, peaking in the mid-to-late 2000s due to high homebuyer demand and a comparatively lax regulatory environment, and crashing with the housing market and subsequent financial crisis. The massive overhaul of the financial system, including the Dodd-Frank Act, imposed costly and complicated new requirements on an industry that was already struggling. Among these requirements were loan originator compensation rules that eliminated yield spread premiums, the lifeblood of brokers. The changes came as many banks were already shifting their focus from wholesale channels to direct lending.

Why Read This?

- *Mortgage lenders may be subject to significant regulatory, enforcement, and reputational risk without a strong control framework for their third-party broker network*
- *Mortgage brokers may be subject to significant regulatory and enforcement risk, and may impair their relationships with mortgage lenders, without controls to facilitate compliance with regulatory obligations*

These forces drove many brokers out of business and, for some, fueled an exodus to a mortgage banker model — with former brokers either becoming correspondent lenders (so-called “mini-correspondents”) or joining forces with established mortgage banks as branches. However, in the past few years, wholesale mortgage brokers have re-emerged as independent players in the mortgage loan market because:

- Brokers have become accustomed to the laws and are able to more easily navigate them
- Alternative methods for home financing have rebounded with the housing market
- Correspondent and retail lenders typically make less money, offer fewer products, and have less regulatory flexibility than the wholesale model offers

The Trump administration has taken a different approach than the Obama administration in the supervision and regulation of

the financial services industry — an approach best articulated recently by Consumer Financial Protection Bureau leadership in flatly rejecting what it said was the "push the envelope" governing philosophy of prior leadership. However, states continue to have enforcement authority over mortgage brokers, and some state attorneys general have said they will fill any federal enforcement gap. That should compel lenders and brokers to maintain strong compliance environments. Although lenders approaching this market with strong vendor management programs and high broker standards may initially feel they are at a competitive disadvantage, they should be in a stronger position in the long run, given current and future enforcement, regulatory, and reputational risks.

"MORTGAGE BROKER" DEFINED

Typically, a mortgage broker is an entity or individual that acts as an intermediary between a consumer and a mortgage lender in connection with a mortgage loan. Brokers may perform a number of activities in connection with origination, including advertising, taking applications, checking credit, negotiating terms, and arranging for signatures on documents. Traditionally, mortgage brokers offer loans from multiple lenders and advise borrowers of their options, but it is increasingly common for lenders to get referrals directly from nontraditional sources. For example, many securities broker-dealers partner with lenders, and many lead generators are incorporating mortgage brokerage in their business models.

A mortgage broker can avoid the anti-steering prohibitions by presenting options the consumer will likely qualify for from at least three creditors.

A mortgage broker must actually furnish goods, facilities, or services to be paid, and total compensation must be reasonably related to the fair market value of the goods, facilities, or services provided.[i] In 1999, the U.S. Department of Housing and Urban Development published the Real Estate Settlement Procedures Act Statement of Policy 1999-1, which advises that taking an application and conducting at least five additional services (other than only five "counseling-type" activities) justifies mortgage broker compensation.[ii] While the CFPB now maintains rulemaking and enforcement authority over the RESPA, the HUD statement of policy remains binding in the absence of a CFPB regulation retracting it.[iii]

The definition of "mortgage broker" varies from state to state. In some states, the definition is modeled after the definition of "loan originator" in the Model S.A.F.E. Mortgage Licensing Act published by the Conference of State Bank Supervisors and the American Association of Residential Mortgage Regulators.[iv] The Model SAFE Act provides that a mortgage broker is an individual who, for compensation or gain, takes a residential mortgage loan application or offers or negotiates residential mortgage loan terms. Other states have added the "soliciting" of mortgage loans as a licensing trigger

[i] *See* Real Estate Settlement Procedures Act, 12 U.S.C. § 2607(c).
[ii] *See* U.S. Dep't of Housing and Urban Dev., Real Estate Settlement Procedures Act (RESPA) Statement of Policy 1999-1 Regarding Lender Payments to Mortgage Broker, 64 Fed. Reg. 10080, 10085 (Mar. 1 1999).
[iii] Real Estate Settlement Procedures Act's Regulation X, 12 C.F.R. § 1024.4(a)(1)(ii); Statement of Policy 1999-1, 64 Federal Register at 10084 ("The Department hereby states its position on the legality of payments by lenders to mortgage brokers under the Real Estate Settlement Procedures Act (12 U.S.C. 2601 et seq.) (RESPA) and its implementing regulations at 24 C.F.R. part 3500 (Regulation X). This Statement of Policy is issued pursuant to Section 19(a) of RESPA (12 U.S.C. 2617(a)) and 24 C.F.R. 3500.4(a)(1)(ii).").
[iv] CSBS/AARMR, CSBS/AARMR Model State Law for the Implementation of the S.A.F.E. Act, MSL XX.XXX.030(6)(a)(i) (Oct. 24, 2008), https://mortgage.nationwidelicensingsystem.org/SAFE/NMLS%20Document%20Library/MSL-Final.pdf.

(among other triggers), such that nearly any activity triggers licensure. Thus, industry participants should carefully consider each state's definition of "mortgage broker" and ensure that they comply with applicable law.

VENDOR MANAGEMENT CONSIDERATIONS

The CFPB and other regulators are increasingly inclined to hold mortgage lenders accountable for their mortgage brokers' misconduct. To lower their risk, lenders may require brokers to fulfill certain requirements during onboarding, and submit to their regular oversight and inquiries. In addition to requiring certain representations and warranties in their mortgage broker agreements, lenders may seek to ensure that their brokers understand and comply with applicable legal requirements. This may include lender review of brokers' policies and procedures, compensation plans, training materials, licensing postures, and compliance-management systems.

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MORTGAGE BROKER REQUIREMENTS

Mortgage brokers are subject to many federal and state law requirements, including:

- *Licensing/registration.* Nonbanks that engage in mortgage broker activities and their loan originator employees require state licenses. Currently, every state and the District of Columbia requires licensure at the company, branch, and individual (i.e., mortgage loan originator) levels, unless an exception applies. Most states have modeled their licensing laws after the federal Secure and Fair Enforcement for Mortgage Licensing Act of 2008 or the Model SAFE Act. For companies, the application typically requires submission of formation documents, financial statements, a surety bond, and control person information. For individuals, the license requires completing prelicense education, passing an examination, and submitting to background credit checks. Mortgage broker licensees are subject to a number of state law requirements, including advertising, disclosure, fee, and various reporting requirements.

  Employees of depository institutions and their federally regulated subsidiaries who engage in mortgage broker activities are exempt from state licensing schemes, though they must be federally registered through the Nationwide Multistate Licensing System & Registry. Federal registration is much easier than the state licensing. For example, state license applicants must complete at least 20 hours of prelicense education and pass an examination, but federal registration requires neither. Many mortgage brokers chose to work for depository institutions following the enactment of the SAFE Act in 2008 principally because of these differences.

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- *Truth in Lending Act.* The Truth in Lending Act includes a number of requirements that apply to mortgage brokers. For example, the TILA Loan Originator Rule limits broker compensation, such that brokers generally cannot be compensated based on any term other than loan amount (with certain exceptions for bonuses, retirement plans, and other compensation plans that are based on mortgage-related profits).[v] Many former brokerages that became lender "branches" following the financial crisis are defecting to again become brokerages to avail themselves of various mortgage lenders' loan originator compensation plans. The LO Rule's anti-steering prohibitions are designed to prevent mortgage brokers from directing a consumer to a specific lender simply because the mortgage broker would receive higher compensation from the lender. However, a mortgage broker would not run afoul of the anti-steering prohibition so long as placement of a loan with a particular lender does not result in the consumer receiving less advantageous loan terms, compared with other loans offered through the broker.[vi] A mortgage broker can avoid the anti-steering prohibitions by presenting options the consumer will likely qualify for from at least three creditors with which the broker regularly does business, for each type of loan the consumer expresses an interest in, and including options with (i) the lowest interest rate; (ii) the lowest interest rate on a loan without certain specified features (negative amortization, balloon payment, etc.); and (iii) the lowest total dollar amount of discount points, origination points or origination fees (with certain variations). Having a variety of compensation plans from which to choose helps mortgage brokers maximize their compensation.

  Also, under the LO Rule, individual mortgage brokers who are not state-licensed (and who are not required to be state-licensed) must be "qualified" (i.e., they must pass background and credit checks, as well as complete periodic training covering certain federal and state law requirements).[vii]

  Another example is the TILA/RESPA Integrated Disclosures Rule, commonly referred to as TRID, which requires the creditor or broker to deliver or mail a loan estimate no later than the third business day after receiving the consumer's application. Although a mortgage broker can satisfy the creditor's obligation to provide a loan estimate, the creditor remains legally responsible for errors or defects, and is expected to maintain communication with the broker to ensure that the estimate and its delivery satisfy requirements. Brokers providing the estimate must comply with the rule's three-year record retention requirement.[viii]

- *Loans insured by the Federal Housing Administration.* A mortgage broker not approved by the FHA may nonetheless originate an FHA-insured loan as long as it is sponsored by an FHA-approved

[v] Truth in Lending Act's Regulation Z, 12 C.F.R. § 1026.36(d).
[vi] Truth in Lending Act's Regulation Z, 12 C.F.R. § 1026.36(e)(1)(ii); CFPB Commentary — Supplement I to Part 1026, comment 36(e)(1)-3.
[vii] *See id*. at (f).
[viii] Truth in Lending Act's Regulation Z, 12 C.F.R. § 1026.19(e)(1)(ii); CFPB Commentary — Supplement I to Part 1026, comment 19(e)(1)(ii)-1, -2.

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mortgagee with direct endorsement authority. These third-party originators, or TPOs, may not close loans in their own names, but may originate loans underwritten by their sponsors. Sponsors are required to register their TPOs (or confirm their registration) in FHA Connection. They also are required to ensure that their TPOs comply with state licensing requirements and that they and their officers, partners, directors, principals, managers, supervisors, loan processors, and loan originators are not ineligible under applicable regulations.

- *Net branching.* States and the FHA generally prohibit net branching (i.e., an arrangement whereby a licensee permits a separate company or branch to engage in activity under the authority of its license) in order to prevent a company or branch that the state has not vetted to effectively "rent a license." For example, states may conclude a net branching arrangement exists if:
  - The licensee does not pay for the operating expenses or employee compensation for a particular location
  - The branch manager leases the premises
  - The branch manager has control of a corporate checkbook
  - The branch manager has the power to hire or fire personnel
  - All contractual relationships with vendors are in the name of the branch[ix]

Social media. More than ever, mortgage industry players are leveraging social media to grow their businesses. Importantly, online and social media content generally must comply with the same laws and regulations as print advertising (e.g., fair lending, TILA, RESPA, consumer privacy, state-specific requirements). For example, advertising on social media must display appropriate license information. Social media sites also should not contain negative or defamatory comments concerning competitors, customers, or third parties. Mortgage brokers should carefully review Federal Financial Institutions Examination Council guidance designed to help financial institutions understand potential consumer compliance, legal, reputational, and operational risks associated with social media.[x]

[ix] *See,* e.g., State of North Carolina Office of the Comm'r of Banks, Declaratory Ruling 2003-1 Concerning the Mortgage Lending Act, p. 3-4 (Nov. 6, 2003), https://www.nccob.gov/public/docs/financial%20institutions/mortgage/declaratoryruling2003_01netbranching.pdf; *see also* U.S. Dep't of Housing and Urban Dev., Handbook 4000.1 I.A.4.d. (Sept. 14, 2015).

[x] *See* Fed. Fin. Insts. Examination Council, Social Media: Consumer Compliance Risk Management Guidance (Notice: Final) (Dec. 2013), https://www.ffiec.gov/press/PDF/2013_Dec%20Final%20SMG%20attached%20to%2011Dec13%20press%20release.pdf.