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FRB Bans Mortgage YSPs and Steering, Restricts Other Originator Compensation

The Federal Reserve Board has adopted new rules to restrict steering in dwelling-secured mortgages (except time-shares) by setting limits on compensation to mortgage “originators”—in-house loan originators and mortgage brokers.¹ Effective April 1, 2011, creditors may not base in-house originator or broker compensation on any loan term except the amount borrowed. Yield-spread premiums are typically based on the interest rate. The rule also bans originators from steering borrowers to creditors based on what the creditor will pay the originator.

The new rule is similar to (but substantially narrower than) provisions in the Dodd-Frank Wall Street Reform and Consumer Protection Act² that add new restrictions on loan originator compensation and steering to TILA. Additional rulemaking will be necessary to implement Dodd-Frank and to align Dodd-Frank’s provisions with the FRB’s new rule, and the Dodd-Frank changes will not be effective until those rules are enacted and set an effective date. This article discusses only the FRB’s new rule.

Definition of Loan Originator

The Board defines loan originator as anyone who “arranges, negotiates, or otherwise obtains” a loan for someone else for compensation.³ This includes employees of a creditor, as well as employees of a mortgage broker. One loan transaction is enough to become subject to the rule. A mortgage broker is defined as “any loan originator that is not an employee of the creditor” for a particular transaction.⁴ Creditors can also be loan originators under the rule if they use third-party funding through a table-funded transaction.⁵ Creditors that fund their own loans are not originators under

the regulation.⁶ All subsidiaries of a single parent company must be paid on the same basis.⁷

Restrictions on Originator Compensation

The rule prohibits creditors from paying originators based on the terms or conditions of a transaction, other than the amount borrowed, although there is an exception to allow some upfront costs to be paid through the rate.⁸ Creditors may not evade the rule by using substitutes for loan terms, such as using a borrower’s credit score or debt-to-income ratio as a proxy for the interest rate.⁹ Payments for bona fide and reasonable third-party charges made to the originator are not considered compensation under the rule.¹⁰ However, compensation does include any amount the originator retains. Courts must look to the substance of a fee rather than how the fee is described on the HUD-1.¹¹

Originators may receive compensation from the creditor or the consumer but not both in the same transaction. Anyone who knows or has reason to know a consumer is directly paying the originator may not directly or indirectly pay the originator any additional compensation.¹² The staff commentary includes numerous examples to illustrate the rule.¹³

Anti-Steering Rules and Exceptions

The new rule prohibits originators from steering consumers to one transaction over another based on how much the creditor will pay the originator, unless the consummated transaction is in the consumer’s interest.¹⁴ Notably, the exception does not require the transaction to be in the consumer’s “best” interest. The Board provides guidance on the “consumer’s interest” test, including a questionable example suggesting a higher-rate loan may be in a consumer’s best interest when compared to a lower-rate loan with a prepayment penalty.¹⁵

⁶ Reg. Z § 226.36(a)(1).

⁷ Reg. Z § 226.36(d)(3). OSC § 226.36(d)(3)-1.

⁸ Reg. Z § 226.36(d); OSC § 226.36(d)(1)-4 (describing flexibility granted to creditors to allow partial financing of up-front closing costs). Compensation is defined broadly to include any bonuses, or awards of merchandise, services, trips or similar prizes. OSC § 226.36(d)-1. Payments made by secondary market investors to the creditor for loan sold after closing are not covered by this rule. 75 Fed. Reg. 58,517 (Sept. 24, 2010) (supplementary information accompanying announcement of final rule).

⁹ OSC § 226.36(d)(1)-2.

¹⁰ OSC § 226.36(d)(1)-1(iii). The Commentary also provides several examples of compensation based and not based on transaction terms or conditions. For example, third-party charges are not included if they are bona fide and reasonable, but if the originator marks up a third-party charge and retains the difference between the actual charge and the marked up charge, the amount retained is compensation. *Id.*

¹¹ OSC § 226.36(d)-1(ii).

¹² Reg. Z § 226.36(d)(2).

¹³ OSC § 226.36(d)(1).

¹⁴ Reg. Z § 226.36(e)(1).

¹⁵ See OSC § 226.36(e)(1)-3.

¹ 75 Fed. Reg. 58,509 (Sept. 24, 2010), 12 C.F.R. § 226.36(d), (e). The Board initially instead proposed disclosure regulations, 73 Fed. Reg. 1672 (Jan. 9, 2008), but withdrew the proposal after its own testing showed disclosure was ineffective. 73 Fed. Reg. 44,522, 44,563-65 (July 30, 2008).

² Pub. L. No. 111-203, 124 Stat. 1376 (July 21, 2010).

³ Reg. Z § 226.36(a)(1).

⁴ Reg. Z § 226.36(a)(2).

⁵ Official Staff Commentary § 226.36(a)-1(ii) (hereinafter cited as OSC).

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The anti-steering rule also provides originators with a safe harbor. An originator is deemed in compliance with the steering rule if it presents the consumer with several loan options for each loan type (i.e., fixed APR, adjustable APR, or reverse mortgage) the consumer has expressed interest in.¹⁶ The options must include loans with the:

- Lowest rate;
- Lowest rate without negative amortization, a prepayment penalty, interest-only payments, a balloon payment in the first seven years of the life of the loan, a demand feature, shared equity, or shared appreciation (or for reverse mortgages, a loan without a prepayment penalty, shared equity, or shared appreciation); and
- Lowest total dollar amount for origination points or fees and discount points.¹⁷

In addition, the originator must obtain these options from a significant number of the creditors the originator regularly does business with and must have a good-faith belief that the consumer is likely to qualify for the options.¹⁸ The Commentary further says, if the originator cannot form such a good-faith belief, the originator can still fit the safe harbor “by presenting all loans for which the consumer likely qualifies and that meet the other requirements in § 226.36(e)(3)”¹⁹

Remedies for Violations of New Rule

Because the Board implemented this rule under 15 U.S.C. § 1639,²⁰ creditors who violate the limits on paying originator compensation should be liable for actual, statutory, and enhanced damages as well as attorney fees.²¹ The same should be the case for table-funded creditors who violate the limits on *receiving* originator compensation.

Creditors are not subject to the steering rule, unless they also act as an originator. When they act as originators and violate the rule, they are subject to TIL private remedies. Less clear are TIL remedies where a mortgage broker violates the steering rule, because the language of TILA’s remedy provisions refers to creditors and assignees.

Mortgage brokers violating TILA’s steering provisions may potentially be liable for violations under state UDAP laws. Originators, such as mortgage brokers, are generally considered to be offering a service rather than extending credit. Therefore state UDAP laws should apply even in those states providing an exemption for creditors or credit.

One UDAP claim may be that the originator acted unfairly and deceptively by violating an FRB regulation designed to protect consumers. A stronger claim, however, may be to raise the inherently deceptive nature of the originator’s conduct, such as failing to disclose that a loan is more expensive than others the broker could have arranged. It is clearly deceptive to promise but fail to obtain the best rate or least expensive loan.

¹⁶ Reg. Z § 226.36(e)(2).

¹⁷ Reg. Z § 226.36(e)(3)(i).

¹⁸ Reg. Z § 226.36(e)(3)(i)–(ii).

¹⁹ OSC § 226.36(e)(2)–2.

²⁰ 75 Fed. Reg. 58,509 (Sept. 24, 2010).

²¹ 15 U.S.C. § 1640(a)(1)–(4).

Remedies for TIL Credit Card and Open-End Credit Violations

In recent years there have been numerous changes to how TILA and Regulation Z treat open-end credit, especially credit cards. While there are many new substantive and disclosure requirements, not all have a private right of action. This article summarizes those that do. NCLC’s *Truth in Lending* (7th ed. Dec. 2010) goes into greater detail in Chapters 6, 7, and 11 (renumbered since the 6th edition). When evaluating a case, it is important to recognize that the Act and Regulation Z sometimes distinguish between open-end credit secured by the consumer’s home (typically home equity lines of credits, or HELOCs) and open-end credit that is either unsecured or secured by some other collateral. Some rules overlap and some do not. The FRB is currently considering additional changes to Regulation Z’s treatment of HELOCs.

Remedies for Disclosure Violations

This section provides a quick overview of private remedies for violations of TILA’s disclosure rules for open-end credit and credit cards. Actual damages and attorney fees are available for any violation of the disclosure requirements for this type of credit, except credit advertising.²² Rescission may be available for some transactions secured by the consumer’s real property.²³

Statutory damages are available for all of the open-end disclosure provisions in Part B (§§ 1631–1651) except for certain periodic statement disclosures. Thus, statutory damages are available for:²⁴

- All of the account-opening disclosure provisions (15 U.S.C. § 1637(a));²⁵
- Selected periodic statement disclosures (15 U.S.C. § 1637(b))
 - (4) Finance charge;
 - (5) Periodic rates;
 - (6) Annual percentage rate;
 - (7) Computation of finance charge;
 - (8) Closing balance;
 - (9) Payment date to avoid finance charge;
 - (10) Billing error address;
 - (11) Minimum payment disclosures;²⁶
 - (12) Due date and late payment disclosures.²⁷
- All application or solicitation disclosures (15 U.S.C. § 1637(c)) if the cardholder either uses the card or pays any periodic, annual, membership, activity, or inactivity fee;
- All renewal disclosures (15 U.S.C. § 1637(d)) if the cardholder either uses the card or pays any periodic, annual, membership, activity, or inactivity fee.

Remedies for Violations of TILA’s Substantive Provisions

Actual damages, statutory damages, and attorney fees are available for any violation of the substantive protections for

²² 15 U.S.C. § 1640(a)(1).

²³ See 15 U.S.C. § 1635.

²⁴ 15 U.S.C. § 1640(a) (second sentence of paragraph following (a)(4)).

²⁵ See *Villasenor v. American Signature, Inc.*, 2007 WL 2025739 (N.D. Ill. July 9, 2007) (statutory damages are available for violations of § 1637(a)).

²⁶ Effective February 22, 2010, as amended by Pub. L. No. 111-24, § 201(b), 123 Stat. 1736 (May 22, 2009).

²⁷ *Id.*

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