From: Summit Mortgage Corporation, Dan Hughes

Subject: Reg Z - Truth in Lending

Comments:

Date: Oct 19, 2009

Proposal: Regulation Z - Truth in Lending - Closed-end Mortgages
Document ID: R-1366
Document Version: 1
Release Date: 07/23/2009
Name: Dan Hughes
Affiliation:
Category of Affiliation:
Address: Summit Mortgage Corporation
City:
State:
Country:
Zip:
PostalCode:

Comments:

Thought experiment: Imagine that ABC Bank of Columbia, SC wanted to open a mortgage origination branch in Dillon, SC to better serve the people of Dillon. In keeping with the spirit of Fed proposal 1336, they intend to charge any/all borrowers a flat origination fee of $2,000 per mortgage loan, with any yield spread premium and/or service release premium to be disclosed to and available to the borrower to offset the origination fee and/or other closing costs. Let us further imagine that the ongoing cost to operate said branch totals $10,000/month (for office rent, phones, utilities, computer support, insurance, one full-time loan processor''s salary, etc.). The exact numerical figures of this thought experiment are not as important as the concepts. Lastly, let''s imagine that ABC Bank of Columbia hires a full-time commissioned loan originator (as most originators in this country are paid) to work at the new Dillon branch, with the originator''s compensation to be 50% of the after-expenses revenue to the branch. If the originator originates 10 loans in a given month, the gross income is $20,000, the after-expenses branch income is $10,000 and his income for that month is $5,000 (or $500/loan). If the originator originates 20 loans, the gross income is $40,000, the after-expenses branch income is $30,000 and the originator''s income for the month is $15,000 (or $750 per loan). If the originator originates five loans in a given month, the gross branch income is $10,000, the net branch income is $0 and the originator''s pay is $0. How can the above disparity in net per-loan originator compensation be accomodated with or reconciled to the specific requirement of Fed proposal 1336 which demands that originators'' pay be based upon an immutable predetermined pay structure? Mortgage origination, like other forms of sales, has traditionally been primarily a commissioned job precisely because the overall profitability of a mortgage company or mortgage origination branch is so heavily dependent upon the initiative of the originator. Fed proposal 1336 necessarily uncouples the normal commission structure that has arisen naturally over decades. The proposal could only be readily accomodated by, on the one hand, "lone wolf" broker-originators operating out of their car trunk or, on the other hand, large banks with salaried (and therefore

disinterested) "originators" working on the other end of a 1-800 #. Any other corporate structure operating between these two extremes cannot accomodate the arithmetic paradoxes that will naturally arise (as shown above). The result would be that ABC Bank of Columbia could not risk of running afoul of Fed Reserve proposal 1336 by opening the mortgage origination branch in Dillon, SC. Paying any originator according to a predetermined immutable commission structure without regard to branch profitability would risk an ongoing financial loss to the bank. Paying an originator in such a way that would take branch profits (or losses) into account would be a direct contravention of Fed proposal 1336. ABC Bank would, in all likelihood, choose to forgo opening the Dillon branch, leaving the people of Dillon with their only mortgage loan sources being the lone wolf broker or the disinterested operative of a big bank call center. Would the people of Dillon be well-served by such a bifurcated mortgage environment? I would answer "no". It''s relatively easy to mandate how originators be paid. It''s much more difficult to foresee the unintended consequences of such a mandate. The above example of ABC Bank''s Dillon branch is only the first of many easily imagined situations that demonstrate that proposal 1336''s requirement for predetermined immutable originator commissions (without regard to the profit or loss on a loan or a series of loans) is entirely untenable given the widely variable bookkeeping structures that exist in the vast majority of mortgage companies. And even if such pernicious effects could somehow be justified (which they cannot), ensuring compliance would require an expensive and unparalleled intrusion into the mortgage and banking businesses.

Comments:
As it relates to originator compensation, Fed proposal R-1366 can be summed up as follows: an originator must be compensated according to a predetermined and immutable pay structure, wholly ignoring the profit or loss that the originator brought about for their employer on a particular loan or series of loans. This would create a perverse situation where a commissioned originator is incented to originate loans at a loss to their employer, secure in the knowledge that not only will they not be required to share in the loss, they will be paid a full commission despite the loss. For example, a loan officer whose commission structure were $1,000 per closed loan would have an incentive to say to a large homebuilder, "if you refer your home buyers to me, I will give them a fixed rate 1% below the prevailing fixed rate". Such a policy could create a significant (perhaps life-threatening) loss to that originator''s employer (the creditor), but the creditor would be obliged to pay the originator according to the predetermined immutable pay structure. The creditor''s only recourse in such a case of willfully created losses by its own originator employee would be to fire the originator. That constitutes an insufficient restraint to a situation that could cause serious financial risk to creditors, including federally-regulated banks. If the prospect of being fired were enough to dissuade commissioned employees from taking financial risks that could threaten the viability of their employer, the London office of AIG would not have created losses to AIG that subsequently required a massive bailout by the US government. It it odd indeed that this proposal that so endangers the financial stability of banks and other creditors has been formulated by the Federal Reserve itself, among whose primary duties is ensuring the financial stability of those very banks.