STRATMOR GROUP
Consulting
Investment Banking

WEINER
BRODSKY
SIDMAN
KIDER PC

December 24, 2009

Ms. Jennifer Johnson
Secretary, Board of Governors
Federal Reserve System
20th Street & Constitution Avenue, NW
Washington, DC 20551

Re: Docket No. R-1366

Dear Ms. Johnson:

This letter responds to the Federal Reserve's (the "Board") proposed rules addressing the compensation of mortgage loan originators.[1] It has been prepared by the law firm of Weiner Brodsky Sidman Kider PC and The STRATMOR Group, a leading mortgage industry consulting firm, based on substantive discussions occurring during three workshops (Washington, D.C., Chicago and Los Angeles) held in late October and early November attended by a total of 58 lenders (see Attachment A).

Fifteen (15) lenders have chosen to sponsor the preparation of this letter and endorse its contents (see Attachment B). However, we believe that most of the lenders who have not "signed-on" to this letter would support most its content, but have elected to communicate their thoughts either directly to the Board or through other industry organizations.

The spirit in which this letter has been prepared is one of cooperation. Our shared purpose is not to deny the significance of the problems being addressed by the Board, but to consider how best to address them in ways that reflect sound public policy. But based on serious analysis, we have found significant problems and, we think, unintended consequences with the proposed rules. These findings have led us to suggest significant modifications to the Board's proposals and other strategies designed to achieve the common goal of assuring that the mortgage industry deals with consumers in an open, fair and ethical fashion.

---

[1] Federal Register/ Volume 74, No. 164/ Wednesday, August 26, 2009/ §226.36

I. Summary of the Board's Proposed Rules

To address its concerns regarding abusive loan originator practices, the Board's proposed rules contain two alternatives regulating the compensation of loan originators plus rules prohibiting "loan steering" by loan originators. Under both compensation alternatives, a loan originator would be able to receive compensation from either the creditor or the borrower -- but not both. A broker therefore would have to choose between accepting compensation from the lender or directly from the borrower.

A. Compensation Alternative One

Under Alternative One, the Board has proposed that, in connection with a consumer credit transaction secured by real property or a dwelling, no loan originator shall receive and no person shall pay to a loan originator, directly or indirectly, compensation in an amount that is based on any of the transaction's terms or conditions.

As used by the Board, a "person" includes lenders as well as other actors in the lending process, such as consumers and secondary-market investors. And, in addition to commissions, loan originator compensation would include salary, annual or periodic bonuses, and awards of merchandise, services, trips or similar prizes.

The Board defines a "loan originator" as a person who, for compensation or other monetary gain, or for the expectation of compensation or other monetary gain, arranges, negotiates, or otherwise obtains an extension of consumer credit for another person. This definition includes employees of a creditor, e.g., traditional loan officers, and mortgage brokers, including brokers whose loans are table funded by a creditor and broker employees who meet the definition of a "loan originator."

Alternative One stipulates that compensation paid to loan originators could no longer be based on a loan's principal amount, interest rate, product type and other loan terms such as a prepayment penalty or loan-to-value ratio. Conversely, a loan originator's compensation could take into account factors that are independent of individual loan terms and conditions. Such factors could include the number of loans originated, long term loan performance, hours worked and whether the borrower was an existing customer or a new customer.

The Board's proposed rule does not preclude "compensation that differs by geographical area" but goes on to say that: "Creditors that use geography as a criterion for setting originator compensation would need to be able to demonstrate that this reflects legitimate differences in the cost of origination and in the level of competition for originators' services."

Periodic revision of fees paid to loan originators by lenders would be allowed, but not if it results in go-forward payments based on the terms and conditions of a loan or in connection with each transaction.

B. Compensation Alternative Two

Alternative Two differs from Alternative One insofar as it would permit compensation based on the loan amount. In other words, for purposes of Alternative Two, the principal amount of the credit extended would not be deemed a transaction term or condition. All other Alternative One rules are retained by Alternative Two.

C. Proposed Prohibition on Loan Originators "Steering" Consumers

The Board contemplates that loan originators (brokers) would still be able to offer loans from different lenders. However, loan originators would not be able to "steer" consumers to loans from certain creditors solely in the interest of increasing their commissions.

In this regard, however, a loan originator could achieve a "safe harbor" against an allegation of steering by presenting a prospective borrower with at least three loans for each transaction type in which the consumer is interested (e.g., a fixed-rate loan or an ARM loan).

To achieve this safe harbor, however, the three loans presented to the borrower must include: (a) the loan with the lowest interest rate; (b) the loan with the second lowest interest rate; and (c), the loan with the lowest total dollar amount for origination points or fees and discount points, as offered by the creditors.

The way in which this "anti-steering" provision is worded suggests that it is aimed at eliminating situations involving the same loan type in which a loan originator --- primarily brokers --- steers the consumer to a specific creditor for purposes of increasing their commission.

While such steering practices should indeed be proscribed, we would note that in its most pernicious form, "steering" involves placing a consumer in a loan product that is "unsuitable" or "inappropriate" for the consumer, but results in a higher commission for the loan originator. An example of this would be where a consumer is put into a subprime loan when, in fact, they could qualify for a less costly Agency or government loan.

II. Board's Basis for Proposal and Objectives

A. Board's Basis for This Rule

The Board has rightfully concluded that many borrowers do not understand the relationship between the interest rate on their loan and the compensation received by the loan originator. The industry has acknowledged that there have been situations where loan originators and brokers have taken advantage of unsophisticated borrowers.[2]

The proposal targets three practices that may permit loan originators to take advantage of the unsophisticated consumer who is not aware of market rates for mortgage loans--yield spread premiums, overages and steering.

- Yield Spread Premiums. Yield spread premiums provide for a broker to receive compensation from the lender. Currently, the broker has the ability to obtain its compensation from the lender, the borrower or both. Yield spread premiums permit the broker to negotiate and establish a loan rate with the borrower, determining the broker's compensation and determining the borrower's cost for closing.

- Overages. Overages permit an employee to negotiate a rate with a consumer and to receive some financial benefit from the value a higher interest rate represents to the employee lender.

- Steering. Steering involves a loan originator directing or encouraging an applicant to accept a loan that provides greater compensation to the loan originator when the loan may not be in the consumer's best interest.

B. Board's Concerns and Presumptions

In connection with all three practices, the Board is concerned that the lender compensation to the broker or employee is not transparent to the borrower. The borrower does not know the absolute lowest interest rate the lender would be willing to take at a particular point in time and is unaware that points or fees paid may enhance the loan originator's compensation. A borrower who is unaware of market rates may assume he or she is getting the lender's lowest possible rate.

[2] Ironically, both alternatives would prevent the broker from taking advantage of an unsophisticated borrower by receiving compensation in excess of the most competitive market amounts from the lender, but neither alternative would prohibit a broker from taking advantage of an unsophisticated borrower by receiving compensation in excess of the most competitive market amounts directly from the borrower.

The Board is also concerned that brokers and lenders cultivate an attitude or belief about consumers that the loan originator is a trusted advisor or financial advisor looking out for the best interests of the consumer.

Further, as we understand the Board's position in proposing these alternatives, the Board has made the following assumptions:

- Current loan originator compensation practices are an unfair and deceptive practice.[3]
- To the extent that compensation practices are unfair and deceptive, the injury to consumers cannot be avoided by disclosures or education of the customers.[4] Unlike any other transaction in which the borrower purchases goods or services, the consumer cannot effectively shop for the best rate, the best terms, or the most appropriate loan product.[5]
- Unlike any other transaction in which the borrower purchases goods or services, the complexity of the mortgage transaction and the infrequency with which the consumer acquires mortgage services and the attitude of borrowers to brokers and loan originators, makes it impossible to educate consumers regarding interest rates and fees associated with the mortgage.[6]

---

[3] The Board states: "As noted above, the Board is now proposing rules to prohibit certain practices relating to payments made to compensate mortgage brokers and other loan originators. These rules would be adopted pursuant to the Board's authority under HOEPA, as contained in TILA Section 129(l), which authorized the Board to prohibit acts or practices in connection with mortgage loans that the Board finds to be unfair or deceptive." 74 FR 43281.

[4] The Board states: "Furthermore, based on its experience with consumer testing, particularly in connection with the HOEPA proposal, the Board believes that the disclosure alone would be insufficient for most consumers to avoid the harm caused by this practice." 74 FR 43281.

[5] The Board states: "The Board's recent consumer testing also suggests that many consumers shop little for mortgages and often rely on one broker or lender because of their trust in the relationship."

[6] The Board states: "Consumers generally lack expertise in complex mortgage transactions because they engage in such mortgage transactions infrequently." 74 FR 43282. The Board states: "The Board's recent consumer testing also suggests that many consumers shop little for mortgages and often rely on one broker or lender because of their trust in the relationship." 74 FR 43280.

We respectfully disagree with many aspects of the Board's presumptions and with the conclusion that the only method for addressing this issue is to take the drastic step of regulating the essential compensation relationship present in the industry. In Section III, we seek to demonstrate why the Board's presumptions and conclusions regarding this issue are incorrect and why further information is needed. In Section IV of our comments, we seek to show the unintended economic consequences of this rule.

III. Analysis of Board's Basis and Presumptions

In addition to the economic and other potential unintended consequences describe in Section IV of this comment letter, we believe that the underlying presumptions and basis for this portion of the proposed rule is deficient.

A. Standard for Determining that Practices Are Unfair and Deceptive

The Board's proposed rules governing loan originator compensation are founded on a presumption that the practices of loan originators are unfair and deceptive. The Board purports to follow the FTC standard with respect to what is unfair and deceptive. Specifically, the Board states: "A practice is considered unfair when it causes or is likely to cause substantial injury to consumers that are not reasonably avoidable by consumers themselves. . ."

However, we would point out that the FTC Act provides for far more rigorous and well developed processes for determining what acts or practices are "unfair" than the process followed by the Board in making this conclusion. These more rigorous processes should be considered by the Board before reaching the conclusion that the compensation of loan originators is an unfair practice.

Before the FTC can declare by rule that a practice is unfair, it must publish an advanced notice of proposed rulemaking giving interested parties the opportunity to provide alternatives and suggestions to the FTC. The FTC must "define with specificity those acts or practices which are unfair or deceptive acts or practices in or affecting commerce." Further, the FTC must provide for informal hearings at which interested parties are accorded the right to cross examine the persons who are seeking to establish the basis for the rule. This form of rulemaking was designed to make certain that there were not alternatives to a rule and that a rule was based on sound data and understanding of the problem.

In the present situation, it is our view that the Board could have benefited for giving the industry and consumer representatives advance notice that this proposal was coming. The industry has had no opportunity to conduct studies to support or challenge the data relied upon by the Board, to determine the effect of such a proposal on the

competitive balance in the industry, or to better prepare to comment on and address this unprecedented intrusion into the ability of an employer to compensate an employee, or for parties to contract in a business relationship.

Further, the Board has done nothing to define the unfair practice with specificity. In this situation, the Board has done no rigorous studies to define or determine the extent to which loan officer compensation causes damage to consumers. Rather, the Board's action seems to be based exclusively on one minor study[7] and unsupported testimony of consumer advocates seeking to promote their own agenda and relating only to subprime lending coupled with relatively isolated incidences where lenders and loan officers took advantage of unsophisticated consumers. The Board has no evidence to show that the vast majority or even a significant percentage of borrowers are harmed by current compensation practices (i.e., the evidence necessary to show substantial injury). The Board has no evidence to show how frequently consumers pay a higher than market rate of interest or what market rates of interest would be absent current compensation practices.

Finally, the industry will have no opportunity to cross examine or to probe the basis for this rulemaking for the obvious reason that the Board has not presented any significant data to support its conclusions.

In summary, we believe that the Board has not done the necessary background work to support its presumptions and conclusions. In short, the Board does not have a basis for concluding that current loan officer compensation practices are an unfair act or practice.

B. Consumers Ability to Avoid Injury

The Board has concluded that the consumer cannot avoid any injury caused by loan officer compensation practices. This conclusion ignores the obvious fact that the consumer always has the ability to shop for loan rates and terms. The Board has no substantial evidence that consumers cannot be educated to shop for the best interest rate. This assumption that the consumer cannot avoid injury cannot be demonstrated in connection with shopping for a loan any more than it can be demonstrated with respect to shopping for automobiles, home repair services or big screen TVs. Loan originator compensation should not be the focus of the Boards effort to educate consumers. The focus should be on proper disclosures and education that enables the borrower to shop for the best loan. In shopping for a TV, the borrower must make a decision about various features, types of screens, suitability of the TV for the borrower's home and price. Knowledge of loan officer compensation is no more important than knowledge of the compensation paid to the TV salesman. The borrower's decision

[7] Consumer Testing of Mortgage Broker Disclosures (July 10, 2008).

should be based on loan features, suitability of the loan product and price or interest rates.

The Board seems to assume that the vast majority of consumers blindly accept the advice and direction given by the loan originator and that all loan originators take advantage of this situation. The Board states: "In a 2003 survey of older borrowers who had obtained prime or subprime refinancing, majorities of respondents with refinance loans obtained through both brokers and creditor's employees reported that they had relied "a lot" on their loan originators to find the best mortgage for them." This is the kind of statement that should be subject to cross examination, further study and further review. Many buyers would rely "a lot" on the advice and guidance of a TV salesman to help them sort through the complicated features and type of screens available. That does not necessarily mean that they would not have any awareness that the employee is working on commission or that he would make more for selling the more expensive TV. Further, it doesn't demonstrate whether or not the respondents would have had sufficient information regarding market rates to effectively use the advice of the loan originator. Finally, it does not take into account that the vast majority of loan originators do provide effective and valuable education and loan advice to applicants.

As stated above, we believe the Board lacks sufficient evidence to conclude that the vast majority of consumers suffer any injury. Further, we believe the Board has no evidence to support the conclusion that consumers cannot avoid any potential injury.

C. Borrower's Cannot be Educated

The Board has concluded that the complexity of the loan transaction, the infrequency of loan purchases and the relationship between loan originators and the reliance of the borrower on one lender or loan originator make it impossible to disclose or otherwise educate the borrowers with respect to lender compensation. In our view, the Board has prematurely reached this conclusion.

First, as we have asserted, we do not believe the Board has any evidence to support its conclusion that most borrowers do not understand that the broker and loan officers are receiving compensation based on the loan amount or the interest rate on the loan.

The Board may have a legitimate concern that when a broker charges a small fee to the borrower, the borrower may assume that the fee represents the broker's total compensation. However, this issue could be addressed with a far less intrusive rule than the one proposed. For example, the Board could provide that brokers could accept compensation from the lender or the borrower, but not both.

With the exception of this concern, we believe the Board's conclusion with respect to the borrower's understanding or ability to understand is extremely overboard. This

conclusion seems based primarily on the Consumer Testing of Mortgage Broker Disclosures (July 10, 2008) conducted by Macro International, Inc.

This testing only marginally supports the Board's conclusion because it had a very narrow focus and did not involve borrowers actually in the process of shopping for a mortgage. The four rounds of test included only 35 interviews and only one type of document. Thirty five interviews is not statistically significant or an adequate test. The test did not test borrower's awareness or understanding of market rates for mortgage loans. The tests did not determine if the borrower's had paid above market rates for their loan.

The type of document tested focused on the relationship between interest rates and broker compensation. The Board tested no other type of disclosure. We believe there are other types of disclosure documents that can and should be tested. For example, a disclosure designed to educate the borrower on the role of the broker or loan originator should be tested. Such disclosures are used successfully in many jurisdictions with respect to the role of real estate brokers and their representation of sellers and buyers. Another type of disclosure that should be tested is the disclosures that will be implemented January 1, 2010, by HUD in connection with the new RESPA Good Faith Estimate. This disclosure will allow borrowers to see more clearly the rate and charges associated with a loan, to become educated on the relationship of those charges and to more effectively comparison shop for loans. Finally, the disclosures now under consideration by the Board should be tested.

The disclosures and consumer education should not be based on the compensation that creditors, mortgage brokers, loan officers, or anyone else in the mortgage supply chain receives. Such information should ***not*** be relevant to a consumer shopping for a mortgage loan. What ***is*** relevant is the pricing that has been quoted to the consumer. If a consumer receives a clear, accurate and timely disclosure setting forth the interest rate, the monthly principal and interest payment, closing costs and other key loan terms, then such consumer will be fully equipped to effectively shop. We note that the consumers who were tested after receiving a disclosure telling them that shopping is important said that they did indeed understand the importance of shopping.

As noted above, the fact that a consumer may believe that the broker is shopping for the consumer exclusively may indicate a need for greater transparency with respect to broker compensation. It hardly leads to a conclusion that an industry's long established compensation practices should be turned on their head in a risky social and economic experiment.

In summary, we believe that other types of disclosures, such as the disclosures in the current proposal, and other means of education should be tested or tried before the Board takes the drastic action proposed.

D. Other Industry Changes and Disclosures That Will Reduce Abuses

In our view, the Board's proposal regarding loan originator compensation does not take into account the myriad of other regulations and changes in the industry that will provide additional and adequate protection for consumers. The list of such changes is long and includes:

1. *Mortgage Disclosure Improvement Act ("MDIA")*

The Board's own amendments to Regulation Z effective only as of July 1, 2009, implementing MDIA provide, for the first time, for the borrower's ability to obtain loan information at a time when the borrower can still effectively shop for loan terms. By prohibiting a lender from collecting any fee other than a small credit report fee until disclosure are provided, borrowers are now able to obtain loan information for comparison shopping. In adopting this Act and amendment, Congress and the Board expressed faith in the ability of the borrower to make good decisions based on the availability of information. The current proposal expresses the opposite conclusion.

2. *Amendments to RESPA Regulation X*

These amendments, effective January 1, 2010, support the shopping for loan terms consistent with the Board's amendments to Regulation Z by requiring the Good Faith Estimate of settlement costs to be provided before any significant fee can be charged. Further, the new Good Faith Estimate and HUD-1will require disclosure of an "Our Origination Charge" which will capture all of the compensation to be received by the broker through yield spread premium. This will serve to highlight this compensation and encourage borrowers to be aware.

3. *S.A.F.E. Mortgage Licensing Act*

This Act provides, for the first time, the effective regulation of loan originators at the state and federal level. Licensing and education requirements for loan officers will help state regulators to effectively eliminate those loan officers who are involved in fraud and abuses. Many of the state licensing statutes or amendments to state licensing requirements are only recently effective or soon to be effective. Once up and running, licensing statutes will give state regulators stronger ability to ensure the elimination of loan officers who commit abuse.

4. *Amendments to Regulation Z re: "Higher Priced Mortgage Loans"*

These amendments effective October 1, 2009, regulate the higher priced loans that were often the subject of abuse over recent years. Lenders will no longer be able to make such loans without adhering to limitations on prepayment penalties, establishing

escrows and effectively determining the borrower's repayment ability. Most lenders will seek to avoid making higher priced mortgage loans. This fact alone will limit the potential abuses in connection with loan officer compensation. In addition, the requirement with respect to repayment ability will substantially inhibit loan originators from steering borrowers to inappropriate loans.

5. Home Valuation Code of Conduct

This Code, adopted by Fannie Mae and Freddie Mac, and otherwise widely utilized in the industry will prevent loan officers from pressuring appraisers to inflate property values to encourage larger loan amounts. Again, the loan officer will have significantly less opportunity to direct the borrower to an inappropriate loan product.

6. Interagency Statement on Subprime Lending (July 2007) and Interagency Guidance on Non-Traditional Mortgage Products (October 2006)

This guidance for financial institution has been widely adopted by state regulators as well. These policy statements have and will continue to require lenders to perform substantially better underwriting, to monitor risk and to adhere to more consumer protection policies with respect to subprime loans, interest only loans and option ARMS.

7. Greater Scrutiny of Fair Lending Practices

New reporting under Regulation C and the Home Mortgage Disclosure Act have lead federal and state regulators to be much more aggressive in reviewing and challenging lenders' underwriting practices from a fair lending perspective. This will require lenders to carefully monitor broker and loan officer compensation practices, to place stricter parameters around yield spread premiums, total broker compensation and overages.

8. Other Changes in the Lending Industry

There have been a number of changes in the structure and regulation of the mortgage loan industry that come into play here. The number of lenders accepting applications from mortgage brokers has substantially declined as has the number of mortgage brokers. The emphasis in mortgage lending has strongly shifted to originating well underwritten loans from originating high volumes. Regulators are reviewing loan portfolios and loan risk more closely and reviewing capital requirements. Securitization of non-traditional loans has been virtually eliminated.

9. Current Proposed Changes to Disclosures

We note also that the Board's current disclosure proposal will provide additional information to borrowers regarding market rates and how their loan rate compares to such rates. In particular, the proposed graph disclosure of proposed Section 226.38(b)(2) will contribute to the consumer's understanding of the interest rate. Such

disclosure would further contribute to the overall education and understanding of the consumer.

IV. Practical Economic and Social Implications of the Board's Proposed Compensation Alternatives

A. Compensation Alternative One

1. Analysis of Uniform Flat-Fee LO Compensation

Currently, most retail LOs are compensated using a tiered-commission schedule based on the dollar volume of loans originated. Table 1 below illustrates such a schedule.

Table 1
Typical Tiered-Commission Schedule based on Monthly Dollar Volume

Monthly Orig Vol $	Commission Rate (%)
$ 100,000	0.35%
$ 200,000	0.35%
$ 300,000	0.40%
$ 500,000	0.45%
$ 750,000	0.55%
$ 1,000,000	0.65%
$ 1,250,000	0.70%
$ 1,500,000	0.75%
$ 5,000,000	0.80%

Using this schedule, for example, a retail loan originator (LO) originating $800,000 of loans in a month would be paid a commission of 0.55% (55 bps) back to the first dollar. This results in a commission of $4,400, irrespective of the number of loans originated.

Based on 2008 STRATMOR Peer Group data for larger lenders, the "average" retail LO compensation per loan was $1,418. This payout corresponds to approximately a 64.9 bps commission on an average loan balance of $218,572.

Consider a hypothetical flat-fee commission schedule that might be implemented by the "average" 2008 Peer Group lender in response to the Board's Alternative One proposal. For this hypothetical lender, it would not be unreasonable to assume that all retail LOs would be compensated $1,418 for each loan they originate, irrespective of the total number of loans they may originate in a month.

Table 2 compares LO monthly compensation under this hypothetical $1,418 per loan flat-fee commission schedule with the monthly compensation they would receive under the tiered- commission schedule in Table 1. White background cells in Table 2

indicate situations in which an LO is relatively better off under flat-fee compensation; shaded cells, situations in which an LO is relatively worse off.

Table 2
Compensation Difference ($) between a $1,418 Flat-Fee Commission Plan and a Tiered-Commission Plan (Table 1)

Average Loan Balance ($)	# Loans Originated in a Month							
	1	2	3	4	5	6	7	8
$ 100,000	1,068	2,136	3,054	4,072	4,840	5,808	6,776	6,944
$ 125,000	981	1,961	2,754	3,422	4,278	4,383	5,114	4,844
$ 150,000	893	1,636	2,454	2,972	2,965	3,558	3,101	3,544
$ 175,000	806	1,436	1,892	2,522	2,278	1,683	1,964	1,544
$ 200,000	718	1,236	1,554	1,272	590	708	126	(656)
$ 225,000	631	1,036	1,217	722	(223)	(942)	(1,887)	(2,156)
$ 250,000	543	586	129	(828)	(1,660)	(2,742)	(3,199)	(3,656)
$ 275,000	456	361	(284)	(1,478)	(2,535)	(3,867)	(4,512)	(5,156)
$ 300,000	218	136	(696)	(2,128)	(4,160)	(4,992)	(5,824)	(6,656)
$ 325,000	118	(89)	(1,109)	(3,428)	(5,098)	(6,117)	(7,137)	(8,156)
$ 350,000	18	(314)	(2,571)	(4,128)	(6,035)	(7,242)	(8,449)	(9,656)
$ 375,000	(82)	(1,289)	(3,059)	(5,578)	(6,973)	(8,367)	(9,762)	(11,156)
$ 400,000	(182)	(1,564)	(3,546)	(6,328)	(7,910)	(9,492)	(11,074)	(12,656)
$ 425,000	(282)	(1,839)	(4,671)	(7,078)	(8,848)	(10,617)	(12,387)	(14,156)
$ 450,000	(382)	(2,114)	(5,196)	(7,828)	(9,785)	(11,742)	(13,699)	(15,656)

Consider an LO who originates four $100,000 loans in a month. This LO would earn a commission of $5,672 (i.e., 4 x $1,418 = $5,672) under the flat-fee commission plan versus $1,600 under the tiered-commission plan of Table 1. Thus, as indicated in Table 2, this particular LO would be better off under the flat-fee plan by $4,072 (i.e., $ 5,672 - $1,600 = $4,072).

Now consider an LO who originates four loans in a month, with each loan having a loan balance of $400,000. Because this LO was also originating four loans, he or she would also earn a flat-fee commission of $5,672 at $1,418 per loan. But under the tiered-commission plan, at a total volume of $1.6 million, this LO would have earned $12,000. Thus, as indicated in Table 2, this higher producing LO would earn $6,328 less under the flat-fee commission plan (i.e., $12,000 - $5,672 = $6,328).

More generally, for any number of loans originated in a month, LOs who originate loans with large average balances are relatively worse off under flat-fee compensation than LOs who originate the same number of loans at lower average loan amounts.

While this is apparent from Table 2, the degree to which this is the case is made clear in Table 3 below, which shows the percentage change in payouts that an LO would experience from a switch to a $1,418 per loan flat fee commission from a Table 1 tiered-commission plan.

Table 3
Compensation Difference (%) between a $1,418 Flat-Fee Commission Plan and a Tiered-Commission Plan (Table 1)

Average Loan Balance ($)	Monthly Originations (#)							
	1	2	3	4	5	6	7	8
$ 100,000	305.1%	305.1%	254.5%	254.5%	215.1%	215.1%	215.1%	157.8%
$ 125,000	224.1%	224.1%	183.6%	152.1%	152.1%	106.3%	106.3%	74.5%
$ 150,000	170.1%	136.3%	136.3%	110.1%	71.9%	71.9%	45.4%	45.4%
$ 175,000	131.5%	102.6%	80.1%	80.1%	47.3%	24.7%	24.7%	15.8%
$ 200,000	102.6%	77.3%	57.6%	28.9%	9.1%	9.1%	1.3%	-5.5%
$ 225,000	80.1%	57.6%	40.0%	14.6%	-3.0%	-10.0%	-16.0%	-16.0%
$ 250,000	62.1%	26.0%	3.1%	-12.7%	-19.0%	-24.4%	-24.4%	-24.4%
$ 275,000	47.3%	14.6%	-6.2%	-20.7%	-26.3%	-31.2%	-31.2%	-31.2%
$ 300,000	18.2%	5.0%	-14.1%	-27.3%	-37.0%	-37.0%	-37.0%	-37.0%
$ 325,000	9.1%	-3.0%	-20.7%	-37.7%	-41.8%	-41.8%	-41.8%	-41.8%
$ 350,000	1.3%	-10.0%	-37.7%	-42.1%	-46.0%	-46.0%	-46.0%	-46.0%
$ 375,000	-5.5%	-31.2%	-41.8%	-49.6%	-49.6%	-49.6%	-49.6%	-49.6%
$ 400,000	-11.4%	-35.5%	-45.5%	-52.7%	-52.7%	-52.7%	-52.7%	-52.7%
$ 425,000	-16.6%	-39.3%	-52.3%	-55.5%	-55.5%	-55.5%	-55.5%	-55.5%
$ 450,000	-21.2%	-42.7%	-55.0%	-58.0%	-58.0%	-58.0%	-58.0%	-58.0%

For the LO originating four $100,000 loans per month, the commissions paid under a flat-fee plan at $1,474 per loan would be 254.5% larger than would be paid out under the typical tiered-commission plan. For $400,000 loan amounts, LO's commissions under a flat-fee plan would be 52.7% lower than they would earn under a tiered-commission plan.

In other words:

> ***Relative to a typical tiered-commission plan --- the type of plan that most larger retail lenders use today --- a simple flat-fee commission plan would strongly benefit LOs who originate a below average number of loans (in 2008, for example, the average Peer Group retail LO originated roughly 4.4 loans per month) with relatively low average loan balances. In fact, irrespective of the number of loans originated, LOs originating low balance loans would benefit from a flat-fee commission plan --- and by a considerable amount.***

We think that this result turns logic on its head, with arguably better loan originators getting the worst of it if compensation shifts to a flat-fee commission structure. At a deeper level, there is a basic philosophical difference involved. Traditional tiered-commission plans aim at rewarding LOs based on value-added as measured by the dollar volume of loans originated. Flat-fee commissions tend to reflect the "labor theory of value" --- the idea that what one earns should be proportional to the amount of hours one puts in, which, for LOs, is regarded as roughly proportional to the number of loans originated.

Were the typical retail LO merely an order taker, the "labor theory of value" might indeed be appropriate and provide a philosophical underpinning for flat-fee compensation. But the typical retail LO, in addition to counseling borrowers and taking loan applications, is also responsible for generating the leads from which applications may result. Generating leads is a value-added activity that involves an LO developing and maintaining relationships with realtors, builders, financial advisors and other sources of potential borrower referrals. [8]

A significant and probably unexpected consequence of a flat-fee commission plan is its likely adverse impact on low-income borrowers. Assuming a flat-fee commission of $1,418 per loan, Table 4 below illustrates effective commission in basis points (bps) as a function of loan balance.

Table 4
Commission (bps) vs. Loan Balance
($1,418/Loan Flat-Fee Commission Plan)

Loan Balance ($)	Commission (bps)
$ 100,000	141.8
$ 125,000	113.4
$ 150,000	94.5
$ 175,000	81.0
$ 218,572	64.9
$ 225,000	63.0
$ 250,000	56.7
$ 275,000	51.6
$ 300,000	47.3
$ 325,000	43.6
$ 350,000	40.5
$ 375,000	37.8
$ 400,000	35.5
$ 425,000	33.4
$ 450,000	31.5

At a loan balance of $218,572 --- the average 2008 retail loan balance of Peer Group lenders --- the commission paid is 64.9 bps. As would be expected, this is exactly the average commission paid out in 2008 to Peer Group retail LOs.

Note, however, the sharp increases in unit commissions for lower loan balances. For example, for a $100,000 loan, commission costs are 141.8 bps, almost 2.2 times the commission for the average $218,572 loan and an absolute increase of 77 bps, i.e., more than ¾ of a point. Conversely, for a $450,000 loan, commission costs are only 31.5 bps,

[8] We would note here that call-center based LOs, who handle borrower leads generated elsewhere, are typically compensated on a flat-fee per loan basis coupled with volume incentives based on loan counts. Because they do not generate leads, their compensation is generally much less than what is paid to a retail LO.

less than half the commissions for the "average" loan (64.9 bps), and almost 80% lower than the 141.8 bps commission on a $100,000 loan.

In pricing loans, lenders could of course choose to allocate selling costs across borrowers in a way that evens out the sales cost in bps. In effect, they could choose to overcharge high loan balance borrowers and undercharge low loan balance borrowers. However, it should be noted that most lenders currently impose a ¼ to ½ point surcharge on low balance loans to account for the higher back office fulfillment costs in bps attributable to such loans.

Therefore, should lenders similarly pass on to borrowers the true sales costs illustrated in Table 4, a shift to a flat-fee commission would have the perverse effect of further penalizing low loan balance borrowers --- typically lower income borrowers and first-time homebuyers. Undoubtedly, this is not a public policy result desired by the Board. Further, this type of pricing may create additional concerns for the lender with respect to the Equal Credit Opportunity Act and the Fair Housing Act.

Table 5 below illustrates six years of retail channel net income performance for the larger lenders participating in the MBA/STRATMOR Peer Group Benchmarking Program.

Table 5
Retail Channel Net Production Income
(2003 – 2008)

Basis Points	2003	2004	2005	2006	2007	2008
Total Revenue	281.6	254.2	227.2	235.3	202.5	218.4
Total Production Expenses	142.2	171.2	162.8	186.4	175.4	178.2
Total Allocated Prod Support Exp.	13.5	19.6	18.1	22.7	18.1	21.9
Total Corporate Allocation	22.2	32.7	30.1	31.1	38.8	37.7
Total Expenses	177.9	223.5	211.0	240.2	232.2	237.8
Net "Channel" Production Income	103.7	30.6	16.3	(4.9)	(29.7)	(19.4)
Average Loan Size	162,000	174,290	192,318	185,693	210,084	218,572
Average Retail Volume ($M)	18,248	12,417	18,576	15,568	14,635	10,425

As industry origination volume declined from its historic high of about $3.8 billion in 2003 (the peak year of the refinance "boom"), profit margins plummeted ---eventually turning negative in 2006, 2007 and 2008 --- primarily because of the lower revenues resulting from excess capacity chasing a much smaller base of loan originations. While fixed costs played a role in reducing margins --- especially in 2004 versus 2003 --- industry costs in bps remained remarkable flat from 2004 on.

The fact that retail LO commissions over this time-frame were largely based on average loan volume (in dollars) or revenues allowed the industry to keep production costs (bps) in check. A shift to flat-fee commissions, however, will increase the operational

cost risk of lenders in down markets, especially when accompanied by lower property values and average loan amounts.

Table 6 below --- which is similar to Table 5 --- illustrates how commission expenses in bps would respond to changes in average loan balance under a $1,418 per loan flat-fee commission plan. The $1,418 flat-fee is based on an assumed average loan balance of $218,572.

Table 6
Commission Expense vs. Loan Amount
($1,418/Loan Flat-Fee Commission Plan)

	% Change in Average Loan Balance								
	-20.0%	-15.0%	-10.0%	-5.0%	0.0%	5.0%	10.0%	15.0%	20.0%
Avg Loan Balance ($)	$174,858	$185,786	$196,715	$207,643	$218,572	$229,501	$240,429	$251,358	$262,286
Commission Expense (bps)	81.09	76.32	72.08	68.29	64.88	61.79	58.98	56.41	54.06
Increase in Commission Expense (bps)	16.22	11.45	7.21	3.41	-	(3.09)	(5.90)	(8.46)	(10.81)

If for example, the average loan balance drops by 10% to $196,715, commission expenses increase by 7.21 bps; for a 20% drop, expenses increase by 16.22 bps. While commission expenses decrease if average loan balances increase, such decreases are not in the same proportion as the commission increases resulting from declines in average loan balances; and, for risk adverse lenders, this asymmetry is significant.

Importantly, for the typical tiered-commission or revenue based plans currently maintained by most lenders, commission expenses in bps will generally decline --- albeit by a small amount --- when average loan balances decline. This affords lenders downside protection in adverse markets.

But a flat-fee commission structure will have just the opposite effect. While average home prices have never until recently declined on a nationwide basis, home price declines at more local levels is a regular occurrence (think Houston in the early 80's). Indeed, in the current market, numerous cities have experienced home price declines in the 25% to 50% range or even higher, e.g., Phoenix, Detroit.

Referring to Table 6, it is clear that a flat-fee commission structure would significantly reduce profit margins on loans originated in down housing markets --- making an already bad situation even worse. In this regard, small lenders --- lenders that operate in relatively tight geographic markets --- have significantly greater operational risk than large regional or nationwide lenders whose geographic exposure to home price declines is diversified.

Thus, a flat-fee commission structure poses significantly greater operational risks to small versus large lenders. And while smaller lenders could consider increasing their pricing in order to give them a buffer against housing market downturns (not a good result for consumers), their ability to do this may be limited if they are competing head-to-head with a less risk averse large lender.

It is also not clear under the Board's proposals that smaller lenders could lower their flat-fee per loan in response to a decline in the average loan balance of their production. Although Alternative One allows for "Periodic changes in loan originator compensation," the proposal for such changes says that:

> *"...A creditor might periodically review factors such as loan performance, transaction volume, as well as current market conditions for originator compensation, and prospectively revise the compensation it agrees to pay a loan originator."*

Would this language permit a lender to lower their flat-fee per loan if their average loan balance declines? And how long would they have to wait before they could implement such a change? Unfortunately, the Board's proposed rules are either silent or ambiguous on these points.

2. *Analysis of Tiered Flat-Fee LO Compensation*

Table 7 below illustrates a tiered flat-fee commission plan that, at an average loan balance of $218,572, has step payment increases with loan counts that are consistent with the tiered-commission plan of Table 1.

Table 7
Tiered Flat-Fee Commission Plan
(Scaled to the Tiered-Commission Plan in Table 1)

Monthly Origination Volume #	Commission Per Loan $
1	$ 765
2	$ 874
3	$ 984
4	$ 1,202
5	$ 1,421
6	$ 1,530
7	$ 1,639
8	$ 1,639

Table 8 below is analogous to Table 3 and illustrates the percentage change in the commissions that an LO would receive after switching from a Table 1 tiered-commission plan to the tiered flat-fee commission plan in Table 7.

Table 8
Compensation Difference (%) between Tiered Flat-Fee Commission Plan (Table 7) and a Tiered-Commission Plan (Table 1)

Average Loan Balance ($)	# Loans Originated in a Month							
	1	2	3	4	5	6	7	8
$ 100,000	118.6%	149.7%	146.0%	200.5%	215.8%	240.0%	264.2%	198.0%
$ 125,000	74.9%	99.8%	96.8%	113.7%	152.6%	122.5%	138.4%	101.7%
$ 150,000	45.7%	45.7%	64.0%	78.1%	72.2%	85.5%	68.1%	68.1%
$ 175,000	24.9%	24.9%	25.0%	52.6%	47.6%	34.5%	44.1%	33.8%
$ 200,000	9.3%	9.3%	9.3%	9.3%	9.3%	17.7%	17.1%	9.3%
$ 218,572	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
$ 250,000	-12.6%	-22.3%	-28.4%	-26.0%	-18.8%	-18.4%	-12.6%	-12.6%
$ 275,000	-20.5%	-29.4%	-34.9%	-32.8%	-26.2%	-25.8%	-20.5%	-20.5%
$ 300,000	-36.3%	-35.3%	-40.4%	-38.4%	-36.8%	-32.0%	-27.2%	-27.2%
$ 325,000	-41.2%	-40.2%	-45.0%	-47.2%	-41.7%	-37.2%	-32.8%	-32.8%
$ 350,000	-45.4%	-44.5%	-56.7%	-50.9%	-45.9%	-41.7%	-37.6%	-37.6%
$ 375,000	-49.0%	-57.6%	-59.6%	-57.3%	-49.5%	-45.6%	-41.7%	-41.7%
$ 400,000	-52.2%	-60.3%	-62.2%	-59.9%	-52.6%	-49.0%	-45.4%	-45.4%
$ 425,000	-55.0%	-62.6%	-66.9%	-62.3%	-55.4%	-52.0%	-48.6%	-48.6%
$ 450,000	-57.5%	-64.7%	-68.8%	-64.4%	-57.9%	-54.7%	-51.4%	-51.4%

Interestingly, LOs who originate loans at the $218,572 average balance assumed for the lender as a whole would experience no change in compensation as a result of switching from a tiered-commission plan (Table 1) to a tiered flat-fee plan (Table 7), irrespective of the number of loans per month they originate.

But if they originate loans with an average balance below $218,572 they are better off; above $218,572, worse off. Overall, however, while somewhat less pronounced, the compensation differences in Table 8 present the same problems as in Table 3, namely, that more productive LOs are generally worse off than less productive LOs.

A tiered flat-fee commission plan also suffers from the same problems previously discussed with respect to a uniform flat-fee plan, namely to the potential cost impact on lower income borrowers and operational risks for lenders, especially smaller lenders.

3. *Initialization and Periodic Reviews of Flat-Fee Compensation*

In its proposed rules, the Board is silent as to what considerations a lender might take into account in setting the initial flat fee compensation for each LO. While many factors might be considered, our analysis suggests that the average loan balance of a LO's previous production is the key consideration that lenders will and should take into account.

Table 9 below illustrates what a multi-tiered flat-fee commission schedule that takes into account an LO's prior average loan balance might look like for the "average" lender we have been considering.

Table 9
Multi-Tiered Flat-Fee Commission Structure

# of Loans Originated/ Month	Average Balance Per Loan													
	$100,000	$125,000	$150,000	$175,000	$200,000	$218,572	$ 250,000	$ 275,000	$ 300,000	$ 325,000	$ 350,000	$ 375,000	$ 400,000	$ 425,000	$ 450,000
1	$ 350	$ 438	$ 525	$ 613	$ 700	$ 765	$ 875	$ 963	$ 1,200	$ 1,300	$ 1,400	$ 1,500	$ 1,600	$ 1,700	$ 1,800
2	$ 350	$ 438	$ 600	$ 700	$ 800	$ 874	$ 1,125	$ 1,238	$ 1,350	$ 1,463	$ 1,575	$ 2,063	$ 2,200	$ 2,338	$ 2,475
3	$ 400	$ 500	$ 600	$ 788	$ 900	$ 984	$ 1,375	$ 1,513	$ 1,650	$ 1,788	$ 2,275	$ 2,438	$ 2,600	$ 2,975	$ 3,150
4	$ 400	$ 563	$ 675	$ 788	$ 1,100	$ 1,202	$ 1,625	$ 1,788	$ 1,950	$ 2,275	$ 2,450	$ 2,813	$ 3,000	$ 3,188	$ 3,375
5	$ 450	$ 563	$ 825	$ 963	$ 1,300	$ 1,421	$ 1,750	$ 1,925	$ 2,250	$ 2,438	$ 2,625	$ 2,813	$ 3,000	$ 3,188	$ 3,375
6	$ 450	$ 688	$ 825	$ 1,138	$ 1,300	$ 1,530	$ 1,875	$ 2,063	$ 2,250	$ 2,438	$ 2,625	$ 2,813	$ 3,000	$ 3,188	$ 3,375
7	$ 450	$ 688	$ 975	$ 1,138	$ 1,400	$ 1,639	$ 1,875	$ 2,063	$ 2,250	$ 2,438	$ 2,625	$ 2,813	$ 3,000	$ 3,188	$ 3,375
8	$ 550	$ 813	$ 975	$ 1,225	$ 1,500	$ 1,639	$ 1,875	$ 2,063	$ 2,250	$ 2,438	$ 2,625	$ 2,813	$ 3,000	$ 3,188	$ 3,375

For each average loan balance, the commissions paid as a function of the number of loans originated in a month are consistent with the tiered-commission plan in Table 1. Thus, for example, an LO whose prior production had an average loan balance of $100,000 would be paid a commission of $350 per loan (35 bps) if he or she originated 1 or 2 loans a month. This flat fee per loan would increase to $550 per loan (55 bps) at 8 loans per month.

At the other end of the spectrum, an LO whose prior production averaged $450,000 per loan would receive a commission of $1,800 per loan (35 bps) for 1 loan per month growing to $3,375 per loan (75 bps) at 8 loans per month.

Applying a multi-tiered flat-fee commission structure for setting the initial compensation plan for each LO virtually eliminates the disparities and inequities of a uniform flat fee (e.g., $1,418 per loan) or simple tiered flat-fee commission plan (Table 7) <u>so long as an LO continues to originate loans at the same average loan balance as previously</u>.

This is clear from Table 10, which, like Tables 3 and 8, illustrates the percentage change in the commissions that an LO would receive after switching from a Table 1 tiered-commission plan to the appropriate multi-tiered flat-fee commission schedule in Table 9.

Table 10
Compensation Difference (%) between a Multi-Tiered Flat-Fee Commission Plan (Table 9) and a Tiered-Commission Plan (Table 1)

Average Loan Balance ($)	# Loans Originated in a Month							
	1	2	3	4	5	6	7	8
$ 100,000	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
$ 125,000	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
$ 150,000	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
$ 175,000	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
$ 200,000	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
$ 218,575	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
$ 250,000	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
$ 275,000	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
$ 300,000	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
$ 325,000	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
$ 350,000	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
$ 375,000	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
$ 400,000	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
$ 425,000	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
$ 450,000	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%

However, if an LO's average loan balance changes from prior levels, even a multi-tiered flat-fee will result in differences from what an LO would have earned under a dollar volume tiered-commission plan (Table 1). An LO will be undercompensated if their average loan balance increases; overcompensated if it decreases. And, of course, there remains increased operational risk for the lender.

This leads naturally to the question of periodic reviews. The Board's proposed rules allow for periodic changes in loan originator compensation so long as such revisions do not result in payments based on loan amount and other loan terms. This formulation does not explicitly preclude changes in a loan originator's flat fee commissions that consider the originator's average loan balance during the preceding adjustment period. Nor does it explicitly preclude a lender from using an LO's average loan balance history --- for example, during the prior year --- as a factor in setting the LO's initial flat fee commission plan (as we have considered in the above analysis).

Indeed, if a lender could consider an LO's prior average loan balance history in setting their <u>initial</u> compensation, it would seem appropriate that they should also be able to periodically adjust per loan compensation up or down in consideration of an LO's average loan balance during the prior adjustment period. Not to permit this would incent those loan officers who have increased their average loan balance in the preceding review period to go to a new lender that could recognize this improvement in setting their <u>initial</u> compensation. Carrying this logic forward could result in a

bizarre process of "musical chairs," whereby LOs with increasing loan balances would periodically jump from lender to lender in order to get their compensation in line with their average loan balance.

It therefore seems clear to us that, in making periodic changes to an LO's compensation, lenders should be able to consider an originator's average loan balance during the preceding review period. Further, the length of the review period should not be too long, e.g., longer than a year, lest it incent LO's to leave and increase the operational risk of the lender. On the other hand, if the review period is very short, e.g., a month, one might as well allow loan amount to be explicitly considered in determining LO compensation as is permitted under Alternative Two discussed below. In effect, a one month review period would essentially morph Alternative One into Alternative Two, but with a lot more administrative burden on the lender.

4. Geographic Considerations

The Board's proposed rule does not preclude "compensation that differs by geographical area," but goes on to say that: "Creditors that use geography as a criterion for setting originator compensation would need to be able to demonstrate that this reflects legitimate differences in the cost of origination and in the level of competition for originators' services."

For large multi-regional or national lenders, this rule would seem to prohibit differences in average loan balances from being a legitimate basis for setting different flat-fee commissions from branch-to-branch. And if this interpretation of the proposed rule is correct, it would create significant competitive advantages for smaller lenders and brokers operating in high-price geographic areas.

For example, a small lender or broker operating solely in Beverly Hills, CA, would be able to pay their LOs much higher flat fee commissions because of higher average home values than LOs working in the Beverly Hills branch of a national lender unless: (a) the national lender could prove that this situation represented "legitimate differences ... in the level of competition for originators' service," or (b) took into account the higher average loan balances in Beverly Hills in initializing the flat-fee commissions of Beverly Hills LOs (a more likely scenario).

But allowing lenders to adopt flat-fee commission plans at a branch level based on the average loan amount originated in that branch is tantamount to recognizing that loan amount should be a consideration in LO compensation. It also gives rise to seemingly unjustifiable disparities in LO compensation among LOs working out of different branches.

For example, assume an LO working out of Branch A, located in an area of million dollar homes, is paid a flat fee of $4,000 for an $800 thousand loan on a house located within the area primarily served by the Branch. Now, consider the situation in which this same $750 thousand loan is originated by an out-of-area LO, who works out of Branch B located in an area of $250,000 homes, and is paid $1,000 per loan (because of the lower average loan balance of loans originated out of Branch B).

In other words, for originating exactly the same loan, the LO working out of Branch A would receive four times the commission as the LO working out of Branch B, merely because Branches A and B have different average loan balances. There is simply no justification for this disparity.

B. Compensation Alternative Two

Alternative Two --- which allows loan amount to be considered in setting loan originator compensation, but is otherwise the same as Alternative One --- avoids most of the pitfalls of Alternative One. But, like Alternative One, Alternative Two tilts the playing field substantially in favor of the very largest, bank-owned lenders.

Currently, most large lenders ---who are also creditors --- base LO compensation on loan amount (and product type) but prohibit or sharply curtail their LOs use of overages. But smaller lenders --- lenders that typically lack the brand recognition and financial strength of their larger competitors --- have nonetheless been able to compete through their ability to recruit superior loan originators attracted by a more entrepreneurial environment in which to work.

Smaller lenders typically pay their LOs a commission calculated as a percentage of the net revenues generated by a loan. For this purpose, net revenues generally include all loan fees, secondary market gains or losses and a split of overages or underages. Because virtually all of these revenue line items vary with loan amount, the principal balance of a loan is clearly embedded into revenue-based LO compensation.

By basing LO commissions on net revenues, smaller lenders --- unlike the typical large, bank owned-lenders --- empower their LOs with the latitude to negotiate the cost of a loan to the consumer. The key to this entrepreneurial environment has been allowing loan officers to adjust loan pricing up (an overage) or down (an underage), with the resulting revenue gains or losses shared between the loan originator and the lender, usually on a 50/50 basis.

Ironically, because of competition, entrepreneurial loan originators have more typically lowered prices in order to "get the deal." Because larger bank-owned competitors have revenue and cost advantages that can translate into aggressive pricing when needed, LOs working for smaller lenders will, more often than not, need to lower the base loan

price at the point-of-sale in order to be competitive, i.e., engage in an underage. And because the LO shares in the cost of this underage, the adverse impact of a price cut on the lenders is mitigated.

Thus, the Board's ban on overages --- which is also a ban on underages --- will likely hurt consumers. But more importantly, we believe it will make it much more difficult for smaller lenders to attract the entrepreneurial loan originators they need in order to compete with the large bank-owned lenders. Indeed, if underages are prohibited, we would project a long protracted decline in the number of smaller lenders.

Large bank-owned lenders have many theoretical competitive advantages over smaller lenders that benefit their LOs. Traditionally, consumers have regarded large banks as more reliable and honest than smaller independent non-bank lenders (although this may be less true today). Coupled with the multiple financial relationships that banks have with their customers, this "brand" awareness can generate a steady flow of mortgage leads into both retail bank branches and affiliated mortgage branches. Further, because large lenders typically service the loans they originate (which smaller lenders typically do not), they are usually "top-of-mind" with their borrowers for repeat loans, again resulting in a steady flow of customers into both retail bank locations and mortgage branches.

Large bank-owned lenders also have significant revenue and cost advantages that allow them to price more aggressively than smaller lenders and still maintain attractive margins and returns. And clearly, aggressive pricing is an advantage in both recruiting and retaining LOs.

On the revenue side, large bank-owned lenders typically have a much lower "cost-of-funds" than smaller lenders that results in much higher "net warehouse income." Their higher origination volume allows them to realize better loan sale executions on the secondary market, resulting in higher secondary gains. They will also usually have lower guarantee fees with the Agencies that significantly boost their net gain on sale. Finally, because they can establish multiple financial services relationships with borrowers, they can realize significant "cross-selling" revenues that are simply unavailable to smaller lenders (although the record of most large bank-lenders has not been great as regards "cross-selling" to mortgage customers).

Large bank-owned lenders also enjoy theoretical cost advantages as a result of scale-economies, branding and other factors. For example, such lenders can pay their LOs several basis points less than smaller lenders because they offer more leads and a more secure environment (the LO community is keenly aware of the many recent shut-downs of small lenders because warehouse lines and investor contracts were precipitously

terminated). Basically, the value proposition of large bank-owned lenders to LOs is: A lower commission scale combined with higher loan volumes, resulting in higher overall income.

However, the realization of potential cost advantages among large bank-owned lenders relative to smaller has been spotty. While Peer Group data has shown several large lenders to have achieved excellent costs of loan origination, many of them have not managed their costs well, either because of their own bureaucratic behavior or because of unreasonably high cost allocations from their parent bank --- cost allocations that enter into their loan pricing decisions.

Overall, therefore, most of the pricing advantages enjoyed by large bank-owned lenders result from revenue advantages that are significantly passed through back to consumers in the form of lower loan prices (and therefore may not show up in the income statement).

Yet, despite all these large bank-owned lender advantages, smaller independent lenders have been able to compete because of their ability to manage costs, despite scale disadvantages, attract and retain entrepreneurial LOs and avoid head-to-head competition with the largest lenders as much as possible.

In this latter regard, smaller lenders have tended to operate in smaller population markets, markets in which there typically is no large bank-owned lender presence, often in cooperation with local community banks that lack sophisticated loan origination skills. Because smaller lenders typically pay higher commissions on harder-to-originate FHA and VA loans --- something that many large lenders do not do --- they originate twice the volume of government loans on a percentage basis than do large lenders and are therefore a key source of home loans for the many lower income and first time homebuyers who cannot afford a significant down payment. The same is true for the loans funded by State bond programs that typically provide below-market interest rates and other terms and conditions that foster home ownership among lower income groups and first-time homebuyers.

Thus, we believe that smaller lenders have and will continue to serve a broad public policy interest of having mortgage origination capacity available to a broad base of consumers, especially first-time and lower income homebuyers. Therefore, we would question policies or regulations that are materially adverse to the survival of smaller lenders.

C. Economic Conclusions as Regards Alternatives One and Two

While we support the broad objectives of the Federal Reserve to curb the abusive practices of loan originators, we believe that Alternative One is not a constructive approach and therefore should be dropped from consideration.

Strict adoption of Alternative One would have numerous undesirable consequences. Foremost among them is that it will significantly increase the cost of borrowing for small balance loans --- typically loans sought by lower income borrowers and first time homebuyers.

Further, unless the Board permits periodic adjustments in loan originator compensation to consider an originator's average loan balance during the prior adjustment period, Alternative One will reward less productive loan originators and penalize the most productive. This perverse result virtually turns the industry's sales culture on its head and is likely to push the best loan originators out of the industry.

Such a shift in incentives may result in other undesirable and unpredictable consequences. For example, it may result in LOs being less quality conscious, Will they simply try to push loans through the system? And will this increase the burden on and cost of underwriting and quality control?

It will also encourage LOs to avoid time consuming, hard-to-do loans --- loans that often involve lower income, first time borrowers, e.g., government loans and loans backed by state housing authorities? Will the net result be that those most in need of more of service receive less?

Finally, Alternative One will increase the operational risks of all lenders, but especially smaller lenders, who typically do not have the deep pockets to sustain steep and protracted downturns. And, as we have discussed, it will make it more difficult for smaller lenders to recruit and retain loan originators in competition with large lenders.

In this latter regard, we would again underscore our belief that there is a strong public policy interest to be served by preserving the competitiveness of small lenders because they have always tended to serve geographic markets and consumer segments ignored by large lenders.

Some of the problems with Alternative One can, of course, be mitigated by allowing average loan amount to be considered with respect to geographic differences in compensation and in making periodic go-forward adjustments to a loan originator's compensation. But by allowing average loan amount to be considered in these ways, Alternative One effectively becomes an administratively complex version of Alternative Two.

Of course, allowing loan amount to be a consideration of loan originator compensation raises the possibility that originators will put borrowers into larger balance loans than is justified, i.e., create higher loan-to-value ("LTV") ratio loans than necessary. Higher LTV loans typically occur when a consumer has limited funds available for a down payment on a home. Consumers purchasing a home for investment purposes will also frequently seek low down payments so as to increase their financial leverage and the potential for higher returns. In both cases, however, the tighter credit and collateral underwriting that now prevail throughout the industry should weed out those situations where the risks to both the lender and borrower are unacceptable.

Based on its proposed rules, the key abuses that the Board seeks to eliminate are overages, yield spread premiums (where the increased back-end fees are not being used to benefit the borrower by buying down origination costs) and pricing differentials among product types that can result in originators "steering" borrowers into higher commission loan products that offer no material benefit to the borrowers.

Nowhere in the discussion of its proposed rules does the Board explicitly cite loan amount as a key source of abuse, although some of the exotic high commission loans into which borrowers were "steered" were undoubtedly high LTV loans (although there is no study that we know of that examines the extent to which the high LTV component of such exotic loans was or wasn't appropriate).

The primary point here is that loan amount is not a key source of abuse and therefore should not be prohibited as a consideration of loan originator compensation, especially given the unintended adverse consequences of Alternative One that we have discussed.

This should not however be read as a ringing endorsement of Alternative Two. Although Alternative Two allows loan amount to be considered in LO compensation, we believe it will inevitably lead to the demise of many smaller lenders, which we regard as bad public policy.

<u>Thus, we cannot support Alternative Two without modifications designed to properly balance the reasonable interests of consumers with the legitimate competitive interests of smaller lenders. And even with such modifications --- as we will discuss below --- we believe that the Board has better options.</u>

V. Alternatives to the Board's Proposals and Recommendations

Given the potential competitive and economic consequences of the Board's current proposal and the lack of a strong basis for moving forward, we strongly urge the Board to delay implementing either Alternatives One or Two and the proposal with respect to steering for at least 18 months. Alternatively, at the very least, the Board should look to modifying Alternative Two to mitigate its adverse economic and competitive effects.

A. Delaying Action

As described in Section IV, above, we believe that the Board has little if any basis for moving forward with a loan officer compensation proposal. The Board simply has not done the ground work necessary to justify a change of this magnitude. Further, as described in Section III, above, the potential negative effects on low balance borrowers, the disruption to and inequitable impact on loan originators and the potential negative consequences on competition in the industry should be enough to dissuade the Board from taking action until all key aspects of the proposal can be more carefully reviewed and considered.

If these reasons are not enough, there are many other strong reasons for delaying action on loan officer compensation. First, the exotic loan programs such as option arms, interest only loans, balloon payment loans and low or no documentation loans have been virtually eliminated from the industry with no immediate prospect for revival. Even if the products were re-introduced, the financial institution regulators and state regulators would more closely monitor and control such products.

Second, there has been a dramatic shift away from mortgage broker originated loans to retail based lending. MBA/STRATMOR Peer Group data, for example, shows that broker share of the origination market has fallen from 39% in 2006 to 19% for the first half of 2009. And the surviving brokers are larger, better managed firms with better compliance and quality control.

Third, the Board should give recent and soon to be effective regulations the opportunity to work before forcing such a major change on the industry. In our view, the list of new regulations and legislative initiatives described in IV. B above will virtually ensure a significant reduction in abuse or the potential for abuse.

In particular, the changes to RESPA will force the industry and borrowers to more closely examine the relationships between interest rate, lender fees and credits against closing costs. The Board's own improved disclosures should also be allowed to have time to affect the education and knowledge of loan applicants.

B. Conducting Appropriate Review and Analysis

Delaying any immediate action on loan originator compensation would allow the Board sufficient time to more carefully evaluate its options and to better study the borrower/loan officer relationship.

The Board needs to conduct more appropriate studies on the ability of disclosures to educate customers about the cost of mortgage loans and the relationship between origination fees and interest rates. The Board should test a wide range of disclosures rather than the single broker agreement/disclosure previously tested. And these studies

and tests should be conducted by post-closing interviews with real borrowers, not via focus groups or by interviews held with consumers outside of a true lending experience.

Over the next 12-18 months, more than a million consumers will obtain a mortgage. With such a large number of borrowers, it should be possible for the Board, with industry cooperation and participation, to conduct a range of statistically valid studies and tests aimed at evaluating new disclosures and measuring consumers' understanding of the elements of mortgage pricing, i.e., rate, down payment, other costs-to-close, monthly payment, etc., originator compensation and other terms and conditions of their loan.

It would also be possible to assess the suitability of the loan products "sold" to consumers --- to evaluate the extent to which the prospect of higher compensation caused loan originators to place consumers into inappropriate or unsuitable loans. To accomplish this, many lenders could and we think would provide loan, borrower and loan-level accounting data through an impartial intermediary on a non-disclosed basis both as to the borrower and lender. Such detailed data would also enable a wide range of statistical analyses to be performed that examine the relationship between loan pricing and originator compensation, adjusted for a variety of other variables that affect pricing, e.g., lender size, geography, etc.

Such studies and tests would provide the Board with the credible data by which to determine if further regulation is necessary.

C. Modification to Alternative Two

We believe that: The Board has not established a compelling basis for promulgating either compensation Alternatives One or Two as a regulation; That Alternative One, in particular, would have a wide range of unintended and adverse consequences; and finally, that the Board has an obligation to conduct further study with respect to the issues involved.

Nevertheless, if the Board feels that it must act on this issue we would recommend adoption of Alternative Two with a modification to permit loan officers to accept reduced compensation in order to reduce an interest rate payable by the borrower.

As currently drafted, Alternative Two would prohibit a lender from allowing a loan originator to receive compensation based on the loans interest rate. This would prevent a loan officer from receiving compensation for convincing a borrower to pay an interest rate above the lender's par rate ('overage"). However, it would also prevent the loan officer from sacrificing a portion of his/her compensation in exchange for a reduction in the borrower's interest rate ("underage"). As noted above, among the lenders represented, the practice of using an underage was much more common than overages.

Loan officers use this technique to compete with the large national lenders to be as competitive as possible.

Alternative Two, with this modification, will accomplish three things. First, it will address most of the concerns the Board has expressed with respect to loan officer compensation. Second, it will alleviate the very difficult implementation for the industry associated with Alternative One. Third, it will help smaller lenders to compete with the large national lenders. Finally, it will avoid the negative cost consequences of Alternative One and an unmodified Alternative Two for lower income and many first-time homebuyers/borrowers.

****

We appreciate the opportunity to make our views known and urge the Board to delay action on this rule until the underlying presumptions can be adequately studied and the unintended economic consequences can be studied and analyzed.

If you have any questions regarding the issues addressed in this letter please call Mitch Kider at Weiner Brodsky, Sidman, Kider, P.C. (202-628-2000) or Dr. Matthew Lind at Stratmor Group (781-749-6457).

Sincerely,

Weiner, Brodsky, Sidman Kider, P.C.

By:

Mitchel H. Kider

By:

Brian J. Evans

Stratmor Group

By:

Dr. Matthew M. Lind

H:\EVANS\BJE - Federal Reserve Letter 12.24.09 Final.docx

Attachment A

Lenders Attending WBSK/STRATMOR Workshops

Washington, DC **October 29, 2009**	**Chicago, Il** **November 5, 2009**	**Los Angeles, CA** **November 12, 2009**
Access National Mortgage	American Bank FSB	Bank of the West
American Bank	BNC National Bank	Assurity Financial Services
Chevy Chase (Capital One)	Cherry Creek Mortgage	BOK Mortgage
Compass/BBVA	CMG Mortgage	Colonial Savings
Corridor Mortgage	Consumers Mortgage Corp.	Evergreen Home Loans
Crescent Mortgage Company	Equity Services	First National Bank Mortgage
First Home Mortgage	Eustis Mortgage	Golf Savings Bank
Gateway Funding	Fairway Independent Mort.	Guild Mortgage
Long & Foster	Fifth Third	Homeowners Financial
Met Life Homes	M&T Bank	Nationstar
MI Homes	Morgan Stanley Credit Corp	Prime Lending
Mortgage Investors Group	National City Mortgage	Prospect Mortgage
PHH	Plaza Home Mortgage	RPM Mortgage
Primary Capital	Prudential Fox & Roach	Shea Financial
Sidus Mortgage Corporation	Quicken Loans	Sierra Pacific Mortgage Co.
SunTrust	Ross Mortgage Corp.	Sun American Mortgage
Superior Mortgage	Seattle Mortgage Company	Universal American Mortgage
Walker Jackson Mortgage	Summit Mortgage	Vitek Mortgage
Weichert Financial	Universal Lending Corp	
Yadkin Valley Bank	Wintrust Mortgage	

Attachment B

Lenders Sponsoring WBSK/STRATMOR Letter

Lender Sponsors

Plaza Home Mortgage

Cherry Creek Mortgage

CMCO Mortgage, LLC

CMG Mortgage

Cobalt

Cornerstone Mortgage

Fairway Independent Mtg.

First National Bank Mtg.

MI Homes

Primary Capital

Prime Lending

RPM Mortgage

Seattle Mortgage Company

Universal American Mortgage

Weichert Financial