LENDERS UPDATE™

ALT & ASSOCIATES NEWSLETTER

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MINI-CORRESPONDENT
SHOULD WE OR SHOULD WE NOT?

As most of us who have been associated with the mortgage lending industry for any length of time know, certain trends develop that seem to sweep through the industry. Often, they result from regulatory changes. Well, that is just what has happened relative to "mini-correspondents".

To start this discussion, we must examine the new "Ability to Repay" rules which become mandatory in January of 2014. Again, as most of us know, these rules develop the concept of a "qualified mortgage" ("QM"). For a loan to be a QM, among other factors, the points and fees may not exceed a cap of 3% of the total loan amount for loans equal to or greater than $100,000. The first issue for our discussion about mini-correspondents is:

Just what is included when calculating points and fees in order to determine if a loan is over that cap?

Specifically, is loan originator compensation included in the calculation? It depends. Compensation paid to a creditor's loan originator employee is <u>not</u> included in the calculation of points, and fees paid to a broker <u>are</u> included. Thus, at first glance, becoming a creditor as opposed to a broker seems to be preferable. In fact, some have predicted the death of brokers because of this very issue.

In response to this perceived predicament, the concept of "mini-correspondents" has taken flight. Basically, this means setting up a broker, usually with a small net worth, as a warehouse lender so that they may call themselves creditors, thus avoiding the impact of including their broker's fee in the new 3% cap.

The general concept has been with us for a while. In fact, HUD began re-examining this issue anew more than two years ago before the concept of a QM was detailed. At that time warehouse lines of this nature were often appropriately called "captive lines".

Are they permissible? Are they needed? We will explore the answer to these questions.

<u>What is the definition of points and fees and how does it impact the decision to become a "creditor"?</u>

The calculation of points and fees as set forth in the new CFPB rule, is reasonably complex. For purposes of this discussion, we will attempt to simplify this definition.

Generally, you must include all items normally included in the finance charge, but may <u>exclude</u> interest, federal or state mortgage insurance premiums and

private mortgage insurance under certain circumstances, as well as <u>bona fide third-party charges not retained by the creditor, loan originator or the affiliate</u>, and bona fide discount points. In addition, you may exclude compensation paid to a loan originator if that originator is an employee of the creditor or of the mortgage broker. Fees paid to the broker, however, must be included. You also should exclude certain real estate related fees if those fees are reasonable and not received by the creditor directly or indirectly. These fees generally include title fees, document preparation fees, notary fees, credit report fees and appraisal fees. Premiums for credit insurance, property insurance and other life, accident, health or loss of income insurance must be included if paid before consummation of the transaction even if the premiums are rolled into the loan amount. Prepayment penalties that may be incurred if the new loan prepays must be included at their maximum level plus any prepayment penalty paid in a refinance if the creditor or its affiliate services a loan.

This simplified definition, while insufficient from a compliance perspective, nevertheless demonstrates that many fees are not included in the calculation. Putting pencil to paper or fingers to the keyboard, will quickly determine whether or not the loans that a broker generally makes are going to be a QM or not. This brings us back to our theme. Does a broker even need to explore becoming a mini-correspondent in order to avoid the impact of the new rule? The answer is in the math. Reliable lenders have said that in their experience many brokers do not have to take this step, because even with the inclusion of the broker's fee in the 3% calculation, these brokers still do not make loans that exceed that cap.

<u>Assuming that a broker determines that becoming a mini-correspondent is necessary, what problems and issues must be considered?</u>

First, let's examine the practical side. It is likely that a broker's operation will require significant expansion. In some states a different license will be

required. Most brokers will have to address the requirements for higher net worth, capital and liquidity. Finally, a broker's infra-structure will need to undergo expansion to address underwriting, processing, funding, closing, QC, vendor management, compliance, etc.

Second, let's next examine whether the relationship created by the purported warehouse line does in fact change the broker's status to that of a creditor? Is this a bona fide warehouse line or is it table funding? Is it a sham or is it real? As we will discuss below, the effects are severe if these questions are not answered correctly. If it is not structured correctly, the broker may in fact just be table funding and then not have real creditor status.

How do we distinguish table funding from legitimate warehouse line?

The regulators, HUD and the CFPB, have given us no bright line test and very little guidance. That said, there are a number of factors that, while not dispositive of these questions, enable us to make some judgment on potential arrangements. Let's review some of these that are indicative of a true warehouse line:

- **An unconditional obligation of the originator to repurchase the loan within a short time if it is not sold off the line, whether or not default occurs.**
- **Real liability to the originator.**
- **Net worth commensurate with the potential liability.**
- **The ability to sell loans off the line to other purchasers, i.e. no captive lines.**
- **Payment of per diem interest on the line.**
- **The lack of any affiliate or control relationship between the originator and the warehouse lender.**
- **The lack of simultaneous funding by the warehouse lender at the time of loan closing.**

Obviously, when one or more of these factors is not present, the risk increases of the CFPB or other regulator determining that the line is just a sham. Unfortunately, we have seen several "warehouse lines" that aren't even close to meeting these criteria.

<u>What are the legal effects of a determination that a warehouse line is actually just table funding?</u>

Without belaboring the point with all the potential penalties/ramifications, the consequences of structuring the line incorrectly are severe. If the supposed "creditor" is found to be a broker rather than a creditor because it is determined to be tabling funding rather than using a warehouse line, then the following could happen:

- **The wrong disclosures may have been provided or contain erroneous information.**
- **The loans put on the "line" may be determined to not be QMs, giving rise to a future challenge by the borrower or buy back demands from a purchaser down the line.**
- **Loan originator compensation rules may be violated.**

Any of these results could easily become a "life changing" event.

From our point of view, the message to any broker or any lender is:

"Make sure the broker needs to take this step and that the relationship is structured correctly".

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