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CONTINUING COMPLIANCE CHALLENGES IN MORTGAGE LOAN ORIGINATOR COMPENSATION

Mortgage loan originators play an important role in serving the residential mortgage industry and American homeowners. Their compensation garners seemingly outsized attention from federal regulators. This article addresses those regulatory efforts from the consumer protection and labor agencies and how those regulations have, and have not, changed.

By Kris D. Kully *

While the restrictions related to mortgage loan originator compensation have remained largely consistent for the past 15 years, they are still the source of considerable focus and frustration. That compensation is a critical aspect of operating a profitable residential mortgage lending business — it is both a key driver of revenue and a significant expense for mortgage lenders and brokers. By prohibiting compensation to loan originators that is based on the loan’s interest rate or other terms, the federal restrictions imposed in 2011¹ upended the typical business model to an extent that some in the industry may still be in denial. In spite of hopes to the contrary, neither the Loan Originator Compensation Rule (“LO Comp Rule”) nor other requirements for that compensation have changed.

This article explains how multiple federal regulators have addressed mortgage loan originator compensation, the basic principles of the LO Comp Rule, and the vacillations on an exemption from requirements for

overtime pay, and the reasons why compliance remains so challenging.

MISALIGNED INCENTIVES

Federal regulators have grappled for decades with how mortgage loan originators are compensated. For this purpose, a “mortgage loan originator” is the individual who works for a mortgage lender or broker, takes a consumer’s application for a closed-end residential mortgage loan, and/or assists the consumer in obtaining such a loan. The term also includes a mortgage broker entity that engages in the business of providing those services under arrangements with one or more lenders. The Board of Governors of the Federal Reserve (the “FED”) finalized a rulemaking effective in 2011 providing that mortgage loan originators must not receive, and no person may pay to those persons, directly or indirectly, compensation based on a term of the transaction.² Although that was the first federal codification of such an express prohibition, federal policymakers were concerned about potentially

¹ 75 Fed. Reg. 58,509 (Sept. 24, 2010), effective April 6, 2011; see also 76 Fed. Reg. 43,111 (July 20, 2011).

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

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misaligned steering incentives of mortgage loan originator since the mid-1990s, if not before.

For some context, mortgage loan originators may receive compensation in a variety of forms, including a salary, commissions, or bonuses, and may receive it from the consumer, a lender, or another source. The concern about potentially misaligned incentives arises because historically a primary method of compensating mortgage brokers was through a yield spread premium. A yield spread premium is essentially the value of the difference between the lowest interest rate a lender would have accepted on a particular loan and the actual rate at which the loan was originated. In other words, a mortgage broker would directly benefit by “up-selling” a loan to a consumer at a higher interest rate. While yield spread premiums were not per se illegal back then, regulators worried that consumers were unaware of the practice.

The FED and the Department of Housing and Urban Development (“HUD”) initially sought to address this incentive of mortgage brokers to steer consumers to higher rate loans through disclosures, hoping to arm consumers with information on how much their loan originator was getting paid and by whom.³ However, the regulators concluded that disclosures were generally confusing and ineffective.⁴

Relying on authority under the Home Ownership Equity Protection Act,⁵ which otherwise addresses only

high-cost mortgage loans, the Federal Reserve Board issued regulations prohibiting lender-paid compensation to loan originators that is based on the loan’s terms and conditions, even for loans that do not reach high-cost thresholds. While those regulations were pending, Congress essentially codified the prohibition through its passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the “Dodd-Frank Act”), and fortified it with onerous enforcement penalties that remain viable as a defense throughout the entirety of the loan’s life.⁶ The Dodd-Frank Act also transferred authority for the regulations to the Consumer Financial Protection Bureau (“CFPB”),⁷ which bolstered those regulations in 2013.⁸

Early enforcement actions under those regulations targeted mortgage originator compensation arrangements that were fairly directly tied to loan terms — in other words, arguably low-hanging fruit. The actions generally involved lenders that allegedly tracked the rates and fees of the loans originated and then compensated the relevant loan originators on that basis, such as through bonuses or funded expense accounts. The fact that those arrangements were fairly predictably contrary to the regulations may have been a sign of how loathe some in the industry were to change this entrenched compensation practice.

While certain compensation practices were clearly out, some of the biggest compliance challenges with the LO Comp Rule derive not from what the Dodd-Frank Act or the regulations expressly provide, but rather from regulatory corollaries, commentary, and nonbinding agency statements. For instance, while the statute and regulations prohibit loan term-based compensation, one initially had to dig through the regulatory commentary to learn that a compensation factor that is not a loan term, but that serves as a proxy for a loan term, also is prohibited.⁹ The CFPB subsequently brought that concept up into the regulatory text and provided some guidance as to what constitutes a prohibited proxy.

³ See, e.g., 57 Fed. Reg. 49,600 (Nov. 2, 1992); 74 Fed. Reg. 43,232, 43,240 (Aug. 26, 2009).

⁴ 74 Fed. Reg. 43,232, 43,240 (Aug. 26, 2009).

⁵ Section 129(l)(2) of the Truth in Lending Act (“TILA”) (now codified at 15 U.S.C. § 1639(p)(2)) required the Federal Reserve to issue regulations to prohibit acts or practices in connection with mortgage loans that are unfair, deceptive, or designed to evade the provisions of that section. As mentioned above, that section of TILA otherwise addresses high-cost mortgage loans, but the Federal Reserve asserted that its authority to declare acts or practices unfair went beyond those loans, and even beyond the actions of lenders, and broadly authorized protections in connection with all consumer-purpose mortgage loans. 74 Fed. Reg. at 43,237.

⁶ 15 U.S.C. §§ 1639b(c), 1640.

⁷ 76 Fed. Reg. 79,768 (Dec. 22, 2011).

⁸ 78 Fed. Reg. 11,280 (Feb. 15, 2013).

⁹ 75 Fed. Reg. 58,509, 58,536. (Sept. 24, 2010).

Specifically, a compensation factor that is not itself a term of a transaction is a proxy for a term of the transaction if the factor consistently varies with that term over a significant number of transactions, and the loan originator has the ability, directly or indirectly, to add, drop, or change the factor in originating the transaction.¹⁰ This fact-dependent proxy analysis applies to a proposal to, for example, pay a loan originator more or less for loans based on the source of the lead, e.g., whether the loan originator found the potential borrower through his or her own efforts or rather through an internal referral. The proxy analysis also applies if a lender proposes to pay a loan originator differently for loans secured by property in different geographic areas (e.g., New York versus Nebraska). Those distinctions present little if any risk that the loan originator can increase his or her compensation in a manner that affects the terms of the loan the borrower obtains. The regulators' allowance for compensation distinctions when an improper steering incentive does not exist as a practical matter seemed reasonable. After all, a loan originator has no real ability to, for example, convince a consumer to buy a home in a different state in order to increase the loan originator's compensation.

However, that proxy analysis and its consideration of whether the loan originator can steer the borrower in order to increase its compensation is only available to compensation distinctions that are not based on loan terms. In other words, if a lender seeks to pay a loan originator a different amount of compensation for a loan with different loan terms, the loan originator's ability as a practical matter to convince the borrower to originate one loan versus the other is irrelevant — the compensation arrangement is prohibited outright. While it is clear that the loan's interest rate is a loan term, and as such is a prohibited basis for compensation, it is not always clear what else constitutes a loan term. The regulations explain that a term of the transaction means any right or obligation of the parties to the transaction (although compensation in the form of a fixed percentage of the amount of credit extended is permissible).¹¹

We also learned (not from the regulatory text but from a footnote in a rulemaking preamble) that compensation to a loan originator may not vary based on loan "products," because the CFPB described a loan product as a bundle of loan terms. Unfortunately, the CFPB did not define the parameters that distinguishes one loan "product" from another. When the CFPB

dropped that footnote, it was discussing jumbo loans,¹² conventional loans,¹³ and credit extended pursuant to government programs for low- to moderate-income borrowers. The CFPB also asserts that loans offered through state housing finance agency ("HFA") programs constitute a separate loan "product."¹⁴ One can conclude, then, that those examples are loan "products," and that loan originators must receive the same compensation for those loans as for others, even if certain of those loans, like those sponsored by HFAs, may be beneficial to consumers but are arduous to originate and generally not a profit-generator for lenders.

Arguably the most challenging point of the LO Comp Rule, though, relates to a concept from the rule's commentary that the regulators assert is a reasonable corollary to the prohibition against loan term-based compensation. Specifically, the commentary provides that a lender and a mortgage loan originator may not agree to set the originator's compensation at a certain level and then subsequently lower it in selective cases, even if the loan originator wants to lower that compensation to cover certain borrower closing costs or to match a competitive offer from another lender.¹⁵ While lower loan originator compensation generally results in lower costs to the consumer — a good thing, surely — the FED and then the CFPB believed that permitting a decrease in loan originator compensation in selective cases would create a gaping loophole. It would, they explained, allow lenders to set a loan originator's compensation at a relatively high level in order to offset the cost of lowering that compensation in certain cases when, for example, the consumer bargains for a better deal. Effectively, loan originators would receive higher compensation for higher-rate loans, and lower compensation for lower-rate loans¹⁶ — striking at the heart of the prohibition.

¹² The phrase "jumbo loans" refers to loans of an amount that exceeds the limits established by the Federal Housing Finance Agency for loans that are eligible for purchase by Fannie Mae and Freddie Mac. "FHFA Announces Conforming Loan Limit Values for 2025," Nov. 26, 2024, *available at* <https://www.fhfa.gov/news/news-release/fhfa-announces-conforming-loan-limit-values-for-2025>.

¹³ "Conventional loans" refers to loans that are not subject to insurance or guaranty by a government agency, such as the Federal Housing Administration.

¹⁴ CFPB Supervisory Highlights, Issue 24, p. 26 (June 2021).

¹⁵ 12 C.F.R. Part 1026, Supp. I, Cmt. 36(d)(1)-5.

¹⁶ 75 Fed. Reg. 58,509, 58,524 (Sept. 24, 2010).

¹⁰ 12 C.F.R. § 1026.36(d)(1).

¹¹ *Id.*

While the agencies' reasoning may be understandable, that prohibition against allowing a loan originator to lower its compensation for a particular transaction means that lenders must generally bear the costs of rate negotiations, and even of loan originators' errors. The mortgage industry, accustomed to sharing at least some of those costs between lenders and loan originators, has pushed for exceptions to that policy. The CFPB granted an exception, but only for limited, unforeseen circumstances.¹⁷

MORTGAGE LOAN ORIGINATOR DUTIES

The financial regulators (HUD, the FED, and the CFPB) were not the only ones concerned about how mortgage loan originators should be compensated. The federal Department of Labor has wrestled for at least as long as those agencies with whether mortgage loan officer employees are more like financial services providers or like salespersons. That distinction is important in determining whether those employees are exempt from the minimum wage and overtime requirements of the federal Fair Labor Standards Act ("FLSA"), as well as certain similar state laws. Applicable regulations provide that employees in the financial services industry generally meet the so-called "administrative exemption duties test." If that is the case, those employees may be eligible for an exemption from the requirements to track their hours, ensure they receive minimum wage, and pay them overtime. That would be the case if those duties consisted of collecting and analyzing information regarding the customer's income, assets, investments, or debts; determining which financial products best meet the customer's needs and financial circumstances; advising the customer regarding the advantages and disadvantages of different financial products; and marketing, servicing, or promoting the employer's financial products.¹⁸ To the contrary, those regulations provide that an employee whose primary

duty is *selling* financial products does *not* qualify for that exemption.¹⁹

If it seems difficult to determine which of those categories applies to a mortgage loan originator, you are in good company. The Department of Labor, as well as dozens of courts, have struggled to draw that line. In 2006, the Department analyzed the typical job duties of a mortgage loan originator and determined that the financial services aspect of their duties predominated over the sales work.²⁰ Additionally, the degree of discretion and judgment²¹ the employees typically exercise supports the characterization of their duties as exempt. While that was good news to the applicable employers, that conclusion ran contrary to the Department's determination from 2001, which in turn was a reconsideration of an opinion from 1999.²²

The good news in 2006 was temporary, though, as the Department flipped again four years later. In 2010, the Department re-reviewed the duties of typical mortgage loan originator employees and concluded that their primary duty is making sales of their employers' loan products. With that, the Department deemed that typical mortgage loan officer employees do not meet the administrative duties test. Unless another exemption applies, then, employers must ensure that the employees' compensation constitutes at least a minimum wage and determine whether their notoriously round-the-clock availability to their consumer clients pushes them over a 40-hour work week.

LOOKING AHEAD — ARE CHANGES COMING?

The concentrated federal efforts to grapple with mortgage loan originator compensation are about 15 years old. However, conditions in the mortgage market have changed — mortgage rates seem high, and flexibility in loan originator compensation requirements could lower costs for new homeowners. Presidential administrations also change — new regulators have different interpretations and enforcement priorities. With all those changes, surely those burdensome loan originator compensation regulations and interpretations have changed with the times.

However, the LO Comp Rule still exists, generally unchanged. While the CFPB, under its recent leadership

¹⁷ 12 C.F.R. Part 1026, Supp. I, Cmt. 36(d)(1)-7, providing that the LO Comp Rule does not prohibit a loan originator from decreasing its compensation to defray the cost, in whole or part, of an unforeseen increase in an actual settlement cost over an estimated settlement cost disclosed to the consumer in the Loan Estimate, or an unforeseen actual settlement cost not disclosed to the consumer in that Loan Estimate. However, a cost is "unforeseen" only if it occurs even though the estimate was consistent with the best information reasonably available to the disclosing person at the time of the estimate. *Id.*

¹⁸ 29 C.F.R. § 541.203.

¹⁹ *Id.*

²⁰ U.S. Dept. of Labor, FLSA 2006-31 (Sept. 8, 2006).

²¹ 29 C.F.R. § 541.202.

²² U.S. Dept. of Labor FLSA Opinion Letter (Feb. 16, 2001).

change, started rumors of a full-scale rescission of the rule, rescission would create other problems.²³ Even without the regulations, the Dodd-Frank Act still prohibits loan term-based compensation to mortgage loan originators. The Act goes even further than the LO Comp Rule, in that the Act sought to wholly restructure the origination costs of residential mortgage loans. The Act provides that a mortgage originator may receive lender-paid compensation only if the consumer does not make an upfront payment of discount points, origination points, or fees other than bona fide third-party charges that neither the mortgage originator, the lender, or an affiliate of either retain.²⁴ In other words, the Act would have eliminated consumers' option to pay upfront points or fees (including discount points for a lower rate) in transactions in which the loan originator's compensation is paid by the lender (a common way that loan originators are paid). Recognizing that such a rule would cause large-scale disruption in the industry, the CFPB used its exception authority and decided not to prohibit lender-paid compensation when a consumer pays upfront points or fees in the transaction. Accordingly, while rescission of the LO Comp Rule, as the CFPB has teased, sounds enticing, a more surgical approach would be much better.

As to the Department of Labor's conclusion that mortgage loan originators are unlikely to qualify for the administration exemption from the FLSA's requirements to pay minimum wage and overtime, change seems fairly unlikely. In 2015, the Supreme Court held²⁵ that the Department's 2010 interpretation was validly issued, providing an arguably strong foundation for the interpretation's longevity. Of course, the agency may change its mind, and courts may decline to defer to the agency's prior interpretations.²⁶

Until then, some are inclined to take comfort in what may be a low regulatory enforcement era. However, it is important to remember that the federal regulatory agencies are not the only ones watching (or not watching). The LO Comp Rule and the minimum wage/overtime-exemption characterizations are both open to scrutiny in private plaintiff actions and even, to a certain degree, by state regulators. Accordingly, compliance with mortgage loan originator compensation restrictions will remain challenging for the foreseeable future. ■

²³ Spring 2025 Unified Agenda of Regulatory and Deregulatory Actions, Consumer Financial Protection Bureau Prerule Stage, "Loan Originator Compensation Requirements Under the Truth in Lending Act (Regulation Z); Rescission (RIN 3170-AB46), available at <https://www.reginfo.gov/public/do/eAgendaViewRule?pubId=202504&RIN=3170-AB46>.

²⁴ 15 U.S.C. § 1639b(c).

²⁵ *Perez v. Mortgage Bankers Ass'n*, 575 U.S. 92 (2015).

²⁶ See, e.g., *Loper Bright Enterprises v. Raimondo*, 603 U.S. ___ (May 1, 2023).