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# Mortgage Loan Brokering and Lending

First Edition



# The SAFE Act: MLO licensing

## Chapter 1



After you read this chapter, you will be able to :

- understand the economic history leading up to the registration and licensing of mortgage loan originators (MLOs);
- understand the goals of the Secure and Fair Enforcement Act (SAFE Act); and
- identify conduct which triggers MLO licensing.

### Learning Objectives

**consumer mortgage**

**consumer mortgage application**

**consumer purpose**

**Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank)**

**dwelling**

**mortgage loan originator (MLO)**

**Nationwide Mortgage Licensing System (NMLS)**

**Secure and Fair Enforcement for Mortgage Licensing Act (SAFE Act)**

### Key Terms

In the last few decades, the regulation of California **mortgage loan originators (MLOs)** has changed drastically. To understand why, a look at recent mortgage lending history is necessary.

Both the Millennium Boom and the housing bust had roots in the mortgage deregulation of the 1980s. Up until the early '80s, mortgage lending was subject to specific and fine-tuned regulations. These regulations protected society and its institutions from banking failures and economic disruption.

### Regulatory erosion

However, the high interest rates and inflation of the early '80s threatened the solvency of lenders — at the time, comprised mainly of savings and loans (S&Ls). To address the potential multi-billion dollar losses and widespread S&L failures, federal regulators and policy makers passed several extensive laws deregulating the S&L market.

These new laws purported to boost S&L profits by allowing money market accounts, increasing deposit insurance, reducing net worth requirements, permitting out-of-state branch operations, removing restrictions on risky lending and — importantly — allowing S&Ls to originate *adjustable rate mortgages (ARMs)*. [See Chapter 20]

Eventually, the S&Ls failed. But the deregulated mortgage market conditions and ARMs remained in the mortgage marketplace.

## A big boom

Fast forward to late 2001 when the *Federal Reserve (the Fed)* interrupted the corrective process a normal business recession works on the economy by prematurely lowering interest rates.

The cheap money and low interest rates entered the market and the national appetite for debt — including mortgage debt — exploded. Big banks made a killing as Wall Street investors begin a frenzy of buying and selling *mortgage backed bonds (MBBs)* and other securitized mortgage debt.

To secure their inflow of money, Wall Street and the big banks poured money into congressional lobbying efforts. Successful banks and related companies had a vested interest in keeping the market volume up to ensure their continued profits. Formal regulations were an impediment to innovation (and ever greater profits through deceptive mortgage products).

In April 2004, the big banks won the right to reduce the amount of capital they held in reserve to offset their risks. The result was a dramatic 40% increase in freed-up funds which drove the Wall Street banking operators to snap up ownership in most all mortgage banking operations across the nation.

As the nation's mortgage bankers, they were able to directly acquire more high-yield, risky ARMs at ever greater profit margins without involving Fannie Mae or Freddie Mac as profit-taking intermediaries.

The ARMs they acquired were bundled into investment pools. These pools were then sliced into various levels of vertical priority, called *tranches*. Investors bought into these tranches, which were fractionalized into millions of mortgage-backed bonds (MBBs). From there, the bonds were peddled by the same Wall Street bankers to other banking institutions and individual investors throughout the world.

By the time *demand* for mortgages peaked in mid-2005, Wall Street had perfected its system for originating, buying, bundling and reselling mortgages through the MBB market. Even the credit rating agencies were promoting the virtues of these pools of bonds induced by fees paid by the same Wall Street banks getting the highest ratings.

The result: tons of transaction fees, wide yield spreads and no accountability. Wall Street's millennium battle cry perfectly sums up the prevailing attitude of the time: "I'll be gone, you'll be gone."

When the real estate market ran out of financially able homebuyers in 2005, the mortgage industry began to entice *tenants-by-nature* to become homeowners. Also, property owners of all sorts had to be motivated to refinance. The key to qualifying this growing pool of mortgage applicants was a relic from the 1982 bank and S&L deregulation era: ARMs.

During the 2000s, ARMs allowed buyers to qualify using low initial interest rates, called *teaser rates*, and very low payment schedule options for up to ten years. On top of the already risky ARM structure, lenders lowered their underwriting standards and created a new breed of ARMs which required no verification of income or assets. Credit standards plummeted. By the end of the Millennium Boom, the only underwriting standard left was proof of a pulse.

This combination of deregulation, easy money and ever riskier products catapulted real estate prices to unprecedented highs, the financial accelerator in full bloom. When the crash came in 2007, big banks, individual homeowners and the world's investors all bowed to economic devastation. The Great Recession and the financial crisis had arrived.

The real estate and mortgage markets need stability to thrive. In reaction to the financial crisis, Congress passed several major consumer protection laws.

The most sweeping consumer protection law to pass was the omnibus **Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act)**, which became law on March 5, 2010. The *Dodd-Frank Act* mandated key changes to mortgage lending regulations.<sup>1</sup> [See Chapters 27 and 29]

The other new consumer protection law resulting from the mortgage meltdown was the **Secure and Fair Enforcement for Mortgage Licensing Act of 2008 (SAFE Act)**. The SAFE Act compels the license and registration of all MLOs.<sup>2</sup>

The SAFE Act protects consumers by:

- establishing national licensing and educational standards for MLOs; and
- registering all MLOs in a national database, the **Nationwide Mortgage Licensing System (NMLS)**.<sup>3</sup> [See Chapter 1]

## ARMs proliferation and the bust

### Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank)

A 2010 enactment of significant changes to U.S. financial regulation in response to the 2007 financial crisis.

## A new era for consumer protection

### Secure and Fair Enforcement for Mortgage Licensing Act (SAFE Act)

A federal consumer protection law which created a uniform national licensing and registration scheme for mortgage loan originators (MLOs).

## The SAFE Act

### Nationwide Mortgage Licensing System (NMLS)

The national registry of consumer mortgage loan originators (MLOs).

<sup>1</sup> 12 United States Code §§5301 et seq.

<sup>2</sup> 12 USC §§5101 et seq.

<sup>3</sup> 12 USC §5101

Two state regulators

In California, two state entities regulate state-licensed MLOs:

- the California Bureau of Real Estate (CalBRE) [Calif. Business and Professions Code §§10166.01 et seq.]; and
- the California Department of Business Oversight (DBO). [Calif. Financial Code §§50002, 22100 et seq.]

CalBRE issues an **MLO endorsement**, which attaches to an existing CalBRE sales agent or broker license. The underlying sales agent or broker license allows the licensee to practice real estate activities in California. The MLO endorsement allows the licensee to originate consumer mortgages as part of those real estate activities. [Bus & P C §10166.02(b)]

In contrast, individual MLOs who meet the SAFE Act requirements under the DBO hold **MLO licenses**. [Fin C §50002(d)]

Though they have different naming conventions, CalBRE's endorsement and DBO's license both meet SAFE Act requirements for state-licensed MLOs. [See Chapter 2]

An MLO with an active CalBRE license and an active MLO endorsement may originate consumer mortgages for a DBO lender. However, a DBO MLO is barred from originating consumer mortgages under a CalBRE broker unless they also hold an active CalBRE license and MLO endorsement. [Fin C §§22100(b), 50002.5]

The SAFE Act breaks MLOs into two different categories:

- **federally registered MLOs**, who are employed by federally regulated banks; and
- **state-licensed MLOs**, who are licensed and regulated by state agencies. [See Chapter 2]

The **Consumer Financial Protection Bureau (CFPB)** has authority over the SAFE Act regulations controlling both federally registered and state-licensed MLOs.<sup>4</sup>

In addition, the SAFE Act compelled each state to adopt laws to enact the minimum licensing and educational standards required of state-licensed MLOs.

The California Bureau of Real Estate (CalBRE) adopted its version of the SAFE Act in 2009.<sup>5</sup>

Licensing required

The SAFE Act requires a CalBRE licensee who performs MLO activities to:

- obtain and maintain a four-year real estate license from CalBRE; and
- obtain and maintain an annual MLO endorsement from CalBRE.<sup>6</sup>

Failure to hold a proper license and endorsement subjects an individual to a monetary penalty of up to \$10,000. The CalBRE commissioner is able to suspend or revoke licenses for failure to hold the proper license and endorsement.<sup>7</sup> [See Chapter 2]

<sup>4</sup> 12 Code of Federal Regulations §§1007-1008 et seq.

<sup>5</sup> Calif. Business and Professions Code §§10166.01 et seq

<sup>6</sup> Bus & P C §10166.02(b)

<sup>7</sup> Bus & P C §10166.02(f)-(g)

An **MLO** is an individual who, for compensation or gain:

- takes an application for, offers or negotiates the terms of a **consumer mortgage**;
- takes an application for, offers or negotiates the terms of a *consumer mortgage modification*;
- advertises they will take a consumer mortgage application, or offer or negotiate the terms of a consumer mortgage; or
- services a **consumer mortgage**.<sup>8</sup>

A consumer mortgage is:

- used primarily for personal, family or household use, called **consumer purpose**; and
- secured by a trust deed or other security device (land sales contract or lease-option sales agreement) on a **dwelling**, or residential real estate on which a dwelling will be constructed.<sup>9</sup>

A *dwelling* is a one-to-four unit residential property, a condominium, cooperative, mobilehome or trailer which is used as a residence.<sup>10</sup>

Consider a real estate broker who is hired by a buyer to locate a single family residence (SFR) to be used as an investment property. The buyer agrees to pay a separate fee to the broker to negotiate a mortgage to fund the purchase of the investment property. A property and a mortgage lender are located, and the broker is paid for both activities on closing.

Based on this transaction, is the real estate broker required to obtain a MLO license?

No! While the property is considered a dwelling, the buyer as an investor used the proceeds for a business purpose, not a consumer purpose. A consumer mortgage must be both a consumer-purpose mortgage and secured by a dwelling (no occupancy by the buyer required) to be a consumer mortgage covered by the SAFE Act licensing requirements.

Thus, the mortgage in this scenario is not a consumer mortgage and thus does not trigger MLO licensing for the originating broker. [See Chapter 4]

Now consider a CalBRE real estate agent with an MLO endorsement on their license. Due to a drop in mortgage business, the agent focuses on real estate brokerage, and allows their MLO endorsement to lapse. While their endorsement is lapsed, they continue to hand out business cards to solicit mortgage originations.

Is the real estate agent in this scenario required to have an MLO endorsement on their license?

Yes! The act of advertising mortgage origination services is enough to trigger the MLO endorsement requirement.<sup>11</sup>

## Activity defining an MLO

### mortgage loan originator (MLO)

An individual who receives fees to arrange a consumer mortgage.

### consumer mortgage

A debt incurred primarily for personal, family, or household purposes and secured by a parcel of real estate containing one-to-four residential units.

### consumer purpose

A primarily personal, family or household use.

### dwelling

A building or personal property occupied or designed to be occupied as a residence by one or more families.

<sup>8</sup> Bus & PC §10166.01(b)(1), Bus & PC §10131(d)

<sup>9</sup> Bus & PC §10166.01(d)

<sup>10</sup> Bus & PC §10166.01(d)

<sup>11</sup> Bus & PC §10166.01(b)(1)

## Taking a mortgage application

### consumer mortgage application

A consumer mortgage application is a request for an offer of consumer mortgage terms.

Taking a **consumer mortgage application** is one of the activities triggering SAFE Act licensing requirements. A *consumer mortgage application* is a request for an offer of consumer mortgage terms in any form, not just the formal written Fannie Mae / Freddie Mac Residential Loan Application form.<sup>12</sup>

Consumer mortgage applications may be taken directly or indirectly. An individual who offers or negotiates a consumer mortgage for compensation or gain is not able to avoid licensing requirements simply by having another person physically receive the application from the prospective buyer or owner.<sup>13</sup>

An individual takes a consumer mortgage application even if they are not responsible for verifying the information in the application. For example, a mortgage broker who interviews an applicant about the applicant's personal and financial situation has taken a consumer mortgage application, even though they later pass the application to a lender for the mortgage decision.<sup>14</sup>

However, a real estate broker or agent who assists an applicant by explaining the general contents of the application is not taking a consumer mortgage application. Generally describing the mortgage application process is not taking a consumer mortgage application, as long as the description does not include a discussion of specific mortgage products.<sup>15</sup>

## Offering or negotiating terms

Offering or negotiating terms of a consumer mortgage for compensation or gain also triggers SAFE Act licensing requirements.<sup>16</sup>

An offer has been made if the individual:

- presents the applicant with specific consumer mortgage terms;
- communicates with the applicant to reach a mutual understanding about the terms of the consumer mortgage;
- recommends, refers or steers an applicant to a specific lender or mortgage product based on an incentive from a third-party; and
- receives or expects to receive compensation in connection with any of the above activities related to the consumer mortgage.<sup>17</sup>

To provide the broadest protection to buyers, the SAFE Act deems an offer to have been made even if:

- the offer is verbal;
- further verification of information is necessary;
- the offer is conditional;
- other individuals are also required to complete the mortgage process;

<sup>12</sup> Bus & P C § 10166.01(b)(1); 12 CFR § 1008.103(b)(2)

<sup>13</sup> 12 CFR § 1008.103(c)(1); 12 CFR § 1008 Appendix A(a)(1)(i)(A)]

<sup>14</sup> 12 CFR § 1008 Appendix A(a)(1)(i)

<sup>15</sup> 12 CFR § 1008 Appendix A(a)(1)(ii)(B)-(C)

<sup>16</sup> Bus & P C § 10166.01(b)(1)

<sup>17</sup> 12 CFR § 1008.103(c)(2)

- the individual making the offer lacks authority to negotiate the interest rate or other mortgage terms; or
- the individual making the offer lacks authority to bind the person that is the source of the prospective financing.<sup>18</sup>

Any communications with an applicant to set consumer mortgage terms are considered negotiations. This includes:

- indirect communications (e.g., negotiations through a third party or email);
- sending the applicant a revised mortgage offer in response to the applicant's request for a different rate or different mortgage fees; and
- any communications regarding mortgage terms, even if the applicant does not ultimately accept the terms.<sup>19</sup>

However, offering or negotiating terms of a consumer mortgage does not include:

- providing general explanations in response to inquiries, such as explaining general mortgage terminology or lending policies;
- arranging the mortgage closing or other aspects of the mortgage process, such as an escrow officer does when coordinating a time and place to sign mortgage documents;
- providing an applicant with information unrelated to mortgage terms, such as explaining the best days of the month for scheduling mortgage closings; or
- explaining the steps an applicant needs to take to obtain a mortgage offer, such as providing general guidance about qualifications not specific to the applicant's circumstances.<sup>20</sup>

The activities of origination and lending are related, but distinct. While lenders do also originate mortgages, a person who makes (funds) a consumer mortgage is not automatically considered an MLO in need of an endorsement. Only mortgage origination activities trigger both the license and endorsement requirements.

For instance, a CalBRE broker license is required when a trust deed investor funds eight or more mortgages (regardless of purpose) in a calendar year when the mortgages are secured by one-to-four unit residential properties.<sup>21</sup>

However, this licensing requirement is distinct from the requirement to hold an MLO endorsement. The MLO endorsement is only required once the licensee charges and collects a separate fee for soliciting the applicant, completing the mortgage application or negotiating the terms of the mortgage (originating).

**Lending and origination, differentiated**

<sup>18</sup> 12 CFR §1008 Appendix A(b)(1)(i)

<sup>19</sup> 12 CFR §1008 Appendix A(b)(1)(ii)

<sup>20</sup> 12 CFR §1008 Appendix A(b)(2)

<sup>21</sup> Bus & PC §10131.1(b)(1)(C)

## Compensation is key

Consider a broker who takes a listing from a seller to locate a buyer for the seller's single family residence. To increase the odds of finding a buyer and to meet the seller's long-term financial goals, the broker counsels the seller to offer seller financing. The broker locates a buyer who will occupy the property as their principal residence, a consumer purpose.

The broker negotiates the terms of the sale, including the seller financing. The deal closes. The broker is paid according to the terms of the listing agreement for the sale of the property. The broker does not collect an additional fee for arranging the seller financing.

Do the broker's activities trigger the MLO endorsement requirement?

No! Here, the broker is compensated for locating a buyer and arranging the sale of the seller's property under the terms of the listing agreement. Recall that in order to fall under the MLO endorsement requirements, the mortgage origination activities must be performed in exchange or in expectation of a fee or other compensation. Since the broker did not charge an additional fee for negotiating the carryback, the broker is not required to hold an MLO endorsement on their license.

Similarly, the source of the compensation also determines whether a broker who negotiates a short sale is required to hold an MLO endorsement.

A short sale is a sale in which the lender accepts the net proceeds at closing in full satisfaction of a greater amount of mortgage debt.

A broker who negotiates a short sale as part of their real estate brokerage services without charging an additional fee for the short sale negotiations is not required to hold an MLO endorsement.

However, if the broker is collecting a fee for negotiating a short sale as part of a consumer mortgage modification service, they are required to hold an MLO endorsement. Here, the broker's underlying service — the consumer mortgage modification service for a fee — is a service which triggers the MLO endorsement.<sup>22</sup>

## Referrals

Fees for referring buyers and sellers to a real estate broker or agent are allowable when paid by a real estate broker to an employee or to another real estate broker.<sup>23</sup> [See **RPI** Form 114]

However, this exception does not extend to the broker's receipt of a referral fee for referring a principal in their sales transaction to an MLO service of any type. If a broker is paid a fee for the referral — and the broker's only service is as a transaction agent (TA) acting on behalf of the seller or buyer — the broker is considered an MLO by the very receipt of a fee. Thus, by the acceptance of a kickback referral fee from a lender, they are subject to MLO endorsement and compensation rules.<sup>24</sup> [See Chapter 6]

<sup>22</sup> Bus & P C §10166.01(b)(1)

<sup>23</sup> 12 CFR §1024.14(g)(1)(v)

<sup>24</sup> Bus & P C §10166.01(b)(2)(B); 12 CFR §1026.36(a)(1)(i)(C); Official Interpretation of 12 CFR §1026.36(a)-(1)(iv)

A broker or agent who only performs real estate brokerage activities is not required to hold an MLO endorsement if they refer business to lenders without expectation or receipt of compensation.

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## Chapter 1 Summary

## Chapter 1 Key Terms