INSERT TAB 300

CONSUMER AFFAIRS LAWS AND REGULATIONS

I. Background and Summary

The Fair Credit Reporting Act (FCRA) [15 USC 1681-1681u] became effective on April 25, 1971. The FCRA is part of a group of acts contained in the Federal Consumer Credit Protection Act [5 USC 1601 *et seq.*], such as the Truth in Lending Act and the Fair Debt Collection Practices Act. Congress subsequently passed the Consumer Credit Reporting Reform Act of 1996 (Reform Act), which substantially revised the FCRA. These revisions generally became effective on September 30, 1997. Minor amendments to the FCRA were made in 1997 and 1998. The Gramm-Leach-Bliley Act of 1999 made additional changes, including provisions permitting regulations to be adopted to implement the requirements of the FCRA.

The purposes of the FCRA, as amended, include the following:

- to regulate aspects of the consumer reporting industry;
- to place disclosure obligations on users of consumer reports;
- to establish requirements applicable to the furnishing of information to consumer reporting agencies; and
- to require timely responses to consumer inquiries regarding information maintained by consumer reporting agencies.

The FCRA places restrictions on the use of consumer reports and, in certain instances, requires the deletion of information from them.

Financial institutions may be subject to the FCRA as:

- procurers and users of information (for example, as credit grantors, purchasers of dealer paper, or when opening deposit accounts);
- furnishers and transmitters of information (by reporting information to consumer reporting agencies or other third parties, or to affiliates);
- marketers of credit or insurance products; or
- employers.

Generally, financial institutions will not be considered to be consumer reporting agencies; however, it is possible for them to become consumer reporting agencies. Therefore, financial institutions should exercise careful scrutiny of their operations to ensure that they comply with the requirements of the FCRA as applicable.

II. Relation to State Laws and Administrative Enforcement

Section 624 [15 USC 1681t] preempts certain state law requirements while generally preserving the rights of states to legislate on matters covered by the FCRA (but only to the extent that state laws are *not inconsistent* with the FCRA). Areas where state requirements/prohibitions are entirely preempted include:

- furnishing and using consumer reports in connection with any credit or insurance transaction that is not initiated by the consumer; and
- the duties of a person taking adverse action with respect to a consumer under sections 615 (a) and (b).

In general, state requirements/prohibitions are preempted with respect to the exchange of information among affiliates. In addition, certain other areas of state laws are preempted as provided by section 624.

Section 621 [15 USC 1681s] establishes responsibilities for administrative enforcement of the FCRA. The Federal Trade Commission (FTC) is authorized to enforce the requirements for certain persons other than banks, savings associations, and credit unions. The banking and thrift supervisory agencies are authorized to enforce the FCRA with respect to their supervised institutions. State law

Approved-FFIEC

enforcement officials also may enforce the FCRA through court actions. Federal regulators, however, have a right to intervene in any action brought by a state.

III. Important Definitions

There are a number of definitions used throughout the FCRA. The more important definitions that financial institutions and examination staff should be aware of include the following:

Consumer

A "consumer" is defined as an individual.

Consumer Report

A "consumer report" is any written, oral, or other communication of any information by a consumer reporting agency that bears on a consumer's creditworthiness, credit standing, credit capacity, character, general reputation, personal characteristics, or mode of living which is used or expected to be used or collected in whole or in part for the purpose of serving as a factor in establishing the consumer's eligibility for:

- credit or insurance to be used primarily for personal, family, or household purposes;
- employment purposes; or
- any other purpose authorized under section 604 [15 USC 1681b]. (Refer to section IV, "Requirements on Consumer Reporting Agencies.")

The term "consumer report" does not include:

- any report containing information solely about transactions or experiences between the consumer and the institution making the report;
- any communication of that transaction or experience information among entities related by common ownership or affiliated by corporate control (for example, different banks that are members of the same holding company, or subsidiary companies of a bank);
- communication of other information among persons related by common ownership or affiliated by corporate control if
  - — it is clearly and conspicuously disclosed to the consumer that the information may be communicated among such persons; and
  - — the consumer is given the opportunity, before the time that the information is communicated, to direct that the information not be communicated among such persons.
- any authorization or approval of a specific extension of credit directly or indirectly by the issuer of a credit card or similar device;
- any report in which a person who has been requested by a third party to make a specific extension of credit directly or indirectly to a consumer, such as a lender who has received a request from a broker conveys his or her decision with respect to such request, if the third party advises the consumer of the name and address of the person to whom the request was made, and such person makes the disclosures to the consumer required under section 615 [15 USC 1681m]; or
- a communication described in section 603(o) [15 USC 1681a(o)] (which relates to certain reports to prospective employers).

Person

A "person" means any individual, partnership, corporation, trust, estate, cooperative, association, government or governmental subdivision or agency, or other entity.

Investigative Consumer Report

An "investigative consumer report" means a consumer report or portion thereof in which information on a consumer's character, general reputation, personal characteristics, or mode of living is obtained through personal interviews with neighbors, friends, or associates of the consumer reported on or with others with whom he is acquainted or who may have knowledge concerning any such items of information. However, such information does not include specific factual information on a consumer's credit record obtained directly from a creditor of the consumer or from a consumer reporting agency when such information was obtained directly from a creditor of the consumer or from the consumer.

Adverse Action

The term “adverse action” has the same meaning as used in section 701(d)(6) [15 USC 1691(d)(6)] of the Equal Credit Opportunity Act (ECOA). Under the ECOA, it means a denial or revocation of credit, a change in the terms of an existing credit arrangement, or a refusal to grant credit in substantially the amount or on substantially the terms requested. Under the ECOA, the term does not include a refusal to extend additional credit under an existing credit arrangement where the applicant is delinquent or otherwise in default, or where such additional credit would exceed a previously established credit limit. The term has the following additional meanings for purposes of the FCRA:

- a denial or cancellation of, an increase in any charge for, or a reduction or other adverse or unfavorable change in the terms of coverage or amount of, any insurance, existing or applied for, in connection with the underwriting of insurance;
- a denial of employment or any other decision for employment purposes that adversely affects any current or prospective employee;
- a denial or cancellation of, an increase in any charge for, or any other adverse or unfavorable change in the terms of, any license or benefit described in section 604(a)(3)(D) [15 USC 1681b(a)(3)(D)]. (Refer to section IV. A., “Permissible Purposes for Furnishing or Using Consumer Reports”); and
- an action taken or determination that is (a) made in connection with an application made by, or transaction initiated by, any consumer, or in connection with a review of an account to determine whether the consumer continues to meet the terms of the account, and (b) adverse to the interests of the consumer.

Employment Purposes

The term “employment purposes” when used in connection with a consumer report means a report used for the purpose of evaluating a consumer for employment, promotion, reassignment or retention as an employee.

Consumer Reporting Agency

The term "consumer reporting agency" means any person which, for monetary fees, dues, or on a cooperative nonprofit basis, regularly engages in whole or in part in the practice of assembling or evaluating consumer credit information or other information on consumers for the purpose of furnishing consumer reports to third parties, and which uses any means or facility of interstate commerce for the purpose of preparing or furnishing consumer reports.

IV. Requirements on Consumer Reporting Agencies

Consumer reporting agencies have substantial obligations placed upon them by the FCRA. These obligations are summarized below. Financial institutions and other persons that are users or furnishers of information from or to consumer reporting agencies should also be aware of the obligations of the consumer reporting agencies since certain requirements on the agencies will affect requirements on users or furnishers of information.

A. Permissible Purposes for Furnishing or Using Consumer Reports

Section 604 [15 USC 1681b] prohibits a consumer reporting agency from furnishing a consumer report, except for the following purposes.

In addition to furnishing consumer reports in connection with credit or insurance pre-screens, a consumer reporting agency may furnish a consumer report:

- when the consumer has authorized the release in writing;

- pursuant to a court order or subpoena issued by a federal grand jury;
- to an agency administering a state plan under section 454 of the Social Security Act [42 USC 654] to establish or modify child support awards;
- in response to a request by a state or local child support enforcement agency, if proper certification is provided; or
- to a person the consumer reporting agency has reason to believe
  - intends to use the information in connection with a credit transaction involving the consumer on whom the information is to be furnished and involving the extension of credit to, or review or collection of an account of, the consumer;
  - intends to use the information for employment purposes;
  - intends to use the information for underwriting insurance involving the consumer;
  - intends to use the information for determining the consumer's eligibility for a license or other benefit granted by a government instrumentality that is required by law to consider an applicant's financial responsibility or status;
  - intends to use the information, as a potential investor or servicer, or current insurer, in connection with a valuation of, or an assessment of the credit or prepayment risks associated with, an existing credit obligation; or
  - otherwise has a legitimate business need for the information, either in connection with a business transaction initiated by the consumer, or to review an account to determine whether the consumer continues to meet the terms of the account.

This last provision permits an institution to obtain consumer reports, for example, for deposit services, such as a consumer opening a transaction account. Consumers who are turned down when attempting to open an account because of information contained in a consumer report must be provided an adverse action notification. (Refer to section V, "Requirements on Users of Consumer Reports.")

Disclosures containing medical information. A consumer reporting agency cannot furnish a consumer report containing medical information about a consumer without the consumer's consent in the following circumstances:

- for employment purposes; or
- in connection with a credit or insurance transaction.

Disclosures to government agencies. Consumer reporting agencies, under section 608 [15 USC 1681f], may furnish to government agencies (federal, state, or local) identifying information on any consumer that is limited to the consumer's name, address, former addresses, places of employment, or former places of employment. This is a specific exemption from the general requirements of section 604 of the FCRA. Special rules under section 604 apply when a U.S. government agency head makes a written finding that a consumer report is relevant to a national security investigation being carried on by the agency.

Disclosures to the Federal Bureau of Investigation (FBI). Consumer reporting agencies are required to furnish information to the FBI when it requests the information pursuant to an authorized foreign counterintelligence investigation. Section 625 [15 USC 1681u] provides specific requirements on how the FBI and the consumer reporting agency must comply with the provisions of the FCRA in this area.

B. Information Contained in Consumer Reports

Section 605 [15 USC 1681c] contains limitations on the type of information contained in consumer reports and the length of time it may be reported by a consumer reporting agency. Examples of information that must be excluded from a consumer report are as follows:

- bankruptcy cases that antedate the report by more than ten years measured from the date of entry of the order for relief or the date of adjudication;

- civil suits, civil judgments and records of arrest that, from date of entry, antedate the report by more than seven years or until the governing statute of limitations has expired, whichever is the longer period;
- paid tax liens which, from date of payment, antedate the report by more than seven years;
- accounts placed for collection or charged off which antedate the report by more than seven years. (The reporting periods have been lengthened for certain adverse information pertaining to U.S. Government-insured or -guaranteed student loans, or pertaining to national direct student loans. Refer to sections 430A(f) and 463(c)(3) of the Higher Education Act of 1965 [20 USC 1080a(f) and 20 USC 1087cc(c)(3)], respectively);
- any other adverse information, other than records of convictions of crimes, which antedates the report by more than seven years.

These time restrictions do not apply in the case of a consumer report to be used in connection with

- a credit transaction involving, or which may reasonably be expected to involve, a principal amount of $150,000 or more;
- the underwriting of life insurance involving, or which may reasonably be expected to involve, a face value of $150,000 or more; or
- the employment of any individual at an annual salary that equals, or which may reasonably be expected to equal, $75,000 or more.

Indication of closure of account by consumer. If a consumer reporting agency is notified pursuant to section 623(a)(4) [15 USC 1681s-2(a)(4)] that a credit account of a consumer was voluntarily closed by the consumer, the agency is to indicate that fact in any consumer report that includes information related to the account.

Indication of dispute by consumer. If a consumer reporting agency is notified pursuant to section 623(a)(3) [15 USC 1681s-2(a)(3)] that information regarding a consumer which was furnished to the agency is disputed by the consumer, the agency is to indicate that fact in each consumer report that includes the disputed information.

Information on overdue child support obligations. In contrast to prohibitions on reporting certain information, section 622 [15 USC 1681s-1] **requires** a consumer reporting agency to include, in any consumer report furnished by the agency, information on the failure of the consumer to pay overdue support where the information (a) is provided or verified by a specified government agency and (b) antedates the report by seven years or less.

C. Investigative Consumer Reports

According to section 606 [15 USC 1681d], an investigative consumer report may not be procured or caused to be prepared unless the consumer has been provided a clear and accurate disclosure by the person requesting the report that an investigative consumer report may be obtained. This disclosure must contain a statement in writing of the consumer's right to request additional disclosures about the report, and a summary of the consumer's rights under the FCRA, mailed or otherwise delivered to the consumer not later than three days after the date on which the report was first requested. The person procuring the report from the consumer reporting agency (or causing it to be prepared) must certify to the consumer reporting agency that the person has complied with these disclosure requirements and will comply in the event the consumer exercises his or her right to request additional disclosures.

D. Compliance Procedures

Section 607 [15 USC 1681e] requires consumer reporting agencies to maintain reasonable procedures to avoid violations of section 605 and limit distribution of consumer reports only to persons with a permissible purpose under section 604. Section 607 requires consumer reporting agencies to follow reasonable procedures in preparing consumer reports to assure maximum possible accuracy of the information that they report on consumers.

Section 607 also establishes rules for persons who obtain consumer reports for resale to other parties. Information generally must be provided back to the consumer reporting agency as to the identity of the end user of the report and each permissible purpose for which it was furnished to the end user.

Consumer reporting agencies may not prohibit the disclosure of the contents of a consumer report to the consumer by the user of the report, if adverse action has been taken by the user based in whole or in part on the report.

E. Disclosures to Consumers

Under sections 609 and 610 [15 USC 1681g and 1681h], a consumer reporting agency, upon request from a consumer, must clearly and accurately disclose the following information to the consumer in writing (unless the consumer has authorized another form of disclosure, including electronic means, if available from the agency) when it is provided proper identification:

- all information in the consumer's file at the time of the request (except that information about credit scores or other risk scores or predictors relating to the consumer need not be disclosed).
- the sources of the information (except that sources of information acquired solely for use in preparing an investigative consumer report and actually used for no other purpose need not be disclosed, provided that in the event an action is brought, such sources would be available to the plaintiff under appropriate discovery procedures).
- in general, the identity of each person that procured a consumer report
  - — for employment purposes, during the two years preceding the request, or
  - — for any other purpose, during the one year preceding the request.

Identification must include the name of the person or, if applicable, the trade name under which such person conducts business, and upon the consumer's request, the address and telephone number of the person.

- dates, original payees, and amounts of any checks upon which is based any adverse characterization of the consumer, included in the file at the time of the disclosure; and
- a record of all inquiries received during the one-year period preceding the request that identified the consumer in connection with a credit or insurance transaction not initiated by the consumer.

The consumer reporting agency shall provide, with each written disclosure made pursuant to the above requirements, a written summary of the consumer's rights in a form prescribed by the FTC. Consumer reporting agencies that maintain consumer files on a nationwide basis (refer to section 603(p) [15 USC 1681a (p)] must include a toll-free telephone number.

F. Procedures in Case of Disputed Accuracy

Under section 611 [15 USC 1681i], if the consumer disputes the completeness or accuracy of any information contained in a consumer file, and the consumer notifies the agency directly, the consumer reporting agency must:

- reinvestigate, at no charge, and record the current status of the disputed information, or delete the item from the file, generally within 30 days of receiving notice from the consumer; and
- provide notification of the dispute to any person that provided any item of the information in dispute, within five business days from the agency's receipt of notice of the dispute.

The 30-day time period above may be extended up to an additional 15 days if the consumer submits additional relevant information during the 30-day period, but no such extension may be made if the information that is the subject of the reinvestigation is found during the 30-day period to be inaccurate or incomplete or the consumer reporting agency determines that the information cannot be verified.

A consumer reporting agency may terminate a reinvestigation of a consumer dispute if it makes a reasonable determination that the dispute is frivolous or irrelevant. If it makes such a determination, it must notify the consumer within five business days. The notice must include the reasons for the determination and identify any information required to investigate the disputed information.

If, after any reinvestigation of any information disputed by a consumer, an item of information is found to be inaccurate or incomplete or cannot be verified, the consumer reporting agency must promptly delete or modify the information, as appropriate. The information cannot be reinserted into the file unless the person who furnishes the information certifies that the information is complete and accurate. If the information is reinserted, the consumer reporting agency must notify the consumer of the reinsertion in writing within five business days. The notice must include (a) the business name and address of any furnisher contacted and the telephone number of such furnisher, if reasonably available, or of any furnisher that contacted the consumer reporting agency, in connection with the reinsertion, and (b) a notice of the consumer's right to add a statement to the file disputing the accuracy or completeness of the information.

A consumer reporting agency must maintain reasonable procedures to prevent the reappearance in a consumer's file, and in consumer reports on the consumer, of information that is deleted, other than information that has been properly reinserted. Consumer reporting agencies that maintain consumer files on a nationwide basis must have an automated system through which a furnisher of information may report the results of a reinvestigation that finds incomplete or inaccurate information in a consumer's file to other such consumer reporting agencies.

Within five business days after completion of a reinvestigation, a consumer reporting agency must notify the consumer of the results of the investigation by mail or other means authorized by the consumer and available to the agency. If the reinvestigation does not resolve the dispute, the consumer may file a brief statement setting forth the nature of the dispute. The statement, or a clear and accurate summary thereof, must be put in any subsequent consumer report containing the disputed information, unless there are reasonable grounds to believe that the dispute is frivolous or irrelevant.

G. Permissible Charges for Disclosures

Section 612 [15 USC 1681j] provides that a consumer reporting agency may not impose any charge on a consumer for providing any notification or disclosure required by the FCRA, except for those authorized under this section. A consumer reporting agency may impose a reasonable charge on a consumer when it:

- makes a disclosure to the consumer pursuant to section 609 [15 USC 1681g]. That charge must not exceed $8.50 for the year 2000 (the amount is to be adjusted annually by the FTC, based on changes in the consumer price index) and must be indicated before the consumer reporting agency provides the disclosure; and
- provides the notification pursuant to section 611(d) [15 USC 1681i(d)] at any time after the 30-day period beginning on the date of the notice of the results of the reinvestigation. That charge may not exceed the amount the agency would impose on each recipient of the notification for a consumer report, and must be indicated before furnishing the information.

According to section 611(d) [15 USC 1681i(d)], following any deletion of information which is found to be inaccurate or whose accuracy can no longer be verified or any notation as to disputed information, the consumer reporting agency must, at the request of the consumer, furnish notification that the item has been deleted, or the statement or summary of dispute referred to above, to any person specifically designated by the consumer who has within two years prior thereto received a consumer report for employment purposes, or within six months prior thereto received a consumer report for any other purpose, which contained the deleted or disputed information.

A consumer reporting agency that maintains a file on a consumer must make all disclosures required by section 609 [15 USC 1681g] at no charge if the consumer has requested them under section 609 within 60 days after receiving:

- a notice of adverse action pursuant to section 615 [15 USC 1681m]; or
- notification from a debt collection agency affiliated with the consumer reporting agency stating that the consumer's credit rating has been or may be adversely affected.

The consumer reporting agency also must make the disclosures required by section 609 [15 USC 1681g] at no charge, once in any 12-month period, if the consumer requests them and certifies in writing that he or she:

- is unemployed and intends to apply for employment in the 60-day period beginning on the date on which the certification is made;
- is a recipient of public welfare assistance; or
- has reason to believe that the file on the consumer at the agency contains inaccurate information due to fraud.

H. Public Record Information for Employment Purposes

Under section 613 [15 USC 1681k], a consumer reporting agency that furnishes a consumer report for employment purposes and for that purpose compiles and reports public record information that is likely to have an adverse effect upon a consumer's ability to obtain employment generally must:

- at the time the public record information is reported to the user of the report, notify the consumer that public record information is being reported, together with the name and address of the person to whom the information is being reported; or
- maintain strict procedures to ensure that such public record information is complete and up to date.

I. Restrictions on Investigative Consumer Reports

Section 614 [15 USC 1681l] provides that when a consumer reporting agency prepares an investigative consumer report, no adverse information in the consumer report (other than public record information) may be included in a subsequent consumer report, unless the information:

- has been verified in the process of making the subsequent report; or
- was received within the three-month period preceding the date the subsequent report is furnished.

V. Requirements on Users of Consumer Reports

A. Information Obtained from a Consumer Report

Section 615(a) [15 USC 1681m(a)] requires that if any person takes any adverse action with respect to any consumer that is based in whole or in part on any information contained in a consumer report, the person must:

- provide oral, written, or electronic notice of the adverse action to the consumer;
- provide to the consumer orally, in writing, or electronically, the name, address, and telephone number of the consumer reporting agency from which it received the information (including a toll-free telephone number established by the agency, if the consumer reporting agency maintains files on a nationwide basis); and a statement that the consumer reporting agency did not make the decision to take the adverse action and is unable to provide the consumer the specific reasons why the adverse action was taken; and
- provide the consumer an oral, written, or electronic notice of the consumer's right to obtain a free copy of the consumer report within 60 days of receiving notice of the adverse action, and the consumer's right to dispute the accuracy or completeness of any information in the consumer report with the consumer reporting agency.

B. Information Obtained from a Source Other Than a Consumer Report

Section 615(b)(1) [15 USC 1681m(b)(1)] provides that if consumer credit is denied or the charge for such credit is increased, partially or wholly on the basis of information obtained from a person other than a consumer reporting agency bearing upon the consumer's creditworthiness, credit standing, credit capacity, character, general reputation, personal characteristics, or mode of living, the user:

- must clearly and accurately disclose the consumer's right to file a written request for the reasons for the adverse action; and
- if it receives such a request within 60 days after the consumer learns of the adverse action, must, within a reasonable period of time, disclose the nature of the adverse information.

C. Information Obtained from an Affiliate

Section 615(b)(2) [15 USC 1681m(b)(2)] provides that if a user takes an adverse action involving credit (taken in connection with a transaction initiated by a consumer), insurance or employment, it must notify the consumer of the adverse action, if it took the action based in whole or part on information provided by an affiliate that:

- bears upon the consumer's creditworthiness, credit standing, credit capacity, character, general reputation, personal characteristics, or mode of living; and
- is not information solely as to the transactions or experiences with the consumer on the part of the person furnishing the information, or information in a consumer report.

The notification must inform the consumer that the consumer may obtain a disclosure of the nature of the information relied upon by making a written request within 60 days of transmittal of the adverse action notice. If the consumer makes such a request, the user must disclose the nature of the information not later than 30 days after receiving the request.

D. Using Consumer Reports for Employment Purposes

Section 604(b)(2) [15 USC 1681b(b)(2)] generally requires the written permission of the consumer to procure a consumer report for "employment purposes." Moreover, a clear and conspicuous disclosure that a consumer report may be obtained for employment purposes generally must be provided in writing to the consumer prior to procuring a report.

Prior to taking any adverse action as to employment based in whole or in part on the consumer report, the user must generally provide to the consumer:

- a copy of the report; and
- the FTC notice described within section 609(c)(3) [15 USC 1681g].

At the time a user of the report takes adverse action in an employment situation, an adverse action notice, as required by section 615, also must be provided to the consumer.

VI. Responsibilities Placed on Furnishers of Information

Section 623 [15 USC 1681s-2] contains a number of new requirements for persons furnishing information to consumer reporting agencies.

Duties of furnishers to provide accurate information. A person may, but need not, specify an address for receipt of notices from consumers concerning inaccurate information. If the person specifies such an address, then the person may not furnish information relating to a consumer to any consumer reporting agency if (a) the person has been notified by the consumer, at the specified address, that the information is inaccurate, and (b) the information is in fact inaccurate. If the person does not specify an address, then the person may not furnish any information relating to a consumer to any consumer reporting agency, if the person knows or consciously avoids knowing that the information is inaccurate.

When a person, who regularly and in the ordinary course of business furnishes information to one or more consumer reporting agencies about the person's transactions or experiences with any consumer, determines that any such information is not complete or accurate, the person must promptly notify the consumer reporting agency of that determination. The person also must provide to the agency any corrections to that information, or any additional information, necessary to make the information provided by the person to the agency complete and accurate and must not thereafter furnish to the agency any of the information that remains incomplete or inaccurate.

If the completeness or accuracy of any information furnished by a person to a consumer reporting agency is disputed to such person by a consumer, that person may not furnish the information to any consumer reporting agency without notice that the information is disputed by the consumer.

Voluntary closures of accounts. Any person, who regularly and in the ordinary course of business furnishes information to a consumer reporting agency regarding a consumer who has a credit account with that person, must notify the agency of the voluntary closure of the account by the consumer in information regularly furnished for the period in which the account is closed.

Notice involving delinquent accounts. A person who furnishes information to a consumer reporting agency about a delinquent account being placed for collection, charged off, or subjected to any similar action must, not later than 90 days after furnishing the information to the consumer reporting agency, notify the agency of the month and year of the commencement of the delinquency that immediately preceded the action.

Duties upon notice of dispute. Whenever a person receives a notice of dispute from a consumer reporting agency regarding the accuracy or completeness of any information provided by the person pursuant to section 611, that person must:

- conduct an investigation regarding the disputed information;
- review all relevant information provided by the consumer reporting agency along with the notice;
- report the results of the investigation to the consumer reporting agency; and
- if the information is found to be incomplete or inaccurate, report those results to all nationwide consumer reporting agencies to which the person previously provided the information.

The investigations, reviews, and reports required to be made must be completed within 30 days. The time period may be extended for 15 days if a consumer reporting agency receives additional relevant information.

Enforcement of the responsibilities of furnishers of information under section 623 (except those described under "Duties Upon Notice of Dispute") is reserved exclusively for the federal and state agencies and officials, including the financial institution regulatory agencies, identified under section 621 [15 USC 1681s]. (Refer to section II, "Relation to State Laws and Administrative Enforcement.")

VII. Pre-Screening Requirements

The practice of using consumer reports for the purpose of selecting pools of individuals for solicitation of financial or other products has expanded substantially since the 1970s. Guidance on these issues is discussed in this section.

A. Firm Offer of Credit or Insurance

The term "firm offer of credit or insurance" means any offer of credit or insurance to a consumer that will be honored if the consumer is determined, based on information in a consumer report on the consumer, to meet the specific criteria used to select the consumer for the offer, except that the offer may be further conditioned on one or more of the following:

- the consumer being determined, based on information in the consumer's application for the credit or insurance, to meet specific criteria bearing on creditworthiness or insurability, as applicable, that are established

- before selection of the consumer for the offer; and
- for the purpose of determining whether to extend credit or insurance pursuant to the offer.

- verification
  - that the consumer continues to meet the specific criteria used to select the consumer for the offer, by using information in a consumer report on the consumer, information in the consumer's application for the credit or insurance, or other information bearing on the creditworthiness or insurability of the consumer; or
  - of the information in the consumer's application for the credit or insurance, to determine that the consumer meets the specific criteria bearing on creditworthiness or insurability.
- the consumer furnishing any collateral that is a requirement for the extension of the credit or insurance that was
  - established before selection of the consumer for the offer of credit or insurance; and
  - disclosed to the consumer in the offer of credit or insurance.

B. Credit or Insurance Transaction Not Initiated by the Consumer

The term “credit or insurance transaction that is not initiated by the consumer” is a new term defined in section 603(m) [15 USC 1681a(m)] for use in dealing with pre-screening issues. The term does not include the use of a consumer report by a person with whom the consumer has an account or insurance policy for the following purposes:

- reviewing the account or insurance policy; or
- collecting the account.

C. Furnishing Reports in Connection with Credit Transactions not Initiated by the Consumer

Section 604(c) [15 USC 1681b(c)] establishes requirements for consumer reporting agencies when furnishing consumer reports for use in connection with pre-screens. A consumer reporting agency may only furnish a person with a consumer report for pre-screening purposes if:

- the consumer authorizes the agency to provide such report to such person, or
- the transaction consists of a firm offer of credit or insurance and
  - the consumer reporting agency has established the required procedures to permit consumers to elect to be excluded from pre-screened lists; and
  - no such election is in effect as to the consumer.

A person receiving a pre-screened list from a consumer reporting agency may, for each consumer on the list, receive only the following information:

- the name and address of the consumer;
- an identifier that is not unique to the consumer and that is used by the person solely for the purpose of verifying the identity of the consumer; and
- other information about the consumer that does not identify the relationship or experience of the consumer with a particular creditor or other entity.

As indicated above, a consumer reporting agency must establish procedures that allow a consumer to notify the agency that the consumer elects to be excluded from pre-screen lists furnished by the agency. Notifications can be made through a notification system maintained by the agency or by submitting a signed notice of election form issued by the agency. Exclusion requests made through the notification system expire two years following notification unless earlier withdrawn. If the request is made on the election form, it never expires, although it may be withdrawn.

D. Duties of Users Making Written Solicitations on the Basis of Information from Consumer Files

Under section 615(d) [15 USC 1681m(d)], any person who uses a consumer report on any consumer in connection with any credit or insurance transaction that is not initiated by the consumer and that is provided to that person in accordance with paragraph C. above must provide with each written solicitation, a clear and conspicuous statement that:

- information contained in a consumer's consumer report was used in connection with the offer;
- the consumer received the offer because he or she satisfied the criteria for creditworthiness or insurability used to screen for the offer;
- if applicable, the credit or insurance may not be extended if, after the consumer responds, it is determined that the consumer does not meet the criteria used for screening or any applicable criteria bearing on creditworthiness or insurability, or the consumer does not furnish required collateral; and
- consumers have the right to prohibit use of information in their consumer file in connection with future pre-screened offers of credit or insurance by contacting a notification system established under section 604(e)(5) by the consumer reporting agency that provided the report. The address and toll-free telephone number of the appropriate notification system must be provided.

Record Retention Requirements. Section 615(d)(3) requires a person who makes an offer of credit or insurance to a consumer in a transaction not initiated by the consumer to maintain on file the criteria used to select the consumer to receive the offer, all criteria bearing on creditworthiness or insurability, as applicable, that are the basis for determining whether or not to extend credit or insurance pursuant to the offer, and any requirement for the furnishing of collateral as a condition of the extension of credit or insurance, until the expiration of the three-year period beginning on the date on which the offer is made to the consumer.

VIII. Civil Liability, Limitation of Actions, and Unauthorized Disclosure

Sections 616 and 617 [15 USC 1681n and 1681o] establish the circumstances under which persons violating the FCRA may be liable for willful or negligent noncompliance. Civil liability awards for violations may include actual damages, court costs, attorneys' fees and, for willful noncompliance, punitive damages.

Section 618 [15 USC 1681p] establishes a statute of limitations for bringing actions under the FCRA. The time period is generally two years from the date the liability arises; however, it can be extended for certain willful and material misrepresentations to a date two years after the individual discovers the misrepresentation.

Sections 619 and 620 [15 USC 1681q and 1681r] make it a crime for any person to knowingly and willfully obtain information on a consumer from a consumer reporting agency under false pretenses, and for any officer or employee of a consumer reporting agency to knowingly and willfully provide information concerning an individual to a person not authorized to receive it. The penalty for violation is a fine, imprisonment for up to two years, or both.

Examination Objectives

1. To determine the financial institution's compliance with the FCRA.
2. To assess the quality of the financial institution's compliance management policies and procedures for implementing the FCRA.
3. To determine the reliance that can be placed on the financial institution's internal controls and procedures for monitoring the institution's compliance with the FCRA.
4. To initiate corrective action when violations of law are identified, or when policies or internal controls are deficient.

Examination Procedures

I. Initial Procedures

1. Through discussions with management and review of available information, determine if the institution's internal controls are adequate to ensure compliance in the area under review. Consider the following:
   a. Organization charts
   b. Process flowcharts
   c. Policies and procedures
   d. Loan documentation
   e. Checklists
   f. Computer program documentation
2. Review any compliance audit material, including work papers, and reports to determine whether:
   a. the procedures address all provisions as applicable (refer to section II of these procedures, "Verification of Policies and Procedures");
   b. steps are taken to follow up on previously identified deficiencies;
   c. the procedures used include samples covering all product types and decision centers;
   d. the work performed is accurate;
   e. significant deficiencies and their causes are included in reports to management and/or to the board of directors;
   f. corrective action is taken in a timely and appropriate manner; and
   g. the frequency of compliance review is appropriate.
3. Through discussions with management, determine if the institution communicates customer information to affiliates or non-affiliates. If so, obtain and review the contracts or other documents governing such communications.

II. Verification of Policies and Procedures

1. From recent reports provided to a consumer reporting agency (CRA), select a sample of reported items and the corresponding loan or collection files. Determine whether the institution's procedures are adequate to ensure that:
   a. it did not report information that it knew or consciously avoided knowing was inaccurate. Section 623(a)(1)(A) [15 USC 1681s-2(a)(1)(A)]. This is not applicable if the institution has, in a clear and conspicuous manner, provided the consumer with an address for notices of inaccurate information. Section 623(a)(1)(C) [15 USC 1681s-2(a)(1)(C)];
   b. it did not report information if it was notified by the consumer that the information was inaccurate and the information was, in fact, inaccurate. Section 623(a)(1)(B) [15 USC 1681s-2(a)(1)(B)];
   c. if it determined that any information it furnished to a CRA was incomplete or inaccurate, it promptly notified the CRA, provided the CRA with corrections or additional information to make the information complete and accurate, and thereafter did not send the CRA the inaccurate or incomplete information (if the institution regularly furnishes information to a CRA). Section 623(a)(2) [15 USC 1681s-2(a)(2)];
   d. if a consumer disputed the completeness or accuracy of any information the institution furnished, and the institution continued furnishing the information, it also furnished a notice of the dispute. Section 623(a)(3) [15 USC 1681s-2(a)(3)];
   e. if a consumer voluntarily closed a credit account with the institution, and the institution regularly furnishes information to a CRA about that consumer, the institution notified the CRA of the account-closing, and did so as part of the information regularly furnished for the period in which the

account was closed. Section 623(a)(4) [15 USC 1681s-2(a)(4)];

f. within ninety days of furnishing information about a delinquent account being placed for collection, charged-off, or subjected to any similar action, the institution notified the CRA of the month and year of commencement of the delinquency that immediately preceded the action. Section 623(a)(5) [15 USC 1681s-2(a)(5)].

2. Review a sample of notices of dispute received from a CRA and determine whether the institution:

   a. conducted an investigation with respect to the disputed information. Section 623(b)(1)(A) [15 USC 1681s-2(b)(1)(A)];

   b. reviewed all relevant information provided by the CRA. Section 623(b)(1)(B) [15 USC 1681s-2(b)(1)(B)];

   c. reported the results of the investigation to the CRA. Section 623(b)(1)(C) [15 USC 1681s-2(b)(1)(C)];

   d. reported the results of the investigation to all other nationwide CRAs to which the information was furnished, if the investigation found that the reported information was inaccurate or incomplete. Section 623(b)(1)(D) [15 USC 1681s-2(b)(1)(D)].

3. Review a sample of applications and accounts (for example, credit, deposit, insurance, and other) where the institution took adverse action (refer to section III of the introduction, "Important Definitions") and determine whether it complied with the adverse action notification requirements of section 615 [15 USC 1681m]. When the following types of notices are required, they must contain the following elements:

   a. <u>When a section 615(a) notice is required, the notice must contain</u>: notice of the adverse action; the name, address, and telephone number of the CRA that furnished the consumer report (including a toll-free number if the CRA is a nationwide CRA); a statement that the CRA did not make the decision to take the adverse action and cannot provide the specific reasons why the adverse action was taken; notice of the consumer's right to obtain a free copy of a consumer report on the consumer from that CRA in accordance with section 612(b) [15 USC 1681j], including notice of the sixty-day period under that section for obtaining the copy; and notice of the consumer's right to dispute with the CRA the completeness or accuracy of any information in the consumer report. Section 615(a) [15 USC 1681m(a)];

   b. <u>When a section 615(b)(1) notice is required, the notice must contain</u>: notice of the adverse action; and notice that if the institution receives a written request from the consumer within sixty days, the institution must, within a reasonable period of time, disclose the nature of the information on which the adverse action was based. Section 615(b)(1) [15 USC 1681m(b)(1)];

   c. <u>When a section 615(b)(2) notice is required, the notice must contain</u>: notice of the adverse action; and notice that, if the institution receives a written request from the consumer within sixty days, the institution must, within thirty days of receiving the request, disclose the nature of the information on which the adverse action was based. Section 615(b)(2) [15 USC 1681m(b)(2)].

4. If the institution has sent consumers credit or insurance solicitations, review the materials sent and a sample of accounts opened as a result. Determine whether:

   a. the institution received only the information from CRAs permissible under section 604(c)(2) [15 USC 1681b (c)(2)];

   b. each written solicitation was accompanied by a clear and conspicuous statement that

      i. information contained in the consumer's consumer report was used in connection with the transaction. Section 615(d)(1)(A) [15 USC 1681m(d)(1)(A)];

ii. the consumer received the offer of credit or insurance because the consumer satisfied the creditworthiness or insurability criteria under which the consumer was selected for the offer. Section 615(d)(1)(B) [15 USC 1681m(d)(1)(B)];

iii. if applicable, the credit or insurance may not be extended if, after the consumer responds to the offer, the consumer does not: meet the criteria used to select the consumer for the offer; meet any other applicable criteria bearing on creditworthiness or insurability (such as criteria for determining whether or not to extend credit or insurance pursuant to the offer); or furnish any required collateral. Section 615(d)(1)(C) [15 USC 1681m(d)(1)(C)];

iv. the consumer has a right to prohibit information contained in the consumer's file with any CRA from being used in connection with any credit or insurance transaction that is not initiated by the consumer. Section 615(d)(1)(D) [15 USC 1681m(d)(1)(D)];

v. the consumer may exercise this right by notifying a notification system established under section 604(e) [15 USC 1681b(e)]. (Refer to section VII of the introduction, "Pre-Screening Requirements.") Section 615(d)(1)(E) [15 USC 1681m (d) (1)(E)];

vi. the address and toll-free telephone number of the notification system. Section 615(d)(2) [15 USC 1681m(d)(2)].

c. for each offer of credit or insurance to each consumer, the institution maintains the following on file for the three-year period beginning on the date on which the offer was made: the criteria used to select the consumer to receive the offer; all criteria bearing on creditworthiness or insurability, as applicable, that are the basis for determining whether or not to extend credit or insurance pursuant to the offer; and any requirement for the furnishing of collateral as a condition of the extension of credit or insurance. Section 615(d)(3) [15 USC 1681m(d)(3)];

d. the institution actually honored the terms of the offers to consumers who had been determined (based on information in the consumers' consumer reports) to meet specific selection criteria. Section 603(l) [15 USC 1681a(l)]. However, the institution is not required to honor the offer if:

i. the institution determines, based on information contained in the consumer's application, that the consumer does not meet specific criteria established for the purpose of extending credit or insurance pursuant to the offer. Section 603(l)(1) [15 USC 1681a(l)(1)];

ii. after verification of the information in the application, the consumer does not meet the specific criteria. Section 603(l)(2)(B) [15 USC 1681a(l)(2)(B)];

iii. based on the application, consumer report or other information bearing on creditworthiness or insurability, the institution determines that the consumer does not continue to meet the specific selection criteria. Section 603(l)(2)(A) [15 USC 1681a(l) (2)(A)]; or

iv. the consumer does not meet specific collateral requirements, established before selection of the consumer for the offer and disclosed in the offer. Section 603(l)(3) [15 USC 1681a (l) (3)].

5. If the institution uses consumer reports for employment purposes, select one or more employment postings for review. Determine whether:

a. the institution provided the consumer with a clear and conspicuous disclosure, in the form of a document consisting solely of that disclosure, and the consumer authorized in writing the procurement of the report, before the report was obtained by the institution. Section 604(b)(2)(A), (B) [15 USC 1681b(b)(2)(A),(B)];

b. prior to taking any adverse action (refer to section III of the introduction, "Important Definitions") based in whole or in part on the information contained in the consumer report, the institution provided to the consumer:

   i. a copy of the consumer report. Section 604(b)(3) [15 USC 1681b(b)(3)], and

   ii. a copy of the FTC's statement of consumers' rights under the FCRA as prescribed under Section 609(c)(3) [15 USC 1681g(c)(3)]. Section 604(b)(3) [15 USC 1681b(b)(3)].

c. after an adverse decision is made for employment purposes based in whole or in part on information contained in a consumer report, the institution provides the required type of adverse action notice. Section 615(a) [15 USC 1681m(a)].

6. If the institution shared information with affiliates (other than about its own transactions or experiences with the consumer), verify whether:

   a. the institution disclosed that the information may be shared and gave the consumer the opportunity to opt out. Section 603(d)(2)(A) [15 USC 1681a(d)(2)(A)]; and

   b. the consumer did not opt out. Section 603(d)(2)(A) [15 USC 1681a(d)(2)(A)].

7. If the institution procures or causes to be prepared an investigative consumer report (refer to section III of the introduction, "Important Definitions,") determine whether the following requirements have been met:

   a. the institution clearly and accurately disclosed to the consumer that an investigative consumer report may be obtained. Section 606(a)(1) [15 USC 1681d(a)(1)];

   b. the disclosure contained a statement of the consumer's right to request additional disclosures about the report, and a summary of the consumer's rights under the FCRA. Section 606(a)(1)(B) [15 USC 1681d(a)(1)(B)];

   c. the disclosure is in writing and is mailed or otherwise delivered to the consumer not later than three days after the date on which the report was first requested. Section 606(a)(1)(A) [15 USC 1681d(a)(1)(A)] ;

   d. the person procuring the report, or causing it to be prepared, certified to the CRA that the person has complied with these disclosure requirements and will comply in the event the consumer exercises the right to request additional disclosures. Section 606(a)(2) [15 USC 1681d(a)(2)].

8. Verify that the institution has procedures to ensure that consumer reports are used only for the permissible purposes that the institution has certified to the CRAs from which it obtained the reports. Section 604(f) [15 USC 1681b(f)].

III. Procedures for Consumer Reporting Agencies

1. If the institution is a CRA [section 603(f); 15 USC 1681a(f)], determine whether the institution's procedures are adequate by:

   a. reviewing a sample of consumer reports to verify that they were provided only for permissible purposes. Section 604 [15 USC 1681b];

   b. verifying that it requires users to identify themselves, certify the purposes for which the information is sought and certify that the information will be used for no other purpose. Section 607(a) [15 USC 1681e(a)];

   c. reviewing a sample of reports to determine whether the CRA followed reasonable procedures to assure maximum possible accuracy of the information concerning the individual to whom the consumer report related. Section 607(b) [15 USC 1681e(b)];

d. reviewing the CRA's required notice (prescribed by the FTC) to each person, who regularly and in the ordinary course of business, furnishes the CRA with information on any consumer or to whom the CRA furnishes a consumer report. Section 607(d) [15 USC 1681e(d)];

e. determining whether the CRA obtained the required information as to the identity and permissible purpose of the end-user of a consumer report where the report is procured for resale. Section 607(e)(1) [15 USC 1681e(e)(1)].

2. Review a sample of responses to disclosure requests from consumers to verify that the CRA clearly and accurately:

a. disclosed to the consumer all information in the CRA's files on the consumer at the time of request by the consumer (credit scores or any other risk scores or predictors relating to the consumer do not need to be disclosed). Section 609(a)(1) [15 USC 1681g(a)(1)];

b. disclosed to the consumer the sources of the information (sources of information acquired solely for use in preparing an investigative consumer report and actually used for no other purpose do not need to be disclosed). Section 609(a)(2) [15 USC 1681g(a)(2)];

c. disclosed to the consumer the dates, original payees, and amounts of any checks upon which is based any adverse characterization of the consumer. Section 609(a)(4) [15 USC 1681g(a)(4)];

d. disclosed to the consumer a record of all inquiries received by the consumer reporting agency during the one-year period preceding the consumer's request that identified the consumer in connection with a credit or insurance transaction that was not initiated by the consumer. Section 609(a)(5) [15 USC 1681g(a)(5)];

e. disclosed to the consumer the identity of each person (including name, and, if requested, address and telephone number) that procured a consumer report for employment purposes during the two years preceding the request, or for any other purpose during the year preceding the request. Section 609(a)(3) [15 USC 1681g (a)(3)]; and

f. included a copy of the FTC's statement of consumers' rights under the FCRA. Section 609(c) [15 USC 1681g(c)].

3. When the CRA is furnishing consumer reports for employment purposes and it compiles and reports items of information on consumers that are matters of public record and are likely to have an adverse effect on the consumer's ability to obtain employment, does the CRA:

a. at the time the public record information is reported to the user of the consumer report, notify the consumer that the information is being reported, together with the name and address of the person to whom the information is being reported? Section 613(a)(1) [15 USC 1681k(a)(1)]; or

b. maintain strict procedures designed to ensure that, whenever public record information that is likely to have an adverse effect on a consumer's ability to obtain employment is reported, the information is complete and up to date? Section 613(a)(2) [15 USC 1681k(a)(2)].

4. When preparing an investigative consumer report, does the CRA verify any adverse information contained in the report if the information was included in a prior investigative consumer report, unless the information was received within the three-month period preceding the date that the subsequent report is furnished? Information that is a matter of public record does not have to be verified. Section 614 [15 USC 1681l].

5. Does the CRA have reasonable procedures to ensure that in any consumer report it furnishes there is no:

a. information about bankruptcy cases that is more than ten years old (counting back from the date of the report to the date of the entry of the order of relief or the date of adjudication, as applicable). Section 605(a)(1) [15 USC 1681c(a)(1);

b. other information that is more than seven years old (for example, civil suits, civil judgments, and arrest records). Section 605(a)(2-5) [15 USC 1681e(a)(2-5)].

Note: The seven-year period is counted in different ways for different items of information. Refer to section IV of the introduction, "Requirements on Consumer Reporting Agencies."

Note: Records of criminal convictions are not subject to a time limit.

6. Review a sample of accounts where the consumer directly notified the CRA to dispute the completeness or accuracy of any information in his or her file. Determine if the CRA is in compliance with the provisions of Section 611 [15 USC 1681i] applicable to reinvestigations of disputed information.

   a. Verify that the CRA reinvestigated the complaint free of charge and recorded the current status of the disputed information or deleted the item from its file. The reinvestigation of the dispute must generally be completed within thirty calendar days from the date the agency received notice of the dispute from the consumer. (The thirty-day period may be extended for up to an additional fifteen days if the consumer submits additional relevant information during the thirty-day period, but not if the information that is the subject of the reinvestigation is found to be inaccurate or incomplete or if the CRA determines that the information cannot be verified during the initial thirty-day period.) Section 611(a)(1) [15 USC 1681i(a)(1)].

   b. Verify that, within five business days of receipt of a notice of a dispute, the CRA provided notification of the dispute to any person who provided any item of information in dispute along with all relevant information regarding the dispute that the CRA has received from the consumer. Section 611(a)(2) [15 USC 1681i(a)(2)].

   c. Verify that, if the CRA reasonably determined that a dispute was frivolous or irrelevant, the CRA provided the required notice of determination to the consumer not later than five business days after making the determination. Section 611(a)(3) [15 USC 1681i(a)(3)].

   d. Verify that, where a reinvestigation found an item of information to be inaccurate, incomplete or unverifiable, the CRA promptly deleted that item from the consumer's file or modified the item, as appropriate, based on the results of the reinvestigation. Section 611(a)(5)(A) [15 USC 1681i(a)(5)(A)].

   e. Verify that the CRA maintained reasonable procedures to prevent the reappearance of information in a consumer's file, and in consumer reports on the consumer, of any information deleted from the file through a reinvestigation. (If any information has been deleted from the consumer's file pursuant to a reinvestigation, that information may not be reinserted in the file by the agency unless the person who furnishes the information certifies the information is complete and accurate, and the CRA must provide appropriate notice to the consumer within five business days after the reinsertion.) Section 611(a)(5)(C),(B) [15 USC 1681i(a)(5)(C), (B)].

   f. Verify that, not later than five business days after the completion of the reinvestigation, the CRA provided written notice to the consumer of the results of the reinvestigation in the manner prescribed in section 611(a)(6). [15 USC 1681i(a)(6)].

7. Determine if the agency only charges those fees permitted by section 612 [15 USC 1681j] for making certain disclosures and notifications.

IV. Conclusions

1. Summarize all violations.
2. If the violation(s) noted above represent(s) a pattern or practice, determine the root cause by identifying weaknesses in internal controls, compliance review, training, management oversight, or other factors.
3. Identify action needed to correct violations and weaknesses in the institution's compliance system, as appropriate.
4. Discuss findings with management and obtain a commitment for corrective action.
5. Determine if any enforcement actions are called for and notify appropriate personnel in your agency.

Introduction

Background and Summary

The Truth in Lending Act (TILA), 15 USC 1601 et seq., was enacted on May 29, 1968, as title I of the Consumer Credit Protection Act (Pub. L. 90-321). The TILA, implemented by Regulation Z (12 CFR 226), became effective July 1, 1969.

The TILA was first amended in 1970 to prohibit unsolicited credit cards. Additional major amendments to the TILA and Regulation Z were made by the Fair Credit Billing Act of 1974, the Consumer Leasing Act of 1976, the Truth in Lending Simplification and Reform Act of 1980, the Fair Credit and Charge Card Disclosure Act of 1988, and the Home Equity Loan Consumer Protection Act of 1988.

Regulation Z also was amended to implement section 1204 of the Competitive Equality Banking Act of 1987 and, in 1988, to include adjustable rate mortgage loan disclosure requirements. All consumer leasing provisions were deleted from Regulation Z in 1981 and transferred to Regulation M (12 CFR 213).

The Home Ownership and Equity Protection Act of 1994 amended TILA. The law imposed new disclosure requirements and substantive limitations on certain closed-end mortgage loans bearing rates or fees above a certain percentage or amount. The law also included new disclosure requirements to assist consumers in comparing the costs and other material considerations involved in a reverse mortgage transaction and authorized the Federal Reserve Board to prohibit specific acts and practices in connection with mortgage transactions. Regulation Z was amended[1] to implement these legislative changes to TILA.

Approved – FFIEC

The TILA amendments of 1995 dealt primarily with tolerances for real estate secured credit. Regulation Z was amended on September 14, 1996 to incorporate changes to the TILA. Specifically, the revisions limit lenders' liability for disclosure errors in real estate secured loans consummated after September 30, 1995. The Economic Growth and Regulatory Paperwork Reduction Act of 1996 further amended TILA. The amendments were made to simplify and improve disclosures related to credit transactions.

Format of Regulation Z

The disclosure rules creditors must follow differ depending on whether the creditor is offering open-end credit, such as credit cards or home-equity lines, or closed-end credit, such as car loans or mortgages.

Subpart A (sections 226.1 through 226.4) of the regulation provides general information that applies to open-end and closed-end credit transactions. It sets forth definitions and stipulates which transactions are covered and which are exempt from the regulation. It also contains the rules for determining which fees are finance charges.

Subpart B (sections 226.5 through 226.16) of the regulation contains rules for disclosures for home-equity loans, credit and charge card accounts, and other open-end credit.

Subpart B also covers rules for resolving billing errors, calculating annual percentage rates, credit balances, and advertising open-end credit. Special rules apply to credit card transactions only, such as certain prohibitions on the issuance of credit cards and restrictions on the right to offset a cardholder's indebtedness. Additional special rules apply to home-equity lines of credit, such as certain prohibitions against closing accounts or changing account terms.

[1] 60 FR 15463, March 24, 1995 and 66 FR 65604, December 20, 2001.

Subpart C (sections 226.17 through 226.24) includes provisions for closed-end credit. Residential mortgage transactions, demand loans, and installment credit contracts, including direct loans by banks and purchased dealer paper, are included in the closed-end credit category. Subpart C also contains disclosure rules for regular and variable rate loans, refinancings and assumptions, credit balances, calculating annual percentage rates, and advertising closed-end credit.

Subpart D (sections 226.25 through 226.30), which applies to both open-end and closed-end credit, sets forth the duty of creditors to retain evidence of compliance with the regulation. It also clarifies the relationship between the regulation and state law, and requires creditors to set a cap for variable rate transactions secured by a consumer's dwelling.

Subpart E (sections 226.31 through 226.34) applies to certain home mortgage transactions including high-cost, closed-end mortgages and reverse mortgages. It requires additional disclosures and provides limitations for certain home mortgage transactions having rates or fees above a certain percentage or amount, and prohibits specific acts and practices in connection with those loans. Subpart E also includes disclosure requirements for reverse mortgage transactions (open-end and closed-end credit).

The appendices to the regulation set forth model forms and clauses that creditors may use when providing open-end and closed-end disclosures. The appendices contain detailed rules for calculating the APR for open-end credit (appendix F) and closed-end credit (appendixes D and J). The last two appendixes (appendixes K and L) provide total annual loan cost rate computations and assumed loan periods for reverse mortgage transactions.

Official staff interpretations of the regulation are published in a commentary that is normally updated annually in March. Good faith compliance with the commentary protects creditors from civil liability under the act. In addition, the commentary includes mandates, which are not necessarily explicit in Regulation Z, on disclosures or other actions required of creditors. It is virtually impossible to comply with Regulation Z without reference to and reliance on the commentary.

Note: The following narrative does not encompass all the sections of Regulation Z, but rather highlights areas that have caused the most problems with the calculation of the finance charge and the calculation of the annual percentage rate.

Subpart A - General

Purpose of the TILA and Regulation Z

The Truth in Lending Act is intended to ensure that credit terms are disclosed in a meaningful way so consumers can compare credit terms more readily and knowledgeably. Before its enactment, consumers were faced with a bewildering array of credit terms and rates. It was difficult to compare loans because they were seldom presented in the same format. Now, all creditors must use the same credit terminology and expressions of rates. In addition to providing a uniform system for disclosures, the act is designed to:

- Protect consumers against inaccurate and unfair credit billing and credit card practices;
- Provide consumers with rescission rights;
- Provide for rate caps on certain dwelling-secured loans; and
- Impose limitations on home equity lines of credit and certain closed-end home mortgages.

The TILA and Regulation Z do not, however, tell financial institutions how much interest they may charge or whether they must grant a consumer a loan.

Summary of Coverage Considerations §226.1 & §226.2

Lenders must carefully consider several factors when deciding whether a loan requires Truth in Lending disclosures or is subject to other Regulation Z requirements. The coverage considerations under Regulation Z are addressed in more detail in the commentary to Regulation Z. For example, broad coverage considerations are included under section 226.1(c) of the regulation and relevant definitions appear in section 226.2.

Exempt Transactions §226.3

The following transactions are exempt from Regulation Z:

- Credit extended primarily for a business, commercial, or agricultural purpose;
- Credit extended to other than a natural person (including credit to government agencies or instrumentalities);
- Credit in excess of $25,000 and not secured by real or personal property used as the principal dwelling of the consumer;
- Public utility credit;
- Credit extended by a broker-dealer registered with the Securities and Exchange Commission (SEC) or the Commodity Futures Trading Commission (CFTC), involving securities or commodities accounts;
- Home fuel budget plans; and
- Certain student loan programs.

Footnote 4: If a credit card is involved, generally exempt credit (e.g., business or agricultural purpose credit) is still subject to requirements that govern the issuance of credit cards and liability for their unauthorized use. Credit cards must not be issued on an unsolicited basis and, if a credit card is lost or stolen, the cardholder must not be held liable for more than $50 for the unauthorized use of the card.

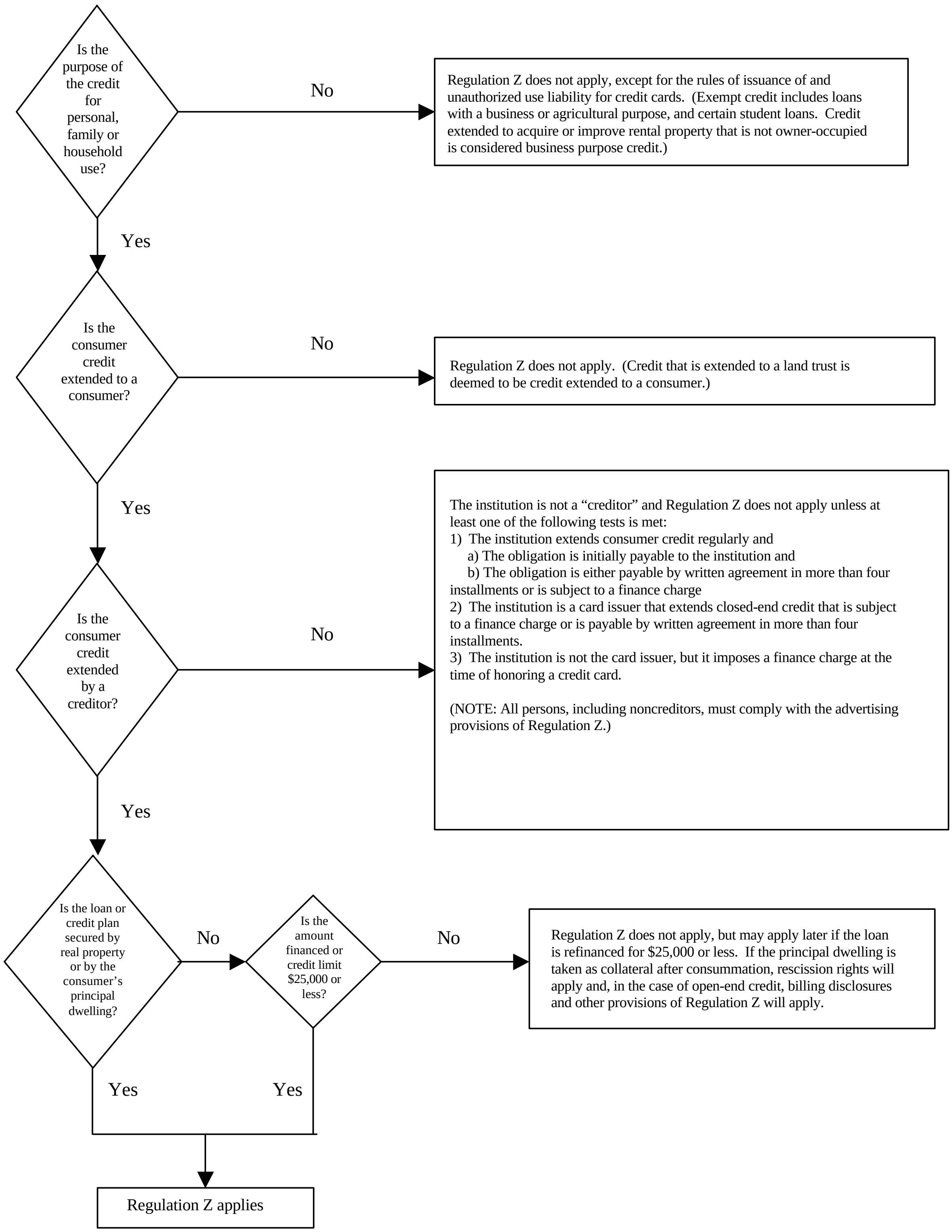
When determining whether credit is for consumer purposes, the creditor must evaluate all of the following:

- Any statement obtained from the consumer describing the purpose of the proceeds.
  - For example, a statement that the proceeds will be used for a vacation trip would indicate a consumer purpose.
  - If the loan has a mixed-purpose (e.g., proceeds will be used to buy a car that will be used for personal and business purposes), the lender must look to the primary purpose of the loan to decide whether disclosures are necessary. A statement of purpose from the consumer will help the lender make that decision.
  - A checked box indicating that the loan is for a business purpose, absent any documentation showing the intended use of the proceeds, could be insufficient evidence that the loan did not have a consumer purpose.
- The consumer's primary occupation and how it relates to the use of the proceeds. The higher the correlation between the consumer's occupation and the property purchased from the loan proceeds, the greater the likelihood that the loan has a business purpose. For example, proceeds used to purchase dental supplies for a dentist would indicate a business purpose.
- Personal management of the assets purchased from proceeds. The lower the degree of the borrower's personal involvement in the management of the investment or enterprise purchased by the loan proceeds, the less likely the loan will have a business purpose. For example, money borrowed to purchase stock in an automobile company by an individual who does not work for that company would indicate a personal investment and a consumer purpose.
- The size of the transaction. The larger the size of the transaction, the more likely the loan will have a business purpose. For example, if the loan is for a $5,000,000 real estate transaction, that might indicate a business purpose.
- The amount of income derived from the property acquired by the loan proceeds relative to the borrower's total income. The lesser the income derived from the acquired property, the more likely the loan will have a consumer purpose. For example, if the borrower has an annual salary of $100,000 and receives about $500 in annual dividends

from the acquired property, that would indicate a consumer purpose.

All five factors must be evaluated before the lender can conclude that disclosures are not necessary. Normally, no one factor, by itself, is sufficient reason to determine the applicability of Regulation Z. In any event, the financial institution may routinely furnish disclosures to the consumer. Disclosure under such circumstances does not control whether the transaction is covered, but can assure protection to the financial institution and compliance with the law.

Coverage Considerations under Regulation Z



Determination of Finance Charge and APR

Finance Charge (Open-End and Closed-End Credit) §226.4

The finance charge is a measure of the cost of consumer credit represented in dollars and cents. Along with APR disclosures, the disclosure of the finance charge is central to the uniform credit cost disclosure envisioned by the TILA.

The finance charge does not include any charge of a type payable in a comparable cash transaction. Examples of charges payable in a comparable cash transaction may include taxes, title, license fees, or registration fees paid in connection with an automobile purchase.

Finance charges include any charges or fees payable directly or indirectly by the consumer and imposed directly or indirectly by the financial institution either as an incident to or as a condition of an extension of consumer credit. The finance charge on a loan always includes any interest charges and often, other charges. Regulation Z includes examples, applicable both to open-end and closed-end credit transactions, of what must, must not, or need not be included in the disclosed finance charge (§226.4(b)).

Accuracy Tolerances (Closed-End Credit) §§226.18(d) & 226.23(h)

Regulation Z provides finance charge tolerances for legal accuracy that should not be confused with those provided in the TILA for reimbursement under regulatory agency orders. As with disclosed APRs, if a disclosed finance charge were legally accurate, it would not be subject to reimbursement.

Under TILA and Regulation Z, finance charge disclosures for open-end credit must be accurate since there is no tolerance for finance charge errors. However, both TILA and Regulation Z permit various finance charge accuracy tolerances for closed-end credit.

Tolerances for the finance charge in a closed-end transaction are generally $5 if the amount financed is less than or equal to $1,000 and $10 if the amount financed exceeds $1,000. Tolerances for certain transactions consummated on or after September 30, 1995 are noted below.

- Credit secured by real property or a dwelling (**closed-end credit only**):
  - — The disclosed finance charge is considered accurate if it does not vary from the actual finance charge by more than $100.
  - — Overstatements are not violations.
- Rescission rights after the three-business-day rescission period (**closed-end credit only**):
  - — The disclosed finance charge is considered accurate if it does not vary from the actual finance charge by more than one-half of 1 percent of the credit extended.
  - — The disclosed finance charge is considered accurate if it does not vary from the actual finance charge by more than 1 percent of the credit extended for the initial and subsequent refinancings of residential mortgage transactions when the new loan is made at a different financial institution. (This excludes high cost mortgage loans subject to §226.32, transactions in which there are new advances, and new consolidations.)
- Rescission rights in foreclosure:
  - — The disclosed finance charge is considered accurate if it does not vary from the actual finance charge by more than $35.
  - — Overstatements are not considered violations.
  - — The consumer can rescind if a mortgage broker fee is not included as a finance charge.

*Note***:** Normally, the finance charge tolerance for a rescindable transaction is either 0.5 percent of the credit transaction or, for certain refinancings, 1 percent of the credit transaction. However, in the event of a foreclosure, the consumer may exercise the right of rescission if the disclosed finance charge is understated by more than $35.

See the “Finance Charge Tolerances” charts within these examination procedures for help in determining appropriate finance charge tolerances.

Calculating the Finance Charge (Closed-End Credit)

One of the more complex tasks under Regulation Z is determining whether a charge associated with an extension of credit must be included in, or excluded from, the disclosed finance charge. The finance charge initially includes any charge that is, or will be, connected with a specific loan. Charges imposed by third parties are finance charges if the financial institution requires use of the third party. Charges imposed by settlement or closing agents are finance charges if the bank requires the specific service that gave rise to the charge and the charge is not otherwise excluded. The “Finance Charge Tolerances” charts within this document briefly summarize the rules that must be considered.

Prepaid Finance Charges §226.18(b)

A prepaid finance charge is any finance charge paid separately to the financial institution or to a third party, in cash or by check before or at closing, settlement, or consummation of a transaction, or withheld from the proceeds of the credit at any time.

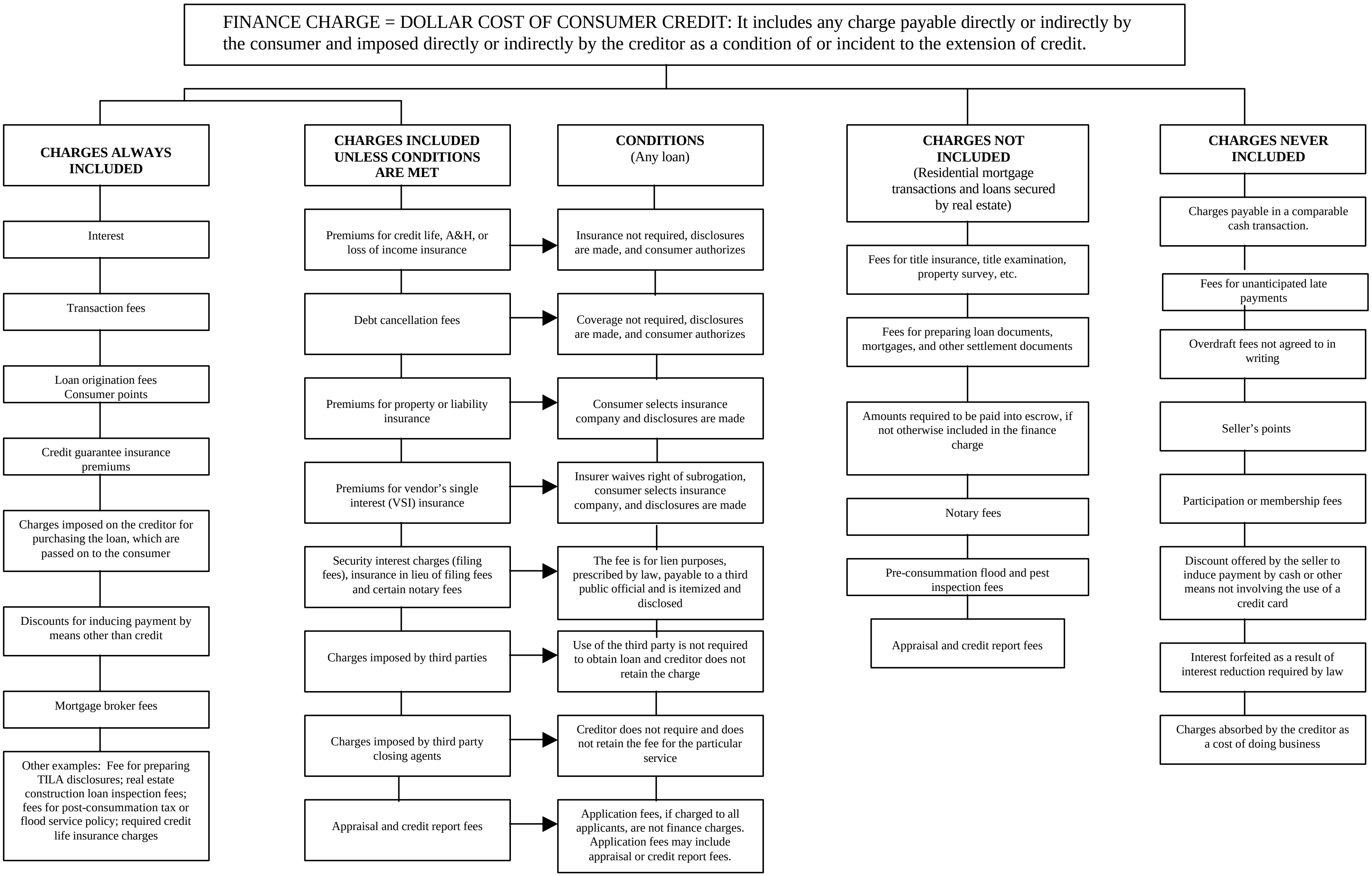
Prepaid finance charges effectively reduce the amount of funds available for the consumer’s use, usually before or at the time the transaction is consummated.

Examples of finance charges frequently prepaid by consumers are borrower’s points, loan origination fees, real estate construction inspection fees, odd days’ interest (interest attributable to part of the first payment period when that period is longer than a regular payment period), mortgage guarantee insurance fees paid to the Federal Housing Administration, private mortgage insurance (PMI) paid to such companies as the Mortgage Guaranty Insurance Company (MGIC), and, in non-real-estate transactions, credit report fees.

Precomputed Finance Charges

A precomputed finance charge includes, for example, interest added to the note amount that is computed by the add-on, discount, or simple interest methods. If reflected in the face amount of the debt instrument as part of the consumer’s obligation, finance charges that are not viewed as prepaid finance charges are treated as precomputed finance charges that are earned over the life of the loan.

Finance Charge Chart



Instructions for the Finance Charge Chart

The finance charge initially includes any charge that is, or will be, connected with a specific loan. Charges imposed by third parties are finance charges if the creditor requires use of the third party. Charges imposed on the consumer by a settlement agent are finance charges only if the creditor requires the particular services for which the **settlement agent** is charging the borrower and the charge is not otherwise excluded from the finance charge.

Immediately below the finance charge definition, the chart presents five captions applicable to determining whether a loan related charge is a finance charge.

The first caption is **charges always included**. This category focuses on specific charges given in the regulation or commentary as examples of finance charges.

The second caption, **charges included unless conditions are met**, focuses on charges that must be included in the finance charge unless the creditor meets specific disclosure or other conditions to exclude the charges from the finance charge.

The third caption, **conditions**, focuses on the conditions that need to be met if the charges identified to the left of the conditions are permitted to be excluded from the finance charge. Although most charges under the second caption may be included in the finance charge at the creditor's option, third party charges and application fees (listed last under the third caption) must be excluded from the finance charge if the relevant conditions are met. However, inclusion of appraisal and credit report charges as part of the application fee is optional.

The fourth caption, **charges not included**, identifies fees or charges that are not included in the finance charge under conditions identified by the caption. If the credit transaction is secured by real property or the loan is a residential mortgage transaction, the charges identified in the column, if they are bona fide and reasonable in amount, must be excluded from the finance charge. For example, if a consumer loan is secured by a vacant lot or commercial real estate, any appraisal fees connected with the loan must not be included in the finance charge.

The fifth caption, **charges never included**, lists specific charges provided by the regulation as examples of those that automatically are not finance charges (e.g., fees for unanticipated late payments).

Annual Percentage Rate Definition §226.22 (Closed-End Credit)

Credit costs may vary depending on the interest rate, the amount of the loan and other charges, the timing and amounts of advances, and the repayment schedule. The APR, which must be disclosed in nearly all consumer credit transactions, is designed to take into account all relevant factors and to provide a uniform measure for comparing the cost of various credit transactions.

The APR is a measure of the cost of credit, expressed as a nominal yearly rate. It relates the amount and timing of value received by the consumer to the amount and timing of payments made. The disclosure of the APR is central to the uniform credit cost disclosure envisioned by the TILA.

The value of a closed-end credit APR must be disclosed as a single rate only, whether the loan has a single interest rate, a variable interest rate, a discounted variable interest rate, or graduated payments based on separate interest rates (step rates), and it must appear with the segregated disclosures. Segregated disclosures are grouped together and do not contain any information not directly related to the disclosures required under §226.18.

Since an APR measures the total cost of credit, including costs such as transaction charges or premiums for credit guarantee insurance, it is not an "interest" rate, as that term is generally used. APR calculations do not rely on definitions of interest in state law and often include charges, such as a commitment fee paid by the consumer, that are not viewed by some state usury statutes as interest. Conversely, an APR might not include a charge, such as a credit report fee in a real property transaction, which some state laws might view as interest for usury purposes. Furthermore, measuring the timing of value received and of payments made, which is essential if APR calculations are to be accurate, must be consistent with parameters under Regulation Z.

The APR is often considered to be the finance charge expressed as a percentage. However, two loans could require the same finance charge and still have different APRs because of differing values of the amount financed or of payment schedules. For example, the APR is 12 percent on a loan with an amount financed of $5,000 and 36 equal monthly payments of $166.07 each. It is 13.26 percent on a loan with an amount financed of $4,500 and 35 equal monthly payments of $152.18 each and final payment of $152.22. In both cases the finance charge is $978.52. The APRs on these example loans are not the same because an APR does not only reflect the finance charge. It relates the amount and timing of value received by the consumer to the amount and timing of payments made.

The APR is a function of:

- The amount financed, which is not necessarily equivalent to the loan amount. If the consumer must pay at closing a separate 1 percent loan origination fee (prepaid finance charge) on a $100,000 residential mortgage loan, the loan amount is $100,000, but the amount financed would be $100,000 less the $1,000 loan fee, or $99,000.

- The finance charge, which is not necessarily equivalent to the total interest amount.

  — If the consumer must pay a $25 credit report fee for an auto loan, the fee must be included in the finance charge. The finance charge in that case is the sum of the interest on the loan (i.e., interest generated by the application of a percentage rate against the loan amount) plus the $25 credit report fee.

  — If the consumer must pay a $25 credit report fee for a home improvement loan secured by real property, the credit report fee must be excluded from the finance charge. The finance charge in that case would be only the interest on the loan.

  — Interest, which is defined by state or other federal law, is not defined by Regulation Z.

- The payment schedule, which does not necessarily include only principal and interest (P + I) payments.

  — If the consumer borrows $2,500 for a vacation trip at 14 percent simple interest per annum and repays that amount with 25 equal monthly payments beginning one month from consummation of the transaction, the monthly P + I payment will be $115.87, if all months are considered equal, and the amount financed would be $2,500. If the consumer's payments are increased by $2.00 a month to pay a non-financed $50 loan fee during the life of the loan, the amount financed would remain at $2,500 but the payment schedule would be increased to $117.87 a month, the finance charge would increase by $50, and there would be a corresponding increase in the APR. This would be the case whether or not state law defines the $50 loan fee as interest.

  — If the loan above has 55 days to the first payment and the consumer prepays interest at consummation ($24.31 to cover the first 25 days), the amount financed would be $2,500 - $24.31, or $2,475.69. Although the amount financed has been reduced to reflect the consumer's reduced use of available funds at consummation, the time interval during which the consumer has use of the $2,475.69, 55 days to the first payment, has not changed. Since the first payment period exceeds the limitations of the regulation's minor irregularities provisions (see §226.17(c)(4)), it may not be treated as regular. In calculating the APR, the first payment period must not be reduced by 25 days (i.e., the first payment period may not be treated as one month).

Financial institutions may, if permitted by state or other law, precompute interest by applying a rate against a loan balance using a simple interest, add-on, discount or some other method, and may earn interest using a simple interest accrual system, the Rule of 78's (if permitted by law) or some other method. Unless the financial institution's internal interest earnings and accrual methods involve a simple interest rate based on a 360-day year that is applied over actual days (even that is important only for determining the accuracy of the payment schedule), it is not relevant in calculating an APR, since an APR is not an interest rate (as that term is commonly used under state or other law). Since the APR normally need not rely on the internal accrual systems of a bank, it always may be computed after the loan terms have been agreed upon (as long as it is disclosed before actual consummation of the transaction).

Special Requirements for Calculating the Finance Charge and APR

Proper calculation of the finance charge and APR are of primary importance. The regulation requires that the terms "finance charge" and "annual percentage rate" be disclosed more conspicuously than any other required disclosure. The finance charge and APR, more than any other disclosures, enable consumers to understand the cost of the credit and to comparison shop for credit. A creditor's failure to disclose those values accurately can result in significant monetary damages to the creditor, either from a class action lawsuit or from a regulatory agency's order to reimburse consumers for violations of law.

Footnote 45d: If an annual percentage rate or finance charge is disclosed incorrectly, the error is not, in itself, a violation of the regulation if:

- The error resulted from a corresponding error in a calculation tool **used in good faith** by the financial institution.
- Upon discovery of the error, the financial institution promptly discontinues use of that calculation tool for disclosure purposes.
- The financial institution notifies the Federal Reserve Board in writing of the error in the calculation tool.

When a financial institution claims a calculation tool was used in good faith, the financial institution assumes a reasonable degree of responsibility for ensuring that the tool in question provides the accuracy required by the regulation. For example, the financial institution might verify the results obtained using the tool by comparing those results to the figures obtained by using another calculation tool. The financial institution might also verify that the tool, if it is designed to operate under the actuarial method, produces figures similar to those provided by the examples in appendix J to the regulation. The calculation tool should be checked for accuracy before it is first used and periodically thereafter.

Subpart B - Open-End Credit

The following is not a complete discussion of the open-end credit requirements in the Truth in Lending Act. Instead, the information provided below is offered to clarify otherwise confusing terms and requirements. Refer to §§226.5 through 226.16 and related commentary for a more thorough understanding of the Act.

Finance Charge (Open-End Credit) §226.6(a)

Each finance charge imposed must be individually itemized. The aggregate total amount of the finance charge need not be disclosed.

Determining the Balance and Computing the Finance Charge

The examiner must know how to compute the balance to which the periodic rate is applied. Common methods used are the previous balance method, the daily balance method, and the average daily balance method, which are described as follows:

- *Previous balance method* – The balance on which the periodic finance charge is computed is based on the balance outstanding at the start of the billing cycle. The periodic rate is multiplied by this balance to compute the finance charge.
- *Daily balance method* – A daily periodic rate is applied to either the balance on each day in

the cycle or the sum of the balances on each of the days in the cycle. If a daily periodic rate is multiplied by the balance on each day in the billing cycle, the finance charge is the sum of the products. If the daily periodic rate is multiplied by the sum of all the daily balances, the result is the finance charge.

- *Average daily balance method* – The average daily balance is the sum of the daily balances (either including or excluding current transactions) divided by the number of days in the billing cycle. A periodic rate is then multiplied by the average daily balance to determine the finance charge. If the periodic rate is a daily one, the product of the rate multiplied by the average balance is multiplied by the number of days in the cycle.

In addition to those common methods, financial institutions have other ways of calculating the balance to which the periodic rate is applied. By reading the financial institution's explanation, the examiner should be able to calculate the balance to which the periodic rate was applied. In some cases, the examiner may need to obtain additional information from the financial institution to verify the explanation disclosed. Any inability to understand the disclosed explanation should be discussed with management, who should be reminded of Regulation Z's requirement that disclosures be clear and conspicuous.

When a balance is determined without first deducting all credits and payments made during the billing cycle, that fact and the amount of the credits and payments must be disclosed.

If the financial institution uses the daily balance method and applies a single daily periodic rate, disclosure of the balance to which the rate was applied may be stated as any of the following:

- A balance for each day in the billing cycle. The daily periodic rate is multiplied by the balance on each day and the sum of the products is the finance charge.
- A balance for each day in the billing cycle on which the balance in the account changes. The finance charge is figured by the same method as discussed previously, but the statement shows the balance only for those days on which the balance changed.
- The sum of the daily balances during the billing cycle. The balance on which the finance charge is computed is the sum of all the daily balances in the billing cycle. The daily periodic rate is multiplied by that balance to determine the finance charge.
- The average daily balance during the billing cycle. If this is stated, however, the financial institution must explain somewhere on the periodic statement or in an accompanying document that the finance charge is or may be determined by multiplying the average daily balance by the number of days in the billing cycle, rather than by multiplying the product by the daily periodic rate.

If the financial institution uses the daily balance method, but applies two or more daily periodic rates, the sum of the daily balances may not be used. Acceptable ways of disclosing the balances include:

- A balance for each day in the billing cycle;
- A balance for each day in the billing cycle on which the balance in the account changes; or
- Two or more average daily balances. If the average daily balances are stated, the financial institution shall indicate on the periodic statement or in an accompanying document that the finance charge is or may be determined by multiplying each of the average daily balances by the number of days in the billing cycle (or if the daily rate varies, by multiplying the number of days that the applicable rate was in effect), multiplying each of the results by the applicable daily periodic rate, and adding the products together.

In explaining the method used to find the balance on which the finance charge is computed, the financial institution need not reveal how it allocates payments or credits. That information may be disclosed as additional information, but all required information must be clear and conspicuous.

Finance Charge Resulting from Two or More Periodic Rates

Some financial institutions use more than one periodic rate in computing the finance charge. For example, one rate may apply to balances up to a certain amount and another rate to balances more than that amount. If two or more periodic rates apply, the financial institution must disclose all rates and conditions. The range of balances to which each rate applies also must be disclosed. It is not necessary, however, to break the finance charge into separate components based on the different rates.

Annual Percentage Rate (Open-End Credit)

Accuracy Tolerance §226.14

The disclosed annual percentage rate (APR) on an open-end credit account is accurate if it is within one-eighth of 1 percentage point of the APR calculated under Regulation Z.

Determination of APR

The regulation states two basic methods for determining the APR in open-end credit transactions. The first involves multiplying each periodic rate by the number of periods in a year. This method is used for disclosing:

- The corresponding APR in the initial disclosures;
- The corresponding APR on periodic statements;
- The APR in early disclosures for credit card accounts;
- The APR in early disclosures for home-equity plans;
- The APR in advertising; and
- The APR in oral disclosures.

The corresponding APR is prospective. In other words, it does not involve any particular finance charge or periodic balance.

The second method is the quotient method, used in computing the APR for periodic statements. The quotient method reflects the annualized equivalent of the rate that was actually applied during a cycle. This rate, also known as the historical rate, will differ from the corresponding APR if the creditor applies minimum, fixed, or transaction charges to the account during the cycle.

If the finance charge is determined by applying one or more periodic rates to a balance, and does not include any of the charges just mentioned, the financial institution may compute the historical rate using the quotient method. In that method, the financial institution divides the total finance charge for the cycle by the sum of the balances to which the periodic rates were applied and multiplies the quotient (expressed as a percentage) by the number of cycles in a year.

Alternatively, the financial institution may use the method for computing the corresponding APR. In that method, the financial institution multiplies each periodic rate by the number of periods in one year. If the finance charge includes a minimum, fixed, or transaction charge, the financial institution must use the appropriate variation of the quotient method. When transaction charges are imposed, the financial institution should refer to appendix F of this handbook for computational examples.

The regulation also contains a computation rule for small finance charges. If the finance charge includes a minimum, fixed, or transaction charge, and the total finance charge for the cycle does not exceed 50 cents, the financial institution may multiply each applicable periodic rate by the number of periods in a year to compute the APR.

Optional calculation methods also are provided for accounts involving daily periodic rates (§226.14(d)).

Brief Outline for Open-End Credit APR Calculations on Periodic Statements

Note: Assume monthly billing cycles for each of the calculations below.

I. APR when finance charge is determined solely by applying one or more periodic rates:

A. Monthly periodic rates:

1. Monthly rate x 12 = APR

or

2. (Total finance charge / applicable balance[2]) x 12 = APR

This calculation may be used when different rates apply to different balances.

A. Daily periodic rates:

1. Daily rate x 365 = APR

or

2. (Total finance charge / average daily balance) x 12 = APR

or

3. (Total finance charge / sum of balances) x 365 = APR

II. APR when finance charge includes a minimum, fixed, or other charge that is not calculated using a periodic rate (and does not include charges related to a specific transaction, like cash advance fees):

A. Monthly periodic rates:

1. (Total finance charge / amount of applicable balance[3]) x 12 = APR[4]

B. Daily periodic rates

1. (Total finance charge / amount of applicable balance[1]) X 365 = APR[3]

2. The following may be used if at least a portion of the finance charge is determined by the application of a daily periodic rate. If not, use the formula above.

a. (Total finance charge / average daily balance) x 12 = APR[3]

or

b. (Total finance charge / sum of balances) x 365 = APR[3]

C. Monthly and daily periodic rates

1. If the finance charge imposed during the billing cycle does not exceed $.50 for a monthly or longer billing cycles (or pro rata part of $.50 for a billing cycle shorter than monthly), the APR may be calculated by multiplying the monthly rate by 12 or the daily rate by 365.

III. If the total finance charge included a charge related to a specific transaction (such as a cash advance fee), even if the total finance charge also included any other minimum, fixed, or other charge not calculated using a periodic rate, then the monthly and daily APRs are calculated as follows: (total finance charge / the greater of: the transaction amounts that created the transaction fees or the sum of the balances and other amounts on which a finance charge was imposed during the billing cycle[5]) X number of billing cycles in a year (12) = APR[6]

[2] If zero, no APR can be determined. The amount of applicable balance is the balance calculation method and may include the average daily balance, adjusted balance, or previous balance method.

[3] If zero, no APR can be determined. The amount of applicable balance is the balance calculation method and may include the average daily balance, adjusted balance, or previous balance method.

[4] Loan fees, points, or similar finance charges that relate to the opening of the account must not be included in the calculation of the APR.

[5] The sum of the balances may include the average daily balance, adjusted balance, or previous balance method. Where a portion of the finance charge is determined by application of one or more daily periodic rates, sum of the balances also means the average of daily balances.

[6] Cannot be less than the highest periodic rate applied, expressed as an APR.

Subpart C - Closed-End Credit

The following is not a complete discussion of the closed-end credit requirements in the Truth in Lending Act. Instead, the information provided below is offered to clarify otherwise confusing terms and requirements. Refer to §§226.17 through 226.24 and related commentary for a more thorough understanding of the Act.

Finance Charge (Closed-End Credit) §226.17(a)

The aggregate total amount of the finance charge must be disclosed. Each finance charge imposed need not be individually itemized and must not be itemized with the segregated disclosures.

Annual Percentage Rate (Closed-End Credit) §226.22

Accuracy Tolerances

The disclosed APR on a closed-end transaction is accurate for:

- Regular transactions (which include any single advance transaction with equal payments and equal payment periods, or an irregular first payment period and/or a first or last irregular payment), if it is within one-eighth of 1 percentage point of the APR calculated under Regulation Z (§226.22(a)(2)).
- Irregular transactions (which include multiple advance transactions and other transactions not considered regular), if it is within one-quarter of 1 percentage point of the APR calculated under Regulation Z (§226.22(a)(3)).
- Mortgage transactions, if it is within one-eighth of 1 percentage point for regular transactions or one-quarter of 1 percentage point for irregular transactions **and**:

    i. The rate results from the disclosed finance charge; **and**

    ii. The disclosed finance charge would be considered accurate under §§226.18(d)(1) or 226.23(g) or (h) (§226.22(a)(4)).

Note: There is an additional tolerance for mortgage loans when the disclosed finance charge is calculated incorrectly but is considered accurate under §§226.18(d)(1) or 226.23(g) or (h) (§226.22(a)(5)).

Construction Loans §226.17(c)(6) and Appendix D

Construction and certain other multiple advance loans pose special problems in computing the finance charge and APR. In many instances, the amount and dates of advances are not predictable with certainty since they depend on the progress of the work. Regulation Z provides that the APR and finance charge for such loans may be estimated for disclosure.

At its option, the financial institution may rely on the representations of other parties to acquire necessary information (for example, it might look to the consumer for the dates of advances). In addition, if either the amounts or dates of advances are unknown (even if some of them are known), the financial institution may, at its option, use appendix D to the regulation to make calculations and disclosures. The finance charge and payment schedule obtained through appendix D may be used with volume one of the Federal Reserve Board's APR tables or with any other appropriate computation tool to determine the APR. If the financial institution elects not to use appendix D, or if appendix D cannot be applied to a loan (e.g., appendix D does not apply to a combined construction-permanent loan if the payments for the permanent loan begin during the construction period), the financial institution must make its estimates under §226.17(c)(2) and calculate the APR using multiple advance formulas.

On loans involving a series of advances under an agreement to extend credit up to a certain amount, a financial institution may treat all of the advances as a single transaction or disclose each advance as a separate transaction. If advances are disclosed separately, disclosures must be provided before each advance occurs, with the disclosures for the first advance provided before consummation.

In a transaction that finances the construction of a dwelling that may or will be permanently financed by the same financial institution, the construction-permanent financing phases may be disclosed in one of three ways listed below.

- As a single transaction, with one disclosure combining both phases.
- As two separate transactions, with one disclosure for each phase.
- As more than two transactions, with one disclosure for each advance and one for the permanent financing phase.

If two or more disclosures are furnished, buyer's points or similar amounts imposed on the consumer may be allocated among the transactions in any manner the financial institution chooses, as long as the charges are not applied more than once. In addition, if the financial institution chooses to give two sets of disclosures and the consumer is obligated for both construction and permanent phases at the outset, both sets of disclosures must be given to the consumer initially, before consummation of each transaction occurs.

If the creditor requires interest reserves for construction loans, special appendix D rules apply that can make the disclosure calculations quite complicated. The amount of interest reserves included in the commitment amount must not be treated as a prepaid finance charge.

If the lender uses appendix D for construction-only loans with required interest reserves, the lender must estimate construction interest using the interest reserve formula in appendix D. The lender's own interest reserve values must be completely disregarded for disclosure purposes.

If the lender uses appendix D for combination construction-permanent loans, the calculations can be much more complex. Appendix D is used to estimate the construction interest, which is then measured against the lender's contractual interest reserves.

If the interest reserve portion of the lender's contractual commitment amount exceeds the amount of construction interest estimated under appendix D, the excess value is considered part of the amount financed if the lender has contracted to disburse those amounts whether they ultimately are needed to pay for accrued construction interest. If the lender will not disburse the excess amount if it is not needed to pay for accrued construction interest, the excess amount must be ignored for disclosure purposes.

Calculating the Annual Percentage Rate §226.22

The APR must be determined under one of the following:

- The actuarial method, which is defined by Regulation Z and explained in appendix J to the regulation.
- The U.S. Rule, which is permitted by Regulation Z and briefly explained in appendix J to the regulation. The U.S. Rule is an accrual method that seems to have first surfaced officially in an early nineteenth century United States Supreme Court case, Story v. Livingston (38 U.S. 359).

Whichever method is used by the financial institution, the rate calculated will be accurate if it is able to "amortize" the amount financed while it generates the finance charge under the accrual method selected. Financial institutions also may rely on minor irregularities and accuracy tolerances in the regulation, both of which effectively permit somewhat imprecise, but still legal, APRs to be disclosed.

360-Day and 365-Day Years §226.17(c)(3)

Confusion often arises over whether to use the 360-day or 365-day year in computing interest, particularly when the finance charge is computed by applying a daily rate to an unpaid balance. Many single payment loans or loans payable on demand are in this category. There are also loans in this category that call for periodic installment payments.

Regulation Z does not require the use of one method of interest computation in preference to another (although state law may). It does, however, permit financial institutions to disregard the fact that months have different numbers of days when calculating and making disclosures. This means financial institutions may base their disclosures on calculation tools that assume all months have an equal number of days, even if their practice is to take account of the variations in months to collect interest.

For example, a financial institution may calculate disclosures using a financial calculator based on a 360-day year with 30-day months, when, in fact, it collects interest by applying a factor of 1/365 of the annual interest rate to actual days.

Disclosure violations may occur, however, when a financial institution applies a daily interest factor based on a 360-day year to the actual number of days between payments. In those situations, the financial institution must disclose the higher values of the finance charge, the APR, and the payment schedule resulting from this practice.

For example, a 12 percent simple interest rate divided by 360 days results in a daily rate of .033333 percent. If no charges are imposed except interest, and the amount financed is the same as the loan amount, applying the daily rate on a daily basis for a 365-day year on a $10,000 one year, single payment, unsecured loan results in an APR of 12.17 percent (.033333% x 365 = 12.17%), and a finance charge of $1,216.67. There would be a violation if the APR were disclosed as 12 percent or if the finance charge were disclosed as $1,200 (12% x $10,000).

However, if there are no other charges except interest, the application of a 360-day year daily rate over 365 days on a regular loan would not result in an APR in excess of the one eighth of one percentage point APR tolerance unless the nominal interest rate is greater than 9 percent. For irregular loans, with one-quarter of 1 percentage point APR tolerance, the nominal interest rate would have to be greater than 18 percent to exceed the tolerance.

Variable Rate Information §226.18(f)

If the terms of the legal obligation allow the financial institution, after consummation of the transaction, to increase the APR, the financial institution must furnish the consumer with certain information on variable rates. Graduated payment mortgages and step-rate transactions without a variable rate feature are not considered variable rate transactions. In addition, variable rate disclosures are not applicable to rate increases resulting from delinquency, default, assumption, acceleration, or transfer of the collateral.

Some of the more important transaction-specific variable rate disclosure requirements under §226.18 follow.

- Disclosures for variable rate loans must be given for the full term of the transaction and must be based on the terms in effect at the time of consummation.

- If the variable rate transaction includes either a seller buydown that is reflected in a contract or a consumer buydown, the disclosed APR should be a composite rate based on the lower rate for the buydown period and the rate that is the basis for the variable rate feature for the remainder of the term.

- If the initial rate is not determined by the index or formula used to make later interest rate adjustments, as in a discounted variable rate transaction, the disclosed APR must reflect a composite rate based on the initial rate for as long as it is applied and, for the remainder of the term, the rate that would have been applied using the index or formula at the time of consummation (i.e., the fully indexed rate).

    — If a loan contains a rate or payment cap that would prevent the initial rate or payment, at the time of the adjustment, from changing to the fully indexed rate, the effect of that rate or payment cap needs to be reflected in the disclosures.

    — The index at consummation need not be used if the contract provides a delay in the implementation of changes in an index value (e.g., the contract indicates that future rate changes are based on the index value in effect for some specified period, like 45 days before the change date). Instead, the financial institution may use any rate from the date of consummation back to the beginning of the specified period (e.g., during the previous 45-day period).

- If the initial interest rate is set according to the index or formula used for later adjustments, but is set at a value as of a date before consummation, disclosures should be based on the initial interest rate, even though the index may have changed by the consummation date.

For variable-rate loans that are not secured by the consumer's principal dwelling or that are secured by the consumer's principal dwelling but have a term of one year or less, creditors must disclose the circumstances under which the rate may increase, any limitations on the increase, the effect of an increase, and an example of the payment terms that would result from an increase. §226.18(f)(1).

For variable-rate consumer loans secured by the consumer's principal dwelling and having a maturity of more than one year, creditors must state that the loan has a variable-rate feature and that disclosures were previously given. (§226.18(f)(2)) Extensive disclosures about the loan program are provided when consumers apply for such a loan (§226.19(b), and throughout the loan term when the rate or payment amount is changed (§226.20(c)).

Payment Schedule §226.18(g)

The disclosed payment schedule must reflect all components of the finance charge. It includes all payments scheduled to repay loan principal, interest on the loan, and any other finance charge payable by the consumer after consummation of the transaction.

However, any finance charge paid separately before or at consummation (e.g., odd days' interest) is not part of the payment schedule. It is a prepaid finance charge that must be reflected as a reduction in the value of the amount financed.

At the creditor's option, the payment schedule may include amounts beyond the amount financed and finance charge (e.g., certain insurance premiums or real estate escrow amounts such as taxes added to payments). However, when calculating the APR, the creditor must disregard such amounts.

If the obligation is a renewable balloon payment instrument that unconditionally obligates the financial institution to renew the short-term loan at the consumer's option or to renew the loan subject to conditions within the consumer's control, the payment schedule must be disclosed using the longer term of the renewal period or periods. The long-term loan must be disclosed with a variable rate feature.

If there are no renewal conditions or if the financial institution guarantees to renew the obligation in a refinancing, the payment schedule must be disclosed using the shorter balloon payment term. The short-term loan must be disclosed as a fixed rate loan, unless it contains a variable rate feature during the initial loan term.

Amount Financed §226.18(b)

Definition

The amount financed is the net amount of credit extended for the consumer's use. It should not be assumed that the amount financed under the regulation is equivalent to the note amount, proceeds, or principal amount of the loan. The amount financed normally equals the total of payments less the finance charge.

To calculate the amount financed, all amounts and charges connected with the transaction, either paid separately or included in the note amount, must first be identified. Any prepaid, precomputed, or other finance charge must then be determined.

The amount financed must not include any finance charges. If finance charges have been included in the obligation (either prepaid or precomputed), they must be subtracted from the face amount of the obligation when determining the amount financed. The resulting value must be reduced further by an amount equal to any prepaid finance charge paid separately. The final resulting value is the amount financed.

When calculating the amount financed, finance charges (whether in the note amount or paid separately) should not be subtracted more than once from the total amount of an obligation. Charges not in the note amount and not included in the finance charge (e.g., an appraisal fee paid separately in cash on a real estate loan) are not required to be disclosed under Regulation Z and must not be included in the amount financed.

In a multiple advance construction loan, proceeds placed in a temporary escrow account and awaiting disbursement in draws to the developer are not considered part of the amount financed until actually disbursed. Thus, if the entire commitment amount is disbursed into the lender's escrow account, the lender must not base disclosures on the assumption that all funds were disbursed immediately, even if the lender pays interest on the escrowed funds.

Required Deposit §226.18(r)

A required deposit, with certain exceptions, is one that the financial institution requires the consumer to maintain as a condition of the specific credit transaction. It can include a compensating balance or a deposit balance that secures the loan. The effect of a required deposit is not reflected in the APR. Also, a required deposit is not a finance charge since it is eventually released to the consumer. A deposit that earns at least 5 percent per year need not be considered a required deposit.

Calculating the Amount Financed

A consumer signs a note secured by real property in the amount of $5,435. The note amount includes $5,000 in proceeds disbursed to the consumer, $400 in precomputed interest, $25 paid to a credit reporting agency for a credit report, and a $10 service charge. Additionally, the consumer pays a $50 loan fee separately in cash at consummation. The consumer has no other debt with the financial institution. The amount financed is $4,975.

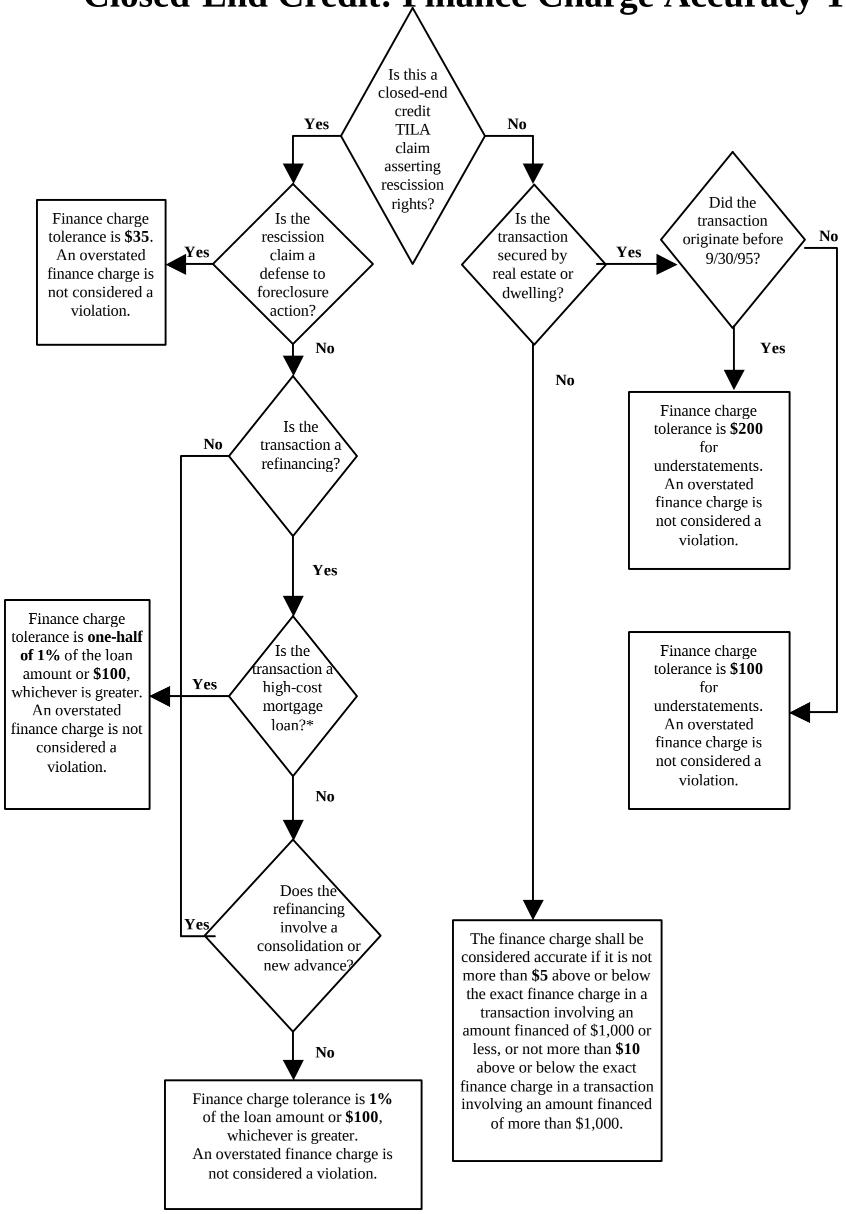
The amount financed may be calculated by first subtracting all finance charges included in the note amount ($5,435 - $400 - $10 = $5,025). The $25 credit report fee is not a finance charge because the loan is secured by real property. The $5,025 is further reduced by the amount of prepaid finance charges paid separately, for an amount financed of $5,025 - $50 = $4,975. The answer is the same whether finance charges included in the obligation are considered prepaid or precomputed finance charges.

The financial institution may treat the $10 service charge as an addition to the loan amount and not as a prepaid finance charge. If it does, the loan principal would be $5,000. The $5,000 loan principal does not include either the $400 or the $10 precomputed finance charge in the note. The loan principal is increased by other amounts that are financed which are not part of the finance charge (the $25 credit report fee) and reduced by any prepaid finance charges (the $50 loan fee, not the $10 service charge) to arrive at the amount financed of $5,000 + $25 - $50 = $4,975.

Other Calculations

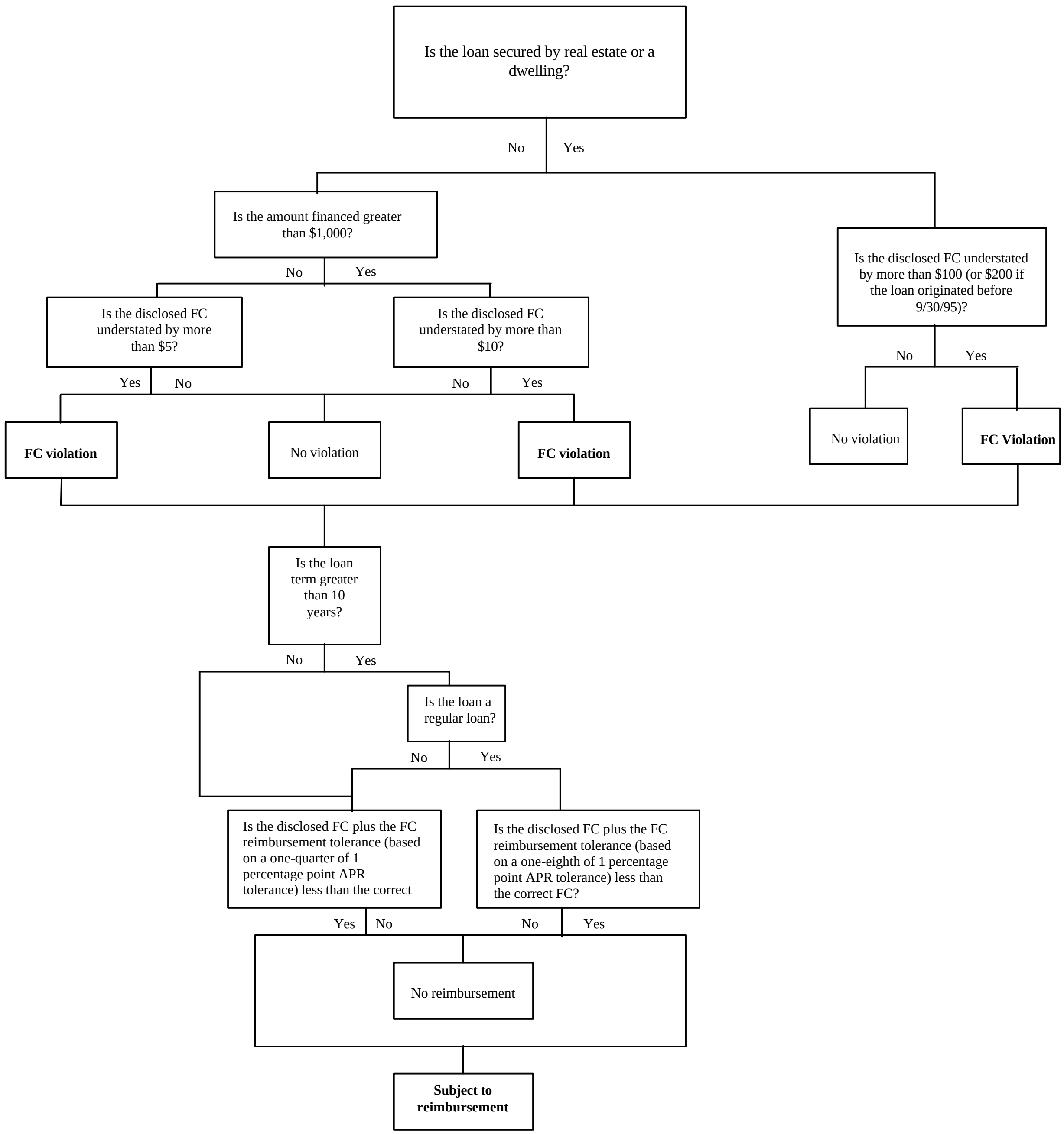
The financial institution may treat the $10 service charge as a prepaid finance charge. If it does, the loan principal would be $5,010. The $5,010 loan principal does not include the $400 precomputed finance charge. The loan principal is increased by other amounts that are financed which are not part of the finance charge (the $25 credit report fee) and reduced by any prepaid finance charges (the $50 loan fee and the $10 service charge withheld from loan proceeds) to arrive at the same amount financed of $5,010 + $25 - $50- $10 = $4,975.

Closed-End Credit: Finance Charge Accuracy Tolerances

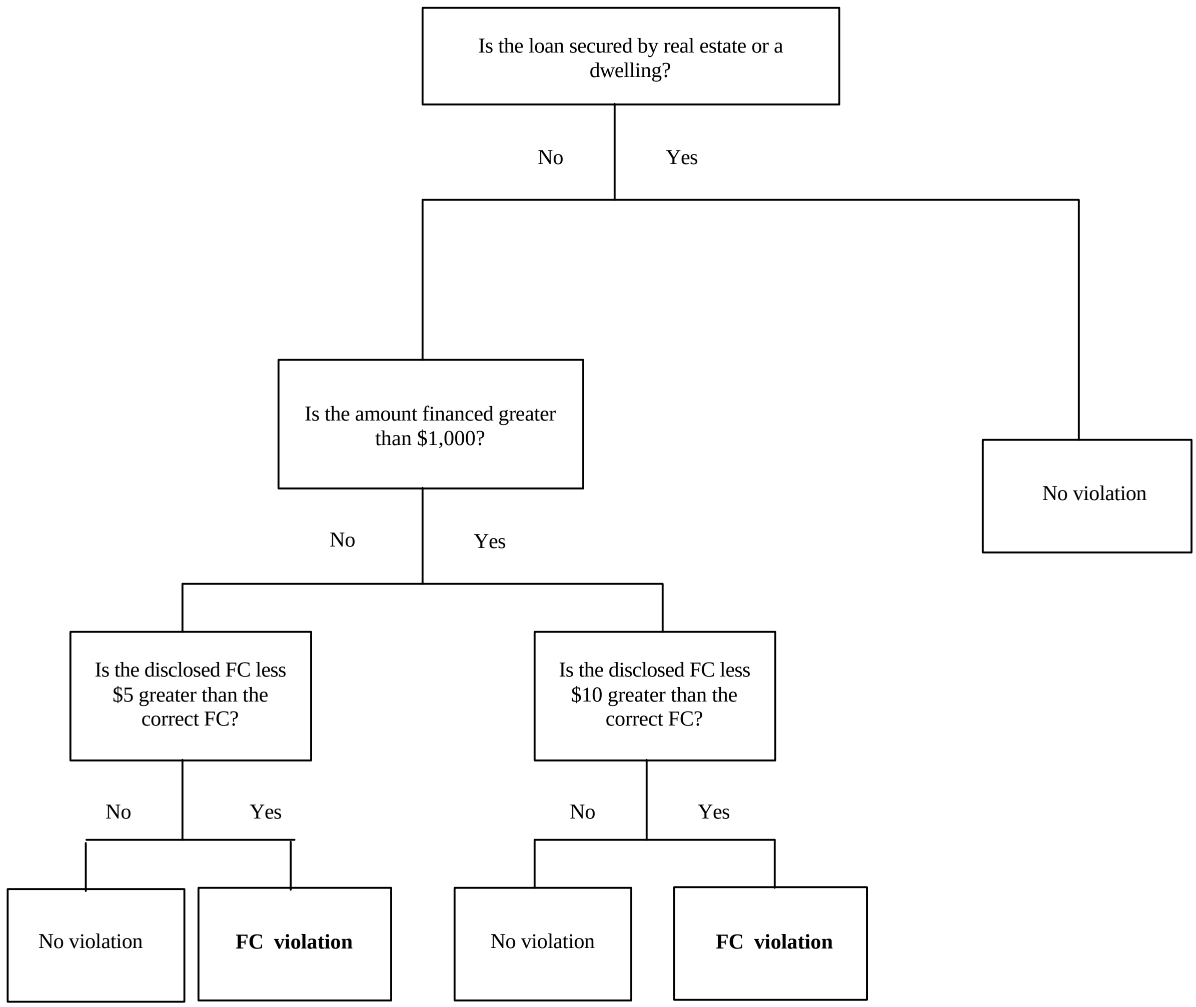


* See 15 USC 160 (aa) and 12 CFR 226.32

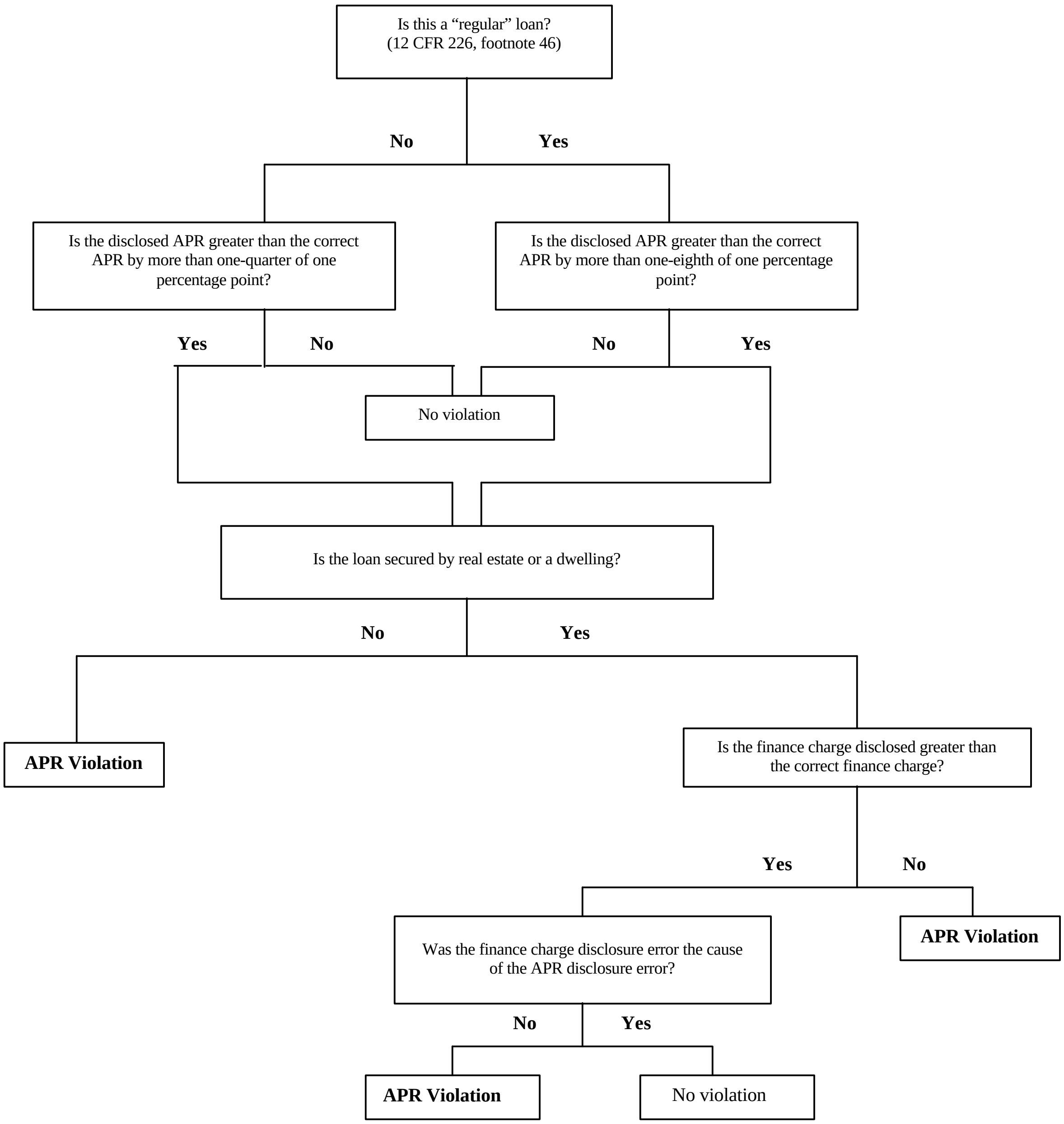
Closed-End Credit: Accuracy and Reimbursement Tolerances for **UNDERSTATED FINANCE CHARGES**



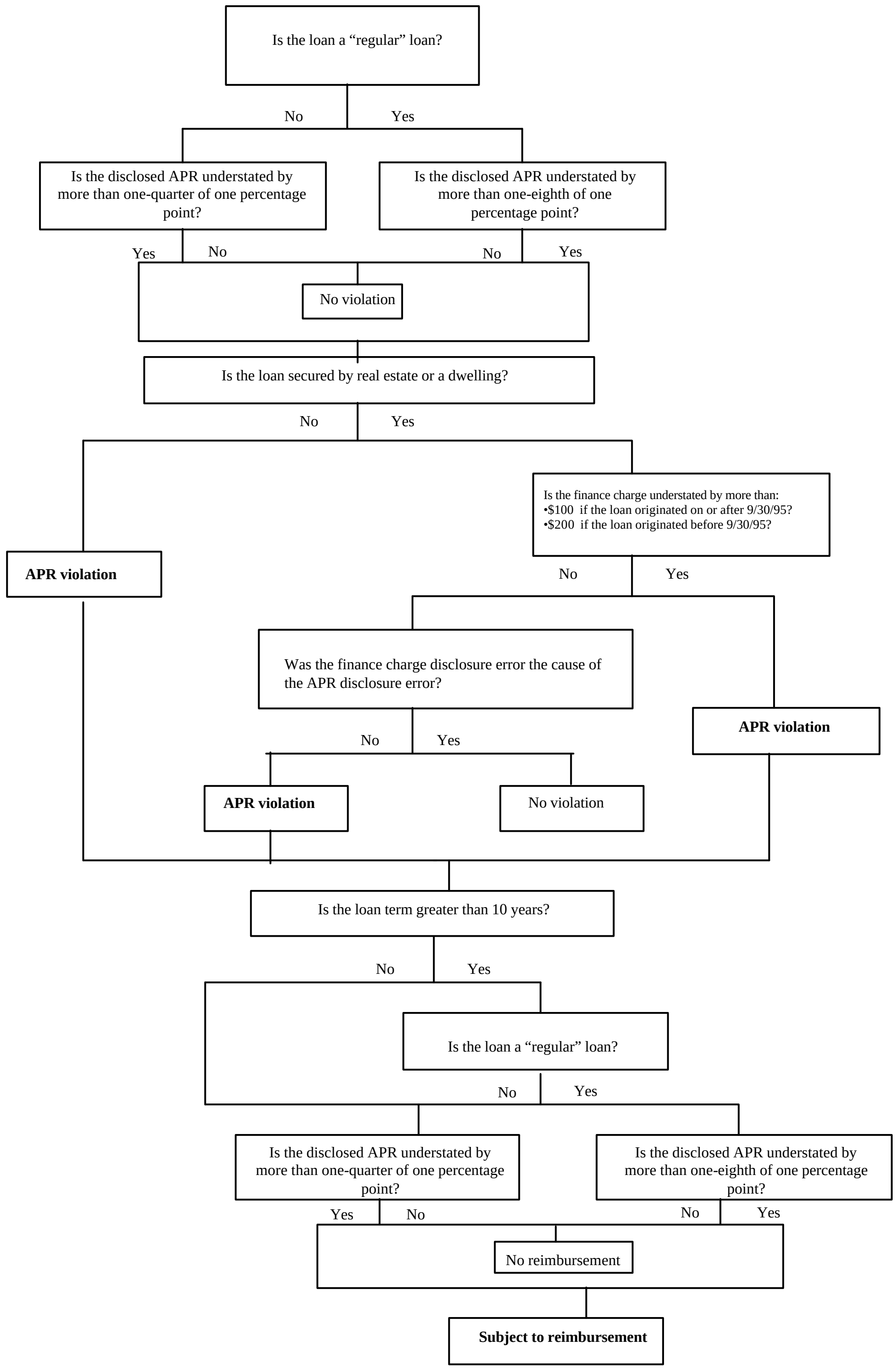
Closed-End Credit: Accuracy Tolerances for
OVERSTATED FINANCE CHARGES



Closed-End Credit: Accuracy Tolerances for **OVERSTATED APRs**



Closed-End Credit: Accuracy and Reimbursement Tolerances For
UNDERSTATED APRs



Refinancings §226.20

When an obligation is satisfied and replaced by a new obligation to the original financial institution (or a holder or servicer of the original obligation) and is undertaken by the same consumer, it must be treated as a refinancing for which a complete set of new disclosures must be furnished. A refinancing may involve the consolidation of several existing obligations, disbursement of new money to the consumer, or the rescheduling of payments under an existing obligation. In any form, the new obligation must completely replace the earlier one to be considered a refinancing under the regulation. The finance charge on the new disclosure must include any unearned portion of the old finance charge that is not credited to the existing obligation. (§226.20(a))

The following transactions are not considered refinancings even if the existing obligation is satisfied and replaced by a new obligation undertaken by the same consumer:

- A renewal of an obligation with a single payment of principal and interest or with periodic interest payments and a final payment of principal with no change in the original terms.
- An APR reduction with a corresponding change in the payment schedule.
- An agreement involving a court proceeding.
- Changes in credit terms arising from the consumer's default or delinquency.
- The renewal of optional insurance purchased by the consumer and added to an existing transaction, if required disclosures were provided for the initial purchase of the insurance.

However, even if it is not accomplished by the cancellation of the old obligation and substitution of a new one, a new transaction subject to new disclosures results if the financial institution:

- Increases the rate based on a variable rate feature that was not previously disclosed; or
- Adds a variable rate feature to the obligation.

If, at the time a loan is renewed, the rate is increased, the increase is not considered a variable rate feature. It is the cost of renewal, similar to a flat fee, as long as the new rate remains fixed during the remaining life of the loan. If the original debt is not canceled in connection with such a renewal, the regulation does not require new disclosures. Also, changing the index of a variable rate transaction to a comparable index is not considered adding a variable rate feature to the obligation.

Subpart D - Miscellaneous

Civil Liability §130

If a creditor fails to comply with any requirements of the TILA, other than with the advertising provisions of chapter 3, it may be held liable to the consumer for:

- Actual damage, and
- The cost of any legal action together with reasonable attorney's fees in a successful action.

If it violates certain requirements of the TILA, the creditor also may be held liable for either of the following:

- In an individual action, twice the amount of the finance charge involved, but not less than \$100 or more than \$1,000. However, in an individual action relating to a closed-end credit transaction secured by real property or a dwelling, twice the amount of the finance charge involved, but not less than \$200 or more than \$2,000.
- In a class action, such amount as the court may allow. The total amount of recovery, however, cannot be more than \$500,000 or 1 percent of the creditor's net worth, whichever is less.

Civil actions that may be brought against a creditor also may be maintained against any assignee of the creditor if the violation is apparent on the face of the disclosure statement or other documents assigned, except where the assignment was involuntary.

A creditor that fails to comply with TILA's requirements for high-cost mortgage loans may be held liable to the consumer for all finance charges and fees paid to the creditor. Any subsequent assignee is subject to all claims and defenses that the consumer could assert against the creditor, unless the assignee demonstrates that it could not reasonably have determined that the loan was subject to §226.32.

Criminal Liability §112

Anyone who willingly and knowingly fails to comply with any requirement of the TILA will be fined not more than $5,000 or imprisoned not more than one year, or both.

Administrative Actions §108

The TILA authorizes federal regulatory agencies to require financial institutions to make monetary and other adjustments to the consumers' accounts when the true finance charge or APR exceeds the disclosed finance charge or APR by more than a specified accuracy tolerance. That authorization extends to unintentional errors, including isolated violations (e.g., an error that occurred only once or errors, often without a common cause, that occurred infrequently and randomly).

Under certain circumstances, the TILA requires federal regulatory agencies to order financial institutions to reimburse consumers when understatement of the APR or finance charge involves:

- Patterns or practices of violations (e.g., errors that occurred, often with a common cause, consistently or frequently, reflecting a pattern with a specific type or types of consumer credit).
- Gross negligence.
- Willful noncompliance intended to mislead the person to whom the credit was extended.

Any proceeding that may be brought by a regulatory agency against a creditor may be maintained against any assignee of the creditor if the violation is apparent on the face of the disclosure statement or other documents assigned, except where the assignment was involuntary. (§131)

Relationship to State Law §111

State laws providing rights, responsibilities, or procedures for consumers or financial institutions for consumer credit contracts may be:

- Preempted by federal law;
- Appropriate under state law and not preempted by federal law; or
- Substituted in lieu of TILA and Regulation Z requirements.

State law provisions are preempted to the extent that they contradict the requirements in the following chapters of the TILA and the implementing sections of Regulation Z:

- Chapter 1, "General Provisions," which contains definitions and acceptable methods for determining finance charges and annual percentage rates. For example, a state law would be preempted if it required a bank to include in the finance charge any fees that the federal law excludes, such as seller's points.
- Chapter 2, "Credit Transactions," which contains disclosure requirements, rescission rights, and certain credit card provisions. For example, a state law would be preempted if it required a bank to use the terms "nominal annual interest rate" in lieu of "annual percentage rate."
- Chapter 3, "Credit Advertising," which contains consumer credit advertising rules and annual percentage rate oral disclosure requirements.

Conversely, state law provisions may be appropriate and are not preempted under federal law if they call for, without contradicting chapters 1, 2, or 3 of the TILA or the implementing sections of Regulation Z, either of the following:

- Disclosure of information not otherwise required. A state law that requires disclosure of the minimum periodic payment for open-end credit, for example, would not be preempted because it does not contradict federal law.

- Disclosures more detailed than those required. A state law that requires itemization of the amount financed, for example, would not be preempted, unless it contradicts federal law by requiring the itemization to appear with the disclosure of the amount financed in the segregated closed-end credit disclosures.

The relationship between state law and chapter 4 of the TILA ("Credit Billing") involves two parts. The first part is concerned with sections 161 (correction of billing errors) and 162 (regulation of credit reports) of the act; the second part addresses the remaining sections of chapter 4.

State law provisions are preempted if they differ from the rights, responsibilities, or procedures contained in sections 161 or 162. An exception is made, however, for state law that allows a consumer to inquire about an account and requires the bank to respond to such inquiry beyond the time limits provided by federal law. Such a state law would not be preempted for the extra time period.

State law provisions are preempted if they result in violations of sections 163 through 171 of chapter 4. For example, a state law that allows the card issuer to offset the consumer's credit-card indebtedness against funds held by the card issuer would be preempted, since it would violate 12 CFR 226.12(d). Conversely, a state law that requires periodic statements to be sent more than 14 days before the end of a free-ride period would not be preempted, since no violation of federal law is involved.

A bank, state, or other interested party may ask the Federal Reserve Board to determine whether state law contradicts chapters 1 through 3 of the TILA or Regulation Z. They also may ask if the state law is different from, or would result in violations of, chapter 4 of the TILA and the implementing provisions of Regulation Z. If the board determines that a disclosure required by state law (other than a requirement relating to the finance charge, annual percentage rate, or the disclosures required under §226.32) is substantially the same in meaning as a disclosure required under the act or Regulation Z, generally creditors in that state may make the state disclosure in lieu of the federal disclosure.

Subpart E - Special Rules for Certain Home Mortgage Transactions

General Rules §226.31

The requirements and limitations of this subpart are in addition to and not in lieu of those contained in other subparts of Regulation Z. The disclosures for high cost and reverse mortgage transactions must be made clearly and conspicuously in writing, in a form that the consumer may keep.

Certain Closed-End Home Mortgages §226.32

The requirements of this section apply to a consumer credit transaction secured by the consumer's principal dwelling, in which either:

- The APR at consummation will exceed by more than 8 percentage points for first-lien mortgage loans, or by more than 10 percentage points for subordinate-lien mortgage loans, the yield on Treasury securities having comparable periods of maturity to the loan's maturity (as of the 15th day of the month immediately preceding the month in which the application for the extension of credit is received by the creditor); or

- The total points and fees (see definition below) payable by the consumer at or before loan closing will exceed the greater of eight percent of the total loan amount or $480 for the calendar year 2002. (This dollar amount is adjusted annually based on changes in the Consumer Price Index. See staff commentary to 32(a)(1)(ii) for a historical list of dollar amount adjustments.) (§226.32(a)(1))

Exemptions:

- Residential mortgage transactions (generally purchase money mortgages),

- Reverse mortgage transactions subject to §226.33, or

- Open-end credit plans subject to Subpart B of Regulation Z.

Points and Fees *include the following:*

- All items required to be disclosed under §226.4(a) and (b), except interest or the time-price differential;
- All compensation paid to mortgage brokers; and
- All items listed in §226.4(c)(7), other than amounts held for future taxes, unless all of the following conditions are met:
  - — The charge is reasonable;
  - — The creditor receives no direct or indirect compensation in connection with the charge;
  - — The charge is not paid to an affiliate of the creditor; and
  - — Premiums or other charges, paid at or before closing whether paid in cash or financed, for optional credit life, accident, health, or loss-of-income insurance, and other debt-protection or debt cancellation products written in connection with the credit transaction (§226.32(b)(1)).

Reverse Mortgages §226.33

A reverse mortgage is a non-recourse transaction secured by the consumer's principal dwelling which ties repayment (other than upon default) to the homeowner's death or permanent move from, or transfer of the title of, the home.

Specific Defenses §108

Defense Against Civil, Criminal, and Administrative Actions

A financial institution in violation of TILA may avoid liability by:

- Discovering the error before an action is brought against the financial institution, or before the consumer notifies the financial institution, in writing, of the error.
- Notifying the consumer of the error within 60 days of discovery.
- Making the necessary adjustments to the consumer's account, also within 60 days of discovery. (The consumer will pay no more than the lesser of the finance charge actually disclosed or the dollar equivalent of the APR actually disclosed.)

The above three actions also may allow the financial institution to avoid a regulatory order to reimburse the customer.

An error is "discovered" if it is:

- Discussed in a final, written report of examination.
- Identified through the financial institution's own procedures.
- An inaccurately disclosed APR or finance charge included in a regulatory agency notification to the financial institution.

When a disclosure error occurs, the financial institution is not required to re-disclose after a loan has been consummated or an account has been opened. If the financial institution corrects a disclosure error by merely re-disclosing required information accurately, without adjusting the consumer's account, the financial institution may still be subject to civil liability and an order to reimburse from its regulator.

The circumstances under which a financial institution may avoid liability under the TILA do not apply to violations of the Fair Credit Billing Act (chapter 4 of the TILA).

Additional Defenses Against Civil Actions

The financial institution may avoid liability in a civil action if it shows by a preponderance of evidence that the violation was not intentional and resulted from a bona fide error that occurred despite the maintenance of procedures to avoid the error.

A bona fide error may include a clerical, calculation, computer malfunction, programming, or printing error. It does not include an error of legal judgment.

Showing that a violation occurred unintentionally could be difficult if the financial institution is unable to produce evidence that explicitly indicates it has an internal controls program designed to ensure compliance. The financial institution's demonstrated commitment to compliance and its adoption of policies and procedures to detect errors before disclosures are furnished to consumers could strengthen its defense.

Statute of Limitations §§108 and 130

Civil actions may be brought within one year after the violation occurred. After that time, and if allowed by state law, the consumer may still assert the violation as a defense if a financial institution were to bring an action to collect the consumer's debt.

Criminal actions are not subject to the TILA one-year statute of limitations.

Regulatory administrative enforcement actions also are not subject to the one-year statute of limitations. However, enforcement actions under the policy guide involving erroneously disclosed APRs and finance charges are subject to time limitations by the TILA. Those limitations range from the date of the last regulatory examination of the financial institution, to as far back as 1969, depending on when loans were made, when violations were identified, whether the violations were repeat violations, and other factors.

There is no time limitation on willful violations intended to mislead the consumer. A summary of the various time limitations follows.

- For open-end credit, reimbursement applies to violations not older than two years.
- For closed-end credit, reimbursement is generally directed for loans with violations occurring since the immediately preceding examination.

RESCISSION RIGHTS (Open-End and Closed-End Credit) §226.15 and §226.23

TILA provides that for certain transactions secured by the consumer's principal dwelling, a consumer has three business days after becoming obligated on the debt to rescind the transaction. The right of rescission allows consumer(s) time to reexamine their credit agreements and cost disclosures and to reconsider whether they want to place their homes at risk by offering it/them as security for the credit. Transactions exempt from the right of rescission include residential mortgage transactions (§226.2(a)(24)) and refinancings or consolidations with the original creditor where no "new money" is advanced.

If a transaction is rescindable, consumers must be given a notice explaining that the creditor has a security interest in the consumer's home, that the consumer may rescind, how the consumer may rescind, the effects of rescission, and the date the rescission period expires.

To rescind a transaction, a consumer must notify the creditor in writing by midnight of the third business day after the latest of three events: (1) consummation of the transaction, (2) delivery of material TILA disclosures, or (3) receipt of the required notice of the right to rescind. For purposes of rescission, business day means every calendar day except Sundays and the legal public holidays (§226.2(a)(6)). The term "material disclosures" is defined in §226.23(a)(3) to mean the required disclosures of the annual percentage rate, the finance charge, the amount financed, the total of payments, the payment schedule, and the disclosures and limitations referred to in §226.32(c) and (d).

The creditor may not disburse any monies (except into an escrow account) and may not provide services or materials until the three-day rescission period has elapsed and the creditor is reasonably satisfied that the consumer has not rescinded. If the consumer rescinds the transaction, the creditor must refund all amounts paid by the consumer (even amounts disbursed to third parties) and terminate its security interest in the consumer's home.

A consumer may waive the three-day rescission period and receive immediate access to loan proceeds if the consumer has a "bona fide personal financial emergency." The consumer must give the creditor a signed and dated waiver statement that describes the emergency, specifically waives the right, and bears the signatures of all consumers entitled to rescind the transaction. The consumer provides the explanation for the bona fide personal financial emergency, but the creditor decides the sufficiency of the emergency.

If the required rescission notice or material TILA disclosures are not delivered or if they are inaccurate, the consumer's right to rescind may be extended from three days after becoming obligated on a loan to up to three years.

Examination Objectives

1. To appraise the quality of the financial institution's compliance management system for the Truth in Lending Act and Regulation Z.

2. To determine the reliance that can be placed on the financial institution's compliance management system, including internal controls and procedures performed by the person(s) responsible for monitoring the financial institution's compliance review function for the Truth In Lending Act and Regulation Z.

3. To determine the financial institution's compliance with the Truth In Lending Act and Regulation Z.

4. To initiate corrective action when policies or internal controls are deficient, or when violations of law or regulation are identified.

5. To determine whether the institution will be required to make adjustments to consumer accounts under the restitution provisions of the Act.

General Procedures

1. Obtain information pertinent to the area of examination from the financial institution's compliance management system program (historical examination findings, complaint information, and significant findings from compliance review and audit).

2. Through discussions with management and review of the following documents, determine whether the financial institution's internal controls are adequate to ensure compliance in the area under review. Identify procedures used daily to detect errors/violations promptly. Also, review the procedures used to ensure compliance when changes occur (e.g., changes in interest rates, service charges, computation methods, and software programs).

   - ❑ Organizational charts.
   - ❑ Process flowcharts.
   - ❑ Policies and procedures.
   - ❑ Loan documentation and disclosures.
   - ❑ Checklists/worksheets and review documents.
   - ❑ Computer programs.

3. Review compliance review and audit work papers and determine whether:

   a. The procedures used address all regulatory provisions (see Transactional Testing section).

   b. Steps are taken to follow up on previously identified deficiencies.

   c. The procedures used include samples that cover all product types and decision centers.

   d. The work performed is accurate (through a review of some transactions).

   e. Significant deficiencies, and the root cause of the deficiencies, are included in reports to management/board.

   f. Corrective actions are timely and appropriate.

   g. The area is reviewed at an appropriate interval.

Disclosure Forms

4. Determine if the financial institution has changed any preprinted TILA disclosure forms or if there are forms that have not been previously reviewed for accuracy. If so:

   Verify the accuracy of each preprinted disclosure by reviewing the following:

   - Note and/or contract forms (including those furnished to dealers).
   - Standard closed-end credit disclosures (§§226.17(a) and 226.18).
   - ARM disclosures (§226.19(b)).
   - High cost mortgage disclosures (§226.32(c)).
   - Initial disclosures (§226.6(a)-(d)) and, if applicable, additional HELC disclosures (§226.6(e)).
   - Credit card application/solicitation disclosures (§226.5a(b)-(e)).
   - HELC disclosures (§226.5b(d) and (e)).
   - Statement of billing rights and change in terms notice (§226.9(a)).
   - Reverse mortgage disclosures (§226.33(b)).

<u>Closed-End Credit Forms Review Procedures</u>

a. Determine the disclosures are clear, conspicuous, grouped, and segregated. The terms Finance Charge and APR should be more conspicuous than other terms (§226.17(a)).

b. Determine the disclosures include the following as applicable (§226.18).

   1. Identity of the creditor
   2. Brief description of the finance charge
   3. Brief description of the APR
   4. Variable rate verbiage (§226.18(f)(1) or (2)).
   5. Payment schedule
   6. Brief description of the total of payments
   7. Demand feature
   8. Description of total sales price in a credit sale
   9. Prepayment penalty’s or rebates
   10. Late payment amount or percentage
   11. Description for security interest
   12. Various insurance verbiage (§226.4(d)).
   13. Statement referring to the contract
   14. Statement regarding assumption of the note
   15. Statement regarding required deposits.

c. Determine all variable rate loans with a maturity greater than one year secured by a principal dwelling are given the following disclosures at the time of application (§226.19).

   1. Consumer handbook on adjustable rate mortgages or substitute
   2. Statement that interest rate payments and or terms can change
   3. The index/formula and a source of information
   4. Explanation of the interest rate/payment determination and margin
   5. Statement that the consumer should ask for the current interest rate and margin
   6. Statement that the interest rate is discounted, if applicable
   7. Frequency of interest rate and payment changes
   8. Rules relating to all changes

9. Either a historical example based on 15 years, or the initial rate and payment with a statement that the periodic payment may substantially increase or decrease together with a maximum interest rate and payment

10. Explanation of how to compute the loan payment, giving an example

11. Demand feature, if applicable

12. Statement of content and timing of adjustment notices

13. Statement that other variable rate loan program disclosures are available, if applicable.

d. Determine that the disclosures required for high-cost mortgage transactions clearly and conspicuously include the items below. [§226.32(c), see Form H-16 in Appendix H.]

1. The required statement "you are not required to complete this agreement merely because you have received these disclosures or have signed a loan application. If you obtain this loan, the lender will have a mortgage on your home. You could lose your home, and any money you have put into it, if you do not meet your obligations under the loan"

2. Annual percentage rate

3. Amount of the regular monthly (or other periodic) payment and the amount of any balloon payment. The regular payment should include amounts for voluntary items, such as credit life insurance or debt-cancellation coverage, only if the consumer has previously agreed to the amount [See staff commentary to 32(c)(3).]

4. Statement that the interest rate may increase, and the amount of the single maximum monthly payment, based on the maximum interest rate allowed under the contract, if applicable.

5. For a mortgage refinancing, the total amount borrowed, as reflected by the face amount of the note; and where the amount borrowed includes premiums or other charges for optional credit insurance or debt-cancellation coverage, that fact shall be stated (grouped together with the amount borrowed).

<u>Open-End Credit Forms Review Procedures</u>

a. Determine the initial disclosure statement is provided before the first transaction under the account and ensure the disclosure includes the items below as applicable (§226.6).

1. Statement of when the finance charge is to accrue and if a grace period exists

2. Statement of periodic rates used and the corresponding APR

3. Explanation of the method of determining the balance on which the finance charge may be computed

4. Explanation of how the finance charge would be determined

5. Statement of the amount of any other charges

6. Statement of creditor's security interest in the property

7. Statement of billing rights (§§226.12 and 226.13)

8. Certain home equity plan information if not provided with the application in a form the consumer could keep. (§226.6(e)(7))

b. Determine the following credit card disclosures were made clearly and conspicuously on or with a solicitation or an application. Disclosures in 12-point type are deemed to comply with the requirements. See staff comment 5a(a)(2)-1. The APR for purchases (other than an introductory rate that is lower than the rate that will apply after the introductory rate expires) must be in at least 18-point type (§226.5a).

1. APR for purchases, cash advances, and balance transfers, including penalty rates that may apply. If the rate is variable, the index or formula, and margin must be identified.
2. Fee for issuance of the card
3. Minimum finance charge
4. Transaction fees
5. Length of the "grace period"
6. Balance computation method
7. Statement that charges incurred by use of the charge card are due when the periodic statement is received.

Note: The above items must be provided in a prominent location in the form of a table. The remaining items may be included in the same table or clearly and conspicuously elsewhere on the same document. An explanation of specific events that may result in the imposition of a penalty rate must be placed outside the table with an asterisk inside the table (or other means) directing the consumer to the additional information.

8. Cash advance fees
9. Late payment fees
10. Fees for exceeding the credit limit

c. Determine that disclosure of items 1-7 in "b" above are made orally for creditor-initiated telephone applications and pre-approved solicitations. Also, determine for applications or solicitations made to the general public that the card issuer makes one of the optional disclosures (§226.5a(d) and (e)).

d. Determine the following home equity disclosures were made clearly and conspicuously, at the time of application (§226.5b).

1. Home equity brochure
2. Statement that the consumer should retain a copy of the disclosure
3. Statement of the time the specific terms are available
4. Statement that terms are subject to change before the plan opens
5. Statement that the consumer may receive a full refund of all fees
6. Statement that the consumer's dwelling secures the credit
7. Statement that the consumer could lose the dwelling
8. Creditors right to change, freeze, or terminate the account
9. Statement that information about conditions for adverse action are available upon request
10. Payment terms including the length of the draw and repayment periods, how the minimum payment is determined, the timing of payments, and an example based on $10,000 and a recent APR
11. A recent APR imposed under the plan and a statement that the rate does not include costs other than interest (fixed rate plans only)
12. Itemization of all fees paid to creditor
13. Estimate of any fees payable to third parties to open the account and a statement that the consumer may receive a good faith itemization of third party fees
14. Statement regarding negative amortization, as applicable
15. Transaction requirements
16. Statement that the consumer should consult a tax advisor regarding the deductibility of interest and charges under the plan

17. For variable rate home equity plans, disclose the following:

    i. That the APR, payment, or term may change

    ii. The APR excludes costs other than interest

    iii. Identify the index and its source

    iv. How the rate will be determined

    v. Statement that the consumer should request information on the current index value, margin, discount, premium, or APR

    vi. Statement that the initial rate is discounted and the duration of the discount, if applicable

    vii. Frequency of APR changes

    viii. Rules relating to changes in the index, APR, and payment amount

    ix. Lifetime rate cap and any annual caps, or a statement that there is no annual limitation

    x. The minimum payment requirement, using the maximum APR, and when the maximum APR may be imposed

    xi. A table, based on a $10,000 balance, reflecting all significant plan terms

    xii. Statement that rate information will be provided on or with each periodic statement.

e. Determine when the last statement of billing rights was furnished to customers and whether the institution used the short form notice with each periodic statement (§226.9(a)).

f. Determine that the notice of any change in terms was provided 15 days prior to the effective date of the change (§226.9(b)).

g. Determine that disclosure of items 1-7 in "b" above are provided if the account is renewed. Additionally, the disclosure provided upon renewal must disclose how and when the cardholder may terminate the credit to avoid paying the renewal fee (§226.9(e)).

h. Determine that a statement of the maximum interest rate that may be imposed during the term of the obligation is made for any loan in which the APR may increase during the plan (§226.30(b)).

<u>Reverse Mortgage Forms Review Procedures (Both open and closed-end)</u>

a. Determine that the disclosures required for reverse mortgage transactions are substantially similar to the model form in Appendix K and include the items below.

   1. A statement that the consumer is not obligated to complete the reverse mortgage transaction merely because he or she has received the disclosures or signed an application

   2. A good faith projection of the total cost of the credit expressed as a table of "total annual loan cost rates" including payments to the consumer, additional creditor compensation, limitations on consumer liability, assumed annual appreciation, and the assumed loan period

   3. An itemization of loan terms, charges, the age of the youngest borrower, and the appraised property value

   4. An explanation of the table of total annual loan costs rates.

   Note: Forms that include or involve current transactions, such as change in terms notices, periodic billing statements, rescission notices, and billing error communications, are verified for accuracy when the file review worksheets are completed.

Timing of Disclosures

5. Review financial institution policies, procedures, and systems to determine, either separately, or when completing the actual file review, whether the applicable disclosures listed below are furnished when required by Regulation Z. Take into account products that have different features, such as closed-end loans or credit card accounts that are fixed or variable rate.

   a. Credit card application and solicitation disclosures - On or with the application (§226.5a(b)).

   b. HELC disclosures – At the time the application is provided or within three business days under certain circumstances (§226.5b(b)).

   c. Open-end credit initial disclosures – Before the first transaction is made under the plan (§226.5(b)(1)).

   d. Periodic disclosures – At the end of a billing cycle if the account has a debit or credit balance of $1 or more or if a finance charge has been imposed (§226.5(b)(2)).

   e. Statement of billing rights – At least once per year (§226.9(a)).

   f. Supplemental credit devices – Before the first transaction under the plan (§226.9(b)).

   g. Open-end credit change in terms – 15 days prior to the effective change date (§226.9(c)).

   h. Finance charge imposed at time of transaction – Prior to imposing any fee (§226.9(d)).

   i. Disclosures upon renewal of credit or charge card – 30 days or one billing cycle, whichever is less before the delivery of the periodic statement on which the renewal fee is charged. Alternatively, notice may be delayed until the mailing or delivery of the periodic statement on which the renewal fee is charged to the accounts if the notice meets certain requirements (§226.9(e)).

   j. Change in credit account insurance provider – Certain information 30 days before the change in provider occurs and certain information 30 days after the change in provider occurs. The institution may provide a combined disclosure 30 days before the change in provider occurs (§226.9(f)).

   k. Closed-end credit disclosures – Before consummation (§226.17(b)).

   l. Disclosures for certain closed-end home mortgages – Three business days prior to consummation (§226.31(c)(1)).

   m. Disclosures for reverse mortgages – Three days prior to consummation of a closed-end credit transaction or prior to the first transaction under an open-end credit plan (§226.31(c)(2)).

   n. Disclosures for adjustable-rate mortgages – At least once each year during which an interest rate adjustment is implemented without an accompanying payment change, and at least 25, but no more than 120 calendar days before a new payment amount is due, or in accordance with other variable-rate subsequent-disclosure regulations issued by a supervisory agency (§226.20(c)).

Record Retention

6. Review the financial institution's record retention practices to determine whether evidence of compliance (for other than the advertising requirements) is retained for at least two years after the disclosures was required to be made or other action was required to be taken (§226.25).

Transactional Testing

Note: When verifying APR accuracies, use the OCC's APR calculation model or other calculation tool acceptable to your regulatory agency.

Advertising

7. Sample advertising copy, including any Internet advertising, since the previous examination and verify that the terms of credit are specific. If triggering terms are used, determine the required disclosures are made (§§226.16 and 226.24).

   For advertisements for closed-end credit, determine:

   — if a rate of finance charge was stated, that it was stated as an APR

   — if an APR will increase after consummation, a statement to that fact is made

Closed-End Credit

8. For each type of closed-end loan being tested, determine the accuracy of the disclosures by comparing the disclosures to the contract and other financial institution documents (§226.17).

9. Determine whether the required disclosures were made before consummation of the transaction and ensure the presence and accuracy of the items below, as applicable (§226.18).

   a. Amount financed

   b. Itemization of the amount financed (RESPA GFE may substitute)

   c. Finance charge

   d. APR

   e. Variable rate verbiage as follows for loans not secured by a principal dwelling or with terms of one year or less:

      1. Circumstances which permit rate increase

      2. Limitations on the increase (periodic or lifetime)

      3. Effects of the increase

      4. Hypothetical example of new payment terms

   f. Payment schedule including amount, timing and number of payments.

   g. Total of payments.

   h. Total sales price (credit sale)

   i. Description of security interest

   j. Credit life insurance premium included in the finance charge unless:

      — Insurance is not required;

      — Premium for the initial term is disclosed; and

      — Consumer signs or initials an affirmative written request for the insurance.

   k. Property insurance available from the creditor excluded from the finance charge if the premium for the initial term of the insurance is disclosed

   l. Required deposit.

10. Determine for adjustable rate mortgage loans secured by the borrower's principal dwelling with maturities of more than one year that the required early and subsequent disclosures are complete, accurate, and timely. Early disclosures required by §226.19(a) are verified during the closed-end credit forms review. Subsequent disclosures should include the items below, as applicable (§226.20(c)).

    a. Current and prior interest rates

    b. Index values used to determine current and prior interest rates

    c. Extent to which the creditor has foregone an increase in the interest rate

    d. Contractual effects of the adjustment (new payment and loan balance)

    e. Payment required to avoid negative amortization.

Note: The accuracy of the adjusted interest rates and indexes should be verified by comparing them with the contract and early disclosures. Refer to the Additional Variable Rate Testing section of these examination procedures.

11. Determine, for each type of closed-end rescindable loan being tested, two copies of the rescission notice are provided to each person whose ownership interest is or will be subject to the security interest. The rescission notice must disclose the items below (§226.23(b)).

    a. Security interest taken in the consumer's principal dwelling

    b. Consumer's right to rescind the transaction

    c. How to exercise the right to rescind, with a form for that purpose, designating the address of the creditor's place of business

    d. Effects of rescission

    e. Date the rescission period expires.

12. Ensure funding was delayed until the rescission period expired (§226.23(c)).

13. Determine if the institution has waived the three-day right to rescind since the previous examination. If applicable, test rescission waivers (§226.23(e)).

14. Determine whether the maximum interest rate in the contract is disclosed for any adjustable rate consumer credit contract secured by a dwelling (§226.30(a)).

Open-End Credit

15. For each open-end credit product tested, determine the accuracy of the disclosures by comparing the disclosure with the contract and other financial institution documents (§226.5(c)).

16. Review the financial institution's policies, procedures, and practices to determine whether it provides appropriate disclosures for creditor-initiated direct mail applications and solicitations to open charge card accounts, telephone applications and solicitations to open charge card accounts, and applications and solicitations made available to the general public to open charge card accounts (§226.5a(b), (c), and (d)).

17. Determine for all home equity plans with a variable rate that the APR is based on an independent index. Further, ensure home equity plans are terminated or terms changed only if certain conditions exist (§226.5b(f)).

18. Determine that, if any consumer rejected a home equity plan because a disclosed term changed before the plan was opened, all fees were refunded. Verify that non-refundable fees were not imposed until three business days after the consumer received the required disclosures and brochure (§226.5b(g) and (h)).

19. Review consecutive periodic billing statements for each major type of open-end credit activity offered (overdraft and home-equity lines of credit, credit card programs, etc.). Determine whether disclosures were calculated accurately and are consistent with the initial disclosure statement furnished in connection with the accounts (or any subsequent change in terms notice) and the underlying contractual terms governing the plan(s). The periodic statement must disclose the items below, as applicable (§226.7).

    a. Previous balance

    b. Identification of transactions

    c. Dates and amounts of any credits

    d. Periodic rates and corresponding APRs, if variable rate plan, must disclose that the periodic rates may vary

    e. Balance on which the finance charge is computed and an explanation of how the balance is determined

    f. Amount of finance charge with an itemization of each of the components of the finance charge

    g. Annual percentage rate

h. Itemization of other charges

i. Closing date and balance

j. Payment date, if there is a "free ride" period

k. Address for notice of billing errors.

20. Verify the institution credits a payment to the open-end account as of the date of receipt (§226.10).

21. Determine institution's treatment of credit balances. Specifically, if the account's credit balance is in excess of $1, the institution must disclose the items below (§226.11).

    a. Credit the amount to the consumer's account;

    b. Refund any part of the remaining credit balance within seven business days from receiving a written request from the consumer; and

    c. Make a good faith effort to refund the amount of the credit to a deposit account of the consumer if the credit remains for more than six months.

22. Review a sample of billing error resolution files and a sample of consumers who have asserted a claim or defense against the financial institution for a credit card dispute regarding property or services. Verify the following (§§226.12 and 226.13).

    a. Credit cards are issued only upon request

    b. Liability for unauthorized credit card use is limited to $50

    c. Disputed amounts are not reported delinquent unless remaining unpaid after the dispute has been settled

    d. Offsetting credit card indebtedness is prohibited

    e. Errors are resolved within two complete billing cycles.

23. Determine, for each type of open-end rescindable loan being tested, two copies of the rescission notice are provided to each person whose ownership interest is or will be subject to the security interest and perform items 11, 12, and 13 under Closed-End Credit.

Additional Variable Rate Testing

24. Verify that when accounts were opened or loans were consummated that loan contract terms were recorded correctly in the financial institution's calculation systems (e.g., its computer). Determine the accuracy of the following recorded information:

    a. Index value,

    b. Margin and method of calculating rate changes,

    c. Rounding method, and

    d. Adjustment caps (periodic and lifetime).

25. Using a sample of periodic disclosures for open-end variable rate accounts (e.g., home equity accounts) and closed-end rate change notices for adjustable rate mortgage loans:

    a. Compare the rate-change date and rate on the credit obligation to the actual rate-change date and rate imposed.

    b. Determine that the index disclosed and imposed is based on the terms of the contract (example: the weekly average of one-year Treasury constant maturities, taken as of 45 days before the change date) (§§226.7(g) and 226.20(c)(2)).

    c. Determine that the new interest rate is correctly disclosed by adding the correct index value with the margin stated in the note, plus or minus any contractual fractional adjustment (§§226.7(g) and 226.20 (c)(1)).

    d. Determine that the new payment disclosed (§226.20(c)(4)) was based on an interest rate and loan balance in effect at least 25 days before the payment change date (consistent with the contract) (§226.20(c)).

Certain Home Mortgage Transactions

26. Determine whether the financial institution originates consumer credit transactions subject to Subpart E of Regulation Z; specifically, certain closed-end home mortgages (high-cost mortgages (§226.32) and reverse mortgages (§226.33).

27. Examiners may use the attached worksheet as an aid for identifying and reviewing high-cost mortgages.

28. Review both high-cost and reverse mortgages to ensure the following:

    a. Required disclosures are provided to consumers in addition to, not in lieu of, the disclosures contained in other subparts of Regulation Z (§226.31(a)).

    b. Disclosures are clear and conspicuous, in writing, and in a form that the consumer may keep (§226.31(b)).

    c. Disclosures are furnished at least three business days prior to consummation of a mortgage transaction covered by §226.32 or a closed-end reverse mortgage transaction (or at least three business days prior to the first transaction under an open-end reverse mortgage) (§226.31(c)).

    d. Disclosures reflect the terms of the legal obligation between the parties (§226.31(d)).

    e. If the transaction involves more than one creditor, only one creditor shall provide the disclosures. Where the obligation involves multiple consumers, the disclosures may be provided to any consumer who is primarily liable on the obligation. However, for rescindable transactions, the disclosures must be provided to each consumer who has the right to rescind (§226.31(e)).

    f. The APR is accurately calculated and disclosed in accordance with the requirements and within the tolerances allowed in §226.22 (§226.31(g)).

29. For high-cost mortgages (§226.32), ensure that:

    b. In addition to other required disclosures, the creditor discloses the following at least three business days prior to consummation: [See model disclosure at App. H-16]

        1. Notice containing the prescribed language (§226.32(c)(1)).

        2. Annual percentage rate (§226.32(c)(2)).

        3. Amount of regular loan payment and the amount of any balloon payment (§226.32(c)(3)).

        4. For variable rate loans, a statement that the interest rate and monthly payment may increase, and the amount of the single maximum monthly payment allowed under the contract (§226.32(c)(4)).

        5. For a mortgage refinancing, the total amount the consumer will borrow (the face amount) and if this amount includes premiums or other charges for optional credit insurance or debt-cancellation coverage, that fact is stated. This disclosure shall be treated as accurate if within $100 (§226.32(c)(5)).

        6. A new disclosure is required if, subsequent to providing the additional disclosure but prior to consummation, there are changes in any terms that make the disclosures inaccurate. For example, if a consumer purchases optional credit insurance and, as a result, the monthly payment differs from the payment previously disclosed, redisclosure is required and a new three-day waiting period applies (§226.31(c)(1)(i)).

        7. If a creditor provides new disclosures by telephone when the consumer

initiates a change in terms, then at consummation: (§226.31(c)(1)(ii))

— The creditor must provide new written disclosures and both parties must sign a statement that these new disclosures were provided by telephone at least three days prior to consummation.

8. If a consumer waives the right to a three-day waiting period to meet a bona fide personal financial emergency, the consumer's waiver must be a dated written statement (not a pre-printed form) describing the emergency and bearing the signature of all entitled to the waiting period (a consumer can waive only after receiving the required disclosures and prior to consummation) (§226.31(c)(1)(iii)).

c. High-cost mortgage transactions do not provide for any of the following loan terms:

1. Balloon payment (if term is less than 5 years, with exceptions) (§226.32(d)(1)(i) and (ii)).

2. Negative amortization (§226.32(d)(2)).

3. Advance payments from the proceeds of more than 2 periodic payments (§226.32(d)(3)).

4. Increased interest rate after default (§226.32(d)(4)).

5. A rebate of interest, arising from a loan acceleration due to default, calculated by a method less favorable than the actuarial method (§226.32(d)(5)).

6. Prepayment penalties (but permitted in the first five years if certain conditions are met) (§226.32(d)(6) and (7)).

7. A due-on-demand clause permitting the creditor to terminate the loan in advance of maturity and accelerate the balance, with certain exceptions (§226.32(d)(8)).

d. The creditor is not engaged in the following acts and practices for high-cost mortgages:

1. <u>Home improvement contracts –</u> paying a contractor under a home improvement contract from the proceeds of a mortgage unless certain conditions are met (§226.34(a)(1)).

2. <u>Notice to assignee</u> – selling or otherwise assigning a high-cost mortgage without furnishing the required statement to the purchaser or assignee (§226.34(a)(2)).

3. <u>Refinancing within one year of extending credit</u> – within one year of making a high-cost mortgage loan, a creditor may not refinance any high-cost mortgage loan to the same borrower into another high-cost mortgage loan that is not in the borrower's interest. This also applies to assignees that hold or service the high-cost mortgage loan. Commentary to 34(a)(3) has examples applying the refinancing prohibition and addressing "borrower's interest" (§226.34(a)(3)).

4. <u>Consumers' ability to repay</u> – engaging in a pattern or practice of extending high-cost mortgages based on the consumer's collateral without regard to repayment ability, including the consumer's current and expected income, current obligations, and employment. A violation is presumed if there is a pattern or practice of making such mortgage loans without verifying and documenting consumers' repayment ability.

A. A creditor may consider any expected income of the consumer, including:

i. Regular salary or wages;

ii. Gifts;

iii. Expected retirement payments; and

iv. Income from self-employment.

B. Equity income that would be realized from the collateral may not be considered.

C. Creditors may verify and document a consumer’s income and obligations through any reliable source that provides the creditor with a reasonable basis for believing that there are sufficient funds to support the loan. Reliable sources include:

i. Credit reports;

ii. Tax return;

iii. Pension statements; or

iv. Payment records for employment income.

D. If a loan transaction includes a discounted introductory rate, the creditor must consider the consumer’s ability to repay based on the non-discounted or fully indexed rate.

Commentary to 34(a)(4) contains guidance on income that may be considered, on “pattern or practice,” and on “verifying and documenting” income and obligations (§226.34(a)(4)).

30. Ensure that the creditor does not structure a home-secured loan as an open-end plan (“spurious open-end credit”) to evade the requirements of Regulation Z. See staff commentary to 34(b) for factors to be considered (§226.34(b)).

Administrative Enforcement

31. If there is noncompliance involving understated finance charges or understated APRs subject to reimbursement under the FFIEC Policy Guide on Reimbursement (policy guide), continue with step 32.

32. Document the date on which the administrative enforcement of the TILA policy statement would apply for reimbursement purposes by determining the date of the preceding examination.

33. If the noncompliance involves indirect (third-party paper) disclosure errors and affected consumers have not been reimbursed:

a. Prepare comments, discussing the need for improved internal controls to be included in the report of examination.

b. Notify your supervisory office for follow up with the regulator that has primary responsibility for the original creditor.

If the noncompliance involves direct credit:

c. Make an initial determination whether the violation is a pattern or practice.

d. Calculate the reimbursement for the loans or accounts in an expanded sample of the identified population.

e. Estimate the total impact on the population based on the expanded sample.

f. Inform management that reimbursement may be necessary under the law and the policy guide, and discuss all substantive facts including the sample loans and calculations.

g. Inform management of the financial institution’s options under section 130 of the TILA for avoiding civil liability and of its option under the policy guide and section 108 (e)(6) of the TILA for avoiding a regulatory agency’s order to reimburse affected borrowers.

HIGH-COST MORTGAGE (§226.32) WORKSHEET

Borrower's Name	Loan Number:

COVERAGE		
	Yes	**No**
Is the loan secured by the consumer's principal dwelling? [§226.2(a)(19), §226.32(a)(1)]		
If the answer is No, STOP HERE		
Is the loan for the following purpose?		
1. Residential Mortgage Transaction – [§226.2(a)(24)]		
2. Reverse Mortgage Transaction – [§226.33]		
3. Open-End Credit Plan – Subpart B [note prohibition against structuring loans as open-end plans to evade §226.32 – [§226.34(b)]		
If the answer is Yes to Box 1, 2, or 3, STOP HERE. If No, continue to Test 1.		

TEST 1 – CALCULATION OF APR		
A. Disclosed APR		
B. Treasury Security Yield of Comparable Maturity Obtain the Treasury Constant Maturities Yield from the FRB's Statistical Release, H-15 – Selected Interest Rates (the "Business" links will display daily yields). Use the yield that has the most comparable maturity to the loan term and is from the 15th day of the month that immediately precedes the month of the application. If the 15th is not a business day, use the yield for the business day immediately preceding the 15th. If the loan term is exactly halfway between two published security maturities, use the lower of the two yields.) Note: Creditors may use the FRB's Selected Interest Rates or the actual auction results. See Staff Commentary to Regulation Z for further details. [§226.32(a)(1)(i)] http://www.federalreserve.gov/releases/H15/data.htm		
C. Treasury Security Yield of Comparable Maturity (Box B) Plus: 8 percentage points for first-lien loan; or 10 percentage points for subordinate-lien loan		
	Yes	**No**
D. Is Box A greater than Box C?		
If Yes, the transaction is a High-Cost Mortgage. If No, continue to Test 2, Points and Fees.		

HIGH-COST MORTGAGE (§226.32) WORKSHEET

TEST 2 – CALCULATION OF POINTS AND FEES		
STEP 1: Identify all Charges Paid by the Consumer at or before Loan Closing		
A. Finance Charges – §226.4(a) and (b) (Interest, including per-diem interest, and time price differential are excluded from these amounts.)		
	Fee	**Subtotals**
Loan Points		
Mortgage Broker Fee		
Loan Service Fees		
Required Closing Agent/3rd Party Fees		
Required Credit Insurance		
Private Mortgage Insurance		
Life of Loan Charges (flood, taxes, etc.)		
Any Other Fees Considered Finance Charges		
Subtotal		
B. Certain Non-Finance Charges Under §226.4(c)(7) – Include fees paid by consumers only if the amount of the fee is unreasonable or if the creditor receives direct or indirect compensation from the charge or the charge is paid to an affiliate of the bank. (See the example in §226.32(b)(1)(ii) of the commentary for further explanation.)		
Title Examination		
Title Insurance		
Property Survey		
Document Preparation Charge		
Credit Report		
Appraisal		
Fee for "Initial" Flood Hazard Determination		
Pest Inspection		
Any Other Fees Not Considered Finance Charges		
Subtotal		
C. Premiums or Other Charges for Optional Credit Life, Accident, Health, or Loss-of-Income Insurance, or Debt-Cancellation Coverage		
D. Total Points & Fees: Add Subtotals for A, B, C		

HIGH-COST MORTGAGE (§226.32) WORKSHEET

TEST 2 – CALCULATION OF POINTS AND FEES (continued)	
STEP 2: Determine the Total Loan Amount for Cost Calculation [226.32(a)(1)(ii)]	
A. Determine the Amount Financed [§226.18(b)] Principal Loan Amount	
Plus: Other Amounts Financed by the Lender *(not already included in the principal and not part of the finance charge)*	
Less: Prepaid Finance Charges [§226.2(a)(23)]	
Equals: Amount Financed	
B. Deduct costs included in the points and fees under §226.32(b)(1)(iii) and (iv) (Step 1, Box B and Box C) that are financed by the creditor	
C. Total Loan Amount (Step 2, Box A minus Box B)	

TEST 2 – CALCULATION OF POINTS AND FEES (continued)		
STEP 3: Perform High-Fee Cost Calculation		
A. Eight Percent of the Total Loan Amount (Step 2, Box C)		
B. Annual Adjustment Amount – [§226.32(a)(1)(ii)] *1999: $441; 2000: $451; 2001: $465; 2002: $480* *(use the dollar amount corresponding to the year of the loan's origination)*		
C. Total Points & Fees (Step 1, Box D)		
	Yes	**No**
In Step 3, does Box C exceed the greater of Box A or Box B?		
If Yes, the transaction is a High-Cost Mortgage. If No, the transaction is not a High-Cost Mortgage under Test 2, Points and Fees.		

Introduction

The Truth in Lending Simplification and Reform Act of 1980 gave the agencies that enforce the Truth in Lending Act (FRB, OCC, FDIC, NCUA, and the OTS) the authority to require Financial institutions that violate certain provisions of the law to reimburse borrowers for faulty disclosures. Generally, the agencies are empowered to order restitution under their cease and desist authority for understatements of the annual percentage rate (APR) and finance charge disclosures resulting from:

- a clear and consistent pattern or practice of disclosure errors;
- gross negligence; or,
- a willful violation of the Act.

The agencies may also require restitution for isolated disclosure errors.

The term “clear and consistent pattern or practice” is not defined in the Act. Consequently, the Interagency Policy Guide does not contain any precepts for application of this phrase.

However, in making a determination, the examiner should attempt to detect the cause for a particular type of violation and determine whether that cause gives rise to violations in other transactions. Patterns or practices can arise from a particular loan officer, a form, a chart, a calculator or computer, or just plain sloppiness, to name a few examples. Patterns or practices can also be present in only certain transactions, e.g. real estate loans and not in other loans.

Section 608 of the TIL Simplification and Reform Act (which contains the restitution provisions) is implemented by the Interagency Policy Guide for Restitution (see Appendix A). The Policy Guide was adopted by each agency represented on the Federal Financial Institutions Examination Council. The Policy Guide summarizes and explains the restitution provisions of the law and also explains the corrective actions that the agencies generally intend to take in those instances where the Act gave the agencies the authority to take equitable remedial action.

The Interagency Policy Guide for Restitution

Definitions

The Policy Guide contains several definitions that are critical to both the understanding and the application of the restitution provisions to individual cases. Some of these definitions are discussed below.

1. Current Examination — this is the most recent examination begun on or after March 31, 1980 (the effective date of Section 608) in which compliance with Regulation Z was reviewed.

This is an extremely important definition because corrective action time periods are measured from the date of the current examination.

2. Understated APR — an understated APR is a disclosed APR which is one-quarter of one percent less than the actual APR for all transactions except for regular mortgage loans which have an amortization schedule of more than ten years; for these transactions the tolerance is one-eighth of one percent.

To explain, if a transaction has a disclosed APR of 10.00 percent and the actual APR is 10.26 or more, the disclosed figure is understated and restitution would be required. If, however, a transaction has an amortization schedule of greater than ten years, and it is otherwise regular (equal payments with or without an odd first or last payment such as a balloon, with a single advance) then the tolerance is only one-eighth of one percent and a corresponding tolerance of .125 would be applied.

3. Understated Finance Charge — a finance charge is considered understated if it is lower than the finance charge that would be generated on the transaction by the APR reduced by the corresponding tolerance. The footnote to this definition in the Policy Guide provides a simple example that explains the application of the tolerance.

To determine whether a finance charge is understated, it is necessary to compare the disclosed finance charge to the finance charge generated by reducing the lowest permissible APR by the applicable tolerance. If the disclosed finance charge falls below the finance charge generated by the reduced APR, then the disclosed finance charge would be understated. If the resulting difference between the disclosed finance charge and the finance charge generated by the reduced APR is more than one dollar, the difference would be reimbursed.

De Minimus Rule

The statute contains a de minimus rule for adjustment amounts that fall below $1.00. However, the agencies could still require a creditor to reimburse the de minimus amounts to the U.S. Treasury.

Corrective Action Period

Generally, the corrective action time period for closed-end credit runs from the date of the current examination back to the date of the prior examination in which Regulation Z was reviewed. However, if the same violation was cited at the date of the prior examination, the corrective action time period continues backwards to the date of the examination in which the creditor was first notified of the violation. Given the fact that restitution has been part of the examination process for a number of years now, rarely will the time periods extend further back than the date of the prior examination.

The Policy Guide also makes reference to requiring restitution on transactions that were originated between January 1, 1977 and March 31, 1980. This was a provision that had meaning and applicability during the first few years of implementation after the effective date of the act. It was designed to assure that those institutions that had restitution requests pending during the time that the Congress was deliberating the restitution provisions within the context of the amended Truth In Lending Act, would still be required to reimburse affected customers.

Terminated closed-end credit transactions have a different corrective action period. An adjustment on a terminated loan will only be requested if the loan was consummated and terminated within the two year period preceeding the date of the current examination.

Open-end credit transactions are subject to an adjustment if the violation occurred within the two-year period preceding the date of the current examination.

Corrective action applies to all applicable transactions during the corrective action period and is not limited to only those found by the examiner to require restitution.

Calculating the Adjustment

The tolerance amount may be applied in calculating the amount of any adjustment to the consumer's account. This means that if a disclosed APR, for example, is understated by .40 percent, the creditor need only reimburse the dollar difference represented by .15 percent.

Methods of Adjustment

Only two methods of reimbursement are permitted, the lump sum, and lump sum/payment reduction methods.

Under the lump sum method, the creditor reimburses to the borrower a cash payment equal to the total adjustment over the life of the loan. Under the lump sum/payment reduction method, the creditor reimburses a cash payment equal to the overcharge up to the time of the adjustment, and reduces the remaining payments on the loan. This latter method is typically used in real estate transactions to mitigate the effects of restitution on cash flow.

Non-Disclosure of the APR or Finance Charge

The Policy Guide provides special guidance for situations where a creditor has failed to disclose either the APR or finance charge on a transaction. If an APR was not disclosed, the contract rate of interest is considered to be the APR for purposes of application of the Policy Guide. If both the APR and the contract rate of interest were not disclosed, a consumer will not be required to pay an amount greater than the actual APR reduced by one-quarter of one percentage point in the case of first lien mortgage transactions, and one percentage point in all other transactions.

A failure to disclose the finance charge altogether does not require reimbursement.

Credit Life, Accident and Health Insurance Disclosure Violations

Violations of the Regulation Z provisions that enable creditors to exclude credit life premiums from the finance charge are to be treated as violations of either the APR of finance charge disclosure rules.

Special Disclosures

Violations of either the property insurance or security interest fee or non-Fling insurance provisions in Section 226.4(e) of Regulation Z are exempt from the restitution requirements by statute.

Obvious Errors

The Policy Guide contains a special rule for errors in the APR or finance charge disclosures that are so obvious that a reasonable person could not have relied on them in making a credit shopping decision. If the APR of finance charge that was disclosed is ten percent or less of the amount that should have been disclosed, no adjustment will be required. This rule is aimed primarily at common clerical mistakes such as disclosing an APR as “1.000” instead of “10.00” or a finance charge as “$37,678.32” instead of “$376,783.20.”

This special rule is infrequently applicable. However, when it has been applied, it has usually been in connection with finance charge disclosure mistakes where the creditor merely discloses the prepaid finance charge as the entire finance charge on a long-term loan, and, consequently, fails to include the much larger interest component.

Agency Discretion

The statute gave the agencies very limited discretion to exempt a creditor from reimbursement if some stringent tests are satisfied. First, the disclosure error had to result from unique circumstances; second, it had to involve a clearly technical and nonsubstantive disclosure violation; third, it did not adversely affect information provided to the borrower; and, fourth, it did not mislead or otherwise deceive the borrower.

This is a very strict series of tests that are very difficult to satisfy. Basically, it would be highly unusual to reach a finding where an APR or a finance charge disclosure violation is considered clearly technical or nonsubstantive. A violation of either of these items, which are the focus of the Truth in Lending Act, would always adversely affect information provided to the borrower. Moreover, a regulatory agency is not in the position to reach a determination that a borrower was not misled or otherwise deceived by a disclosure error.

Given the exacting nature of this very limited exibility, ARDs (Assistant Regional Director for Compliance) should consult with the Division of Compliance Programs within the Office of Thrift Supervision when a situation involving the potential application of the agency discretion clause is being considered.

Safety and Soundness

The statute does not provide the agencies with much latitude for forgiving restitution even when restitution would have a significantly adverse impact on the solvency of the creditor. The agencies are, however, permitted to allow partial, installment payments of reimbursement amounts to borrowers over an extended period to minimize adverse impact on a creditor’s safety and soundness.

Exemption from Restitution Orders

The Policy Guide indicates that a creditor would not be subject to an agency order requiring restitution if it adjusts the accounts on its own within 60 days of learning of the disclosure violation. This is unrelated to the civil liability provisions of Section 130 of the Truth in Lending Act.

Question and Answer Document

To facilitate understanding of application of the Policy Guide to various, common fact situations, the agencies have prepared an internal question and answer document. This document is contained in Appendix B of this Handbook section.

Documentation Requirements

When an understated APR or finance charge is discovered, certain documentation should be recorded on a separate workpaper. Information on this workpaper should be adequate to facilitate calculation of the APR, finance charge, and reimbursement amount for each loan without further reference to the loan file. At a minimum, the following should be recorded for each affected loan:

- loan amount
- note rate
- actual prepaid finance charge
- actual amount financed
- disclosed amount financed
- disclosed finance charge
- actual finance charge
- disclosed APR
- actual APR
- date finance charge began to accrue
- first payment due date
- number of payments made to date
- payment schedule (amount and number, and if on demand, state "demand")
- term of the loan

Report Requirements

A pattern or practice of violations involving understated APRs or finance charges must be included in the report comments. It is not necessary to identify individual loans in the comments except in cases where a lawsuit or consumer complaint has been fled or is anticipated.

The report comments should include the following supporting information for understated APR or finance charge violations constituting a pattern or practice:

- number of violations found by loan type or source
- sample sizes
- volume of lending by loan type or source
- pertinent information establishing the cause of the violations and the extent of the problem
- a statement identifying the specific institution management member(s) with whom the violations were discussed and to whom the exception sheets identifying all violations were given.

Examination Objectives

To determine whether the institution has any obligation under the restitution provisions of the Act to reimburse borrowers for understatements of the APR or finance charge disclosure provisions of Regulation Z.

Examination Procedures

1. The following procedures are performed as an adjunct to the review for general compliance with the Truth in Lending Act. They only apply if the examiner has identified understated APRs or finance charges in the sample taken as part of the Truth in Lending examination procedures.

2. In connection with the examination procedures conducted under "Truth in Lending," determine whether there is a pattern or practice

of APR or finance charge disclosure violations requiring reimburse-ment.

3. If there is a pattern or practice of APR or finance charge disclosure violations requiring restitution, estimate the potential dollar amount, and inform the institution of the potential amount and the cause of the problem.

4. Document findings as appropriate.

Background

The Truth in Lending Act Amendments of 1995 and the Economic Growth and Regulatory Paperwork Reduction Act of 1996 amended the TILA to incorporate new tolerances for disclosures of the finance charge and other disclosures affected by the finance charge on certain types of loans. These amendments specify that in closed-end consumer credit transactions secured by real property or a dwelling, the disclosed finance charge and other disclosures affected by the disclosed finance charge shall be treated as accurate if the amount disclosed as the finance charge is overstated, or is understated by no more than $100 for transactions consummated on or after September 30, 1995, or $200 for loans made before that date. The Federal Reserve Board proposed and adopted amendments to Regulation Z in 1996 to implement the statutory changes (12 CFR 226.18(d)(1), 226.18(d)(2), 226.22(a)(4) and 226.22(a)(5)).

The Policy Statement originally issued in 1980 was directly affected by the amendments to the TILA and the changes to Regulation Z in several respects. First, the changes to the tolerances affect the definition for understated annual percentage rates (APR) contained in the Policy Statement. Second, the amendments enhanced the agencies' abilities to make modifications to the amount or timing of restitution in the event that payment of restitution would adversely affect the capital position of the financial institution. In the main, the revisions to the Policy Statement make only those changes necessary to accommodate statutory requirements. Some other editorial changes were made, however, to reflect that some provisions of the original Policy Statement were no longer needed due to the passage of time.

Summary of Changes

The revised Policy Statement drops the definition of ``Irregular Mortgage Transaction." The term is used in the Truth in Lending Simplification and Reform Act in the definition of an understated APR for loans secured by dwellings consummated prior to March 31, 1982. There is no longer any need for maintaining a separate definition of this term in the Policy Statement. A footnote has been included in the revised Policy Statement to indicate that, should loans consummated prior to March 31, 1982 having understated APRs be found, the original Policy Statement should be consulted for guidance.

The definition of the term ``Understated APR" in the Policy Statement has been modified to reflect revised tolerances for certain real estate secured transactions. The Truth in Lending Amendments of 1995 and the Economic Growth and Regulatory Paperwork Reduction Act of 1996 mandated these revisions. The Policy Statement has also been revised to consolidate six separate sub-parts to the definition of an ``Understated APR" into two subparts; (1) Loans having an amortization schedule of 10 years or less, and (2) loans with an amortization schedule of more than 10 years.

- Loans having an amortization schedule of 10 years or less will be provided a tolerance of 25 basis points (one-quarter of one percent). Loans that are secured by real estate or a dwelling will be provided the tolerances permitted by 12 CFR 226.22(a)(4) and (5).
- Loans having an amortization schedule of more than 10 years will be provided a tolerance of 12.5 basis points (one-eighth of one percent) in the case of a regular transaction and 25 basis points (one-quarter of one percent) in the case of an irregular transaction. Loans that are secured by real estate or a dwelling will be provided the tolerances permitted by 12 CFR 226.22(a)(4) and (5).

References to 15 U.S.C. 1606(c) contained in the body of the definition of an understated APR in the original Policy Statement have now been moved to footnote 3 in the revised Policy Statement. The change was purely editorial in nature. A new footnote 4 has been added to more specifically identify the sections of Regulation Z (12 CFR 226.14(a) and 226.22(a)) that define the requirements for annual percentage rate disclosures.

The ``Corrective Action Period" section of the original Policy Statement contains time frames for determining which loans are subject to adjustment when violations are discovered. Previously, the agencies have collectively taken the position that the phrase ``immediately preceding examination" in subsection 2.b. means the most recent examination that precedes the current examination in which compliance with Regulation Z and the Act was reviewed. However, the United States Court of Appeals for the 8th Circuit (First National Bank of Council Bluffs v. Office of the Comptroller of the Currency, 956 F.2d 1456 (8th Cir. 1992)), and the United States Court of Appeals for the Eleventh Circuit, (Consolidated Bank, N.A. v. United States Department of the Treasury, 118 F.3d 1461 (11th Cir. 1997)) determined that the phrase ``immediately preceding examination'' should be read as referring to an examination of any type conducted immediately prior to the current examination, including examinations in which no review of compliance with Regulation Z or the Act is conducted. Consequently, the agencies, as a matter of policy, will now apply the decisions reached by the Eighth and Eleventh Circuit Courts in carrying out their enforcement responsibilities with respect to the meaning of ``immediately preceding examination.'' No changes to the Policy Statement are necessary to effect this policy position made by the agencies. Additional guidance will be provided to the examination staff for each agency to advise on the proper period for corrective action when violations requiring adjustments are discovered.

In the section of the Policy Statement entitled ``Violations Involving the Improper Disclosure of Credit Life, Accident, Health, or Loss of Income Insurance,'' the original Policy Statement had a separate provision detailing how certain violations involving credit life insurance disclosures would be treated until March 31, 1982. Since this time period has now expired that portion of the section has been deleted.

The Economic Growth and Regulatory Paperwork Reduction Act of 1996 provided additional flexibility for the regulatory agencies to require partial or delayed payments for reimbursements by an institution if the payment would cause the institution to become undercapitalized as that term is defined in section 38 of the Federal Deposit Insurance Act. Those provisions are now reflected in the section of the Policy Statement entitled ``Safety and Soundness.'' That section states that if the results of a full and immediate adjustment required under the Policy Statement would have a significant adverse impact on the capital position of the creditor, the agencies can permit partial adjustments to be made or permit partial payments over an extended period of time

Administrative Enforcement of the Truth in Lending Act—Restitution (Revised September 8, 1998)

Joint Statement of Policy

The Depository Institutions Deregulation and Monetary Control Act of 1980 (Pub. L. 96-221) was enacted on March 31, 1980. Title VI of that Act, the Truth in Lending Simplification and Reform Act, amends the Truth in Lending Act, 15 U.S.C. 1601, et seq. Section 608 of Title VI, effective March 31, 1980, authorizes the federal Truth in Lending enforcement agencies to order creditors to make monetary and other adjustments to the accounts of consumers where an annual percentage rate (APR) or finance charge was inaccurately disclosed. It generally requires the agencies to order restitution when such disclosure errors resulted from a clear and consistent pattern or practice of violations, gross negligence, or a willful violation which was intended to mislead the person to whom the credit was extended. However, the Act does not preclude the agencies from ordering restitution for isolated disclosure errors.

This policy guide summarizes and explains the restitution provisions of the Truth in Lending Act (Act), as amended. The material also explains corrective actions the financial regulatory agencies believe will be appropriate and generally intend to take in those situations in which the Act gives the agencies the authority to take equitable remedial action.

The agencies anticipate that most financial institutions will voluntarily comply with the restitution provisions of the Act as part of the normal regulatory process. If a creditor does not voluntarily act to correct violations, the agencies will use their cease and desist authority to require correction pursuant to: 15 U.S.C. 1607 and 12 U.S.C. 1818(b) in the cases of the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision; and 15 U.S.C. 1607 and 12 U.S.C. 1786(e)(1) in the case of the National Credit Union Administration.

Restitution Provisions

Definitions

Except as provided below, all definitions are those found in the Act and Regulation Z, 12 CFR part 226.

1. ``Current examination" means the most recent examination begun on or after March 31, 1980, in which compliance with Regulation Z was reviewed.

2. ``Lump sum method" means a method of reimbursement in which a cash payment equal to the total adjustment will be made to a consumer.

3. ``Lump sum/payment reduction method" means a method of reimbursement in which the total adjustment to a consumer will be made in two stages:

   a. A cash payment that fully adjusts the consumer's account up to the time of the cash payment; and,

   b. A reduction of the remaining payment amounts on the loan.

4. ``Understated APR" means a disclosed APR that is understated by more than the reimbursement tolerance provided in the Act as follows:

a. For loans with an amortization schedule of 10 years or less, a disclosed APR which, when increased by the greater of the APR tolerance specified in the Act and Regulation Z or one-quarter of one percent, is less than the actual APR calculated under the Act.

b. For loans consummated after March 31, 1982. For loans consummated prior to that date refer to the Policy Guide dated July 21, 1980 (45 FR 48712) for additional guidance.

c. 15 U.S.C. 1606(c)

d. 12 CFR 226.14(a) and 226.22(a)

e. If, however, the loan is closed-end credit secured by real estate or a dwelling and the APR is understated by more than one-quarter of one percent, the APR will be considered accurate and not subject to reimbursement if: (1) The finance charge is understated but considered accurate in accordance with the Act and Regulation (i.e., the finance charge is not understated by more than $100 on loans made on or after 9/30/95, or $200 for loans made before that date); and (2) the APR is not understated by more than the dollar equivalent of the finance charge error and the understated APR resulted from the understated finance charge that is considered accurate.

f. For loans with an amortization schedule of more than 10 years, a disclosed APR which, when increased by the APR tolerance specified in the Act and Regulation Z (i.e., one-quarter of one percent for irregular loans, one-eighth of one percent for all other closed-end loans) is less than the actual APR.

g. If, however, the loan is closed-end credit secured by real estate or a dwelling and the APR is understated by more than one-eighth of one percent if the transaction is not considered to be an irregular transaction as defined by the Regulation (12 CFR 226.22(a)(3)) or one quarter of one percent if the transaction is irregular according to the definition, the APR will be considered accurate and no subject to reimbursement if: (1) The finance charge is understated but considered accurate according to the Actual Regulation (i.e., the finance charge is understated but considered accurate according to the Act and Regulation i.e., the finance charge is not understated by more than $100 on loans made on or after 9/30/95, or $200 for loans made before that date); and (2) the APR is not understated by more than the dollar equivalent of the finance charge error and the understated APR resulted from the understated finance charge that is considered accurate.

5. ``Understated finance charge" means a disclosed finance charge which, when increased by the greater of the finance charge dollar tolerance specified in the Act and Regulation Z or a dollar tolerance that is generated by the corresponding APR reimbursement tolerance is less than the finance charge calculated under the Act.

   a. The finance charge tolerance for each loan will be generated by the corresponding APR tolerance applicable to that loan. For example, consider a single-payment loan with a one-year maturity that is subject to a one-quarter of one percent APR tolerance. If the amount financed is $5,000 and the finance charge is $912.50, the actual APR will be 18.25%. The finance charge generated by an APR of 18% (applying the one-quarter of one percent APR tolerance to 18.25%) for that loan would be $900. The difference between $912.50 and $900 produces a numerical finance charge tolerance of $12.50. If the disclosed finance charge is not understated by more than $12.50, reimbursement would not be ordered.

De Minimis Rule

If the amount of adjustment on an account is less than $1.00, no restitution will be ordered. However, the agencies may require a creditor to make any adjustments of less than $1.00 by paying into the United States Treasury, if more than one year has elapsed since the date of the violation.

Corrective Action Period

1. Open-end credit transactions will be subject to an adjustment if the violation occurred within the two-year period preceding the date of the current examination.

2. Closed-end credit transactions will be subject to an adjustment if the violation resulted from a clear and consistent pattern or practice or gross negligence where:

   a. There is an understated APR on a loan which originated between January 1, 1977 and March 31, 1980.

   b. There is an understated APR or understated finance charge, and the practice giving rise to the violation is identified during the current examination. Loans containing the violation which were consummated since the date of the immediately preceding examination are subject to an adjustment.

   c. There is an understated APR or understated finance charge, the practice giving rise to the violation was identified during a prior examination and the practice is not corrected by the date of the current examination. Loans containing the violation which were consummated since the creditor was first notified in writing of the violation are subject to an adjustment. (Prior examinations include any examinations conducted since July 1, 1969).

3. Each closed-end credit transaction, consummated since July 1, 1969, and containing a willful violation intended to mislead the consumer is subject to an adjustment.

4. For terminated loans subject to 2, above, an adjustment will not be ordered if the violation occurred in a transaction consummated more than two years prior to the date of the current examination.

Calculating the Adjustment

Consumers will not be required to pay any amount in excess of the finance charge or dollar equivalent of the APR actually disclosed on transactions involving:

1. Understated APR violations on transactions consummated between January 1, 1977 and March 31, 1980, or

2. Willful violations which were intended to mislead the consumer.

On all other transactions, applicable tolerances provided in the definitions of understated APR and understated finance charge may be applied in calculating the amount of adjustment to the consumer's account.

Methods of Adjustment

The consumer's account will be adjusted using the lump sum method or the lump sum/payment reduction method, at the discretion of the creditor.

Violations Involving the Non-Disclosure of the APR or Finance Charge

1. In cases where an APR was required to be disclosed but was not, the disclosed APR shall be considered to be the contract rate, if disclosed on the note or the Truth in Lending disclosure statement.
2. In cases where an APR was required to be disclosed but was not, and no contract rate was disclosed, consumers will not be required to pay an amount greater than the actual APR reduced by one-quarter of one percentage point, in the case of first lien mortgage transactions, and by one percentage point in all other transactions.
3. In cases where a finance charge was not disclosed, no adjustment will be ordered.

Violations Involving the Improper Disclosure of Credit Life, Accident, Health, or Loss of Income Insurance

1. If the creditor has not disclosed to the consumer in writing that credit life, accident, health, or loss of income insurance is optional, the insurance shall be treated as having been required and improperly excluded from the finance charge. An adjustment will be ordered if it results in an understated APR or finance charge. The insurance will remain in effect for the remainder of its term.
2. If the creditor has disclosed to the consumer in writing that credit life, accident, health, or loss of income insurance is optional, but there is either no signed insurance option or no disclosure of the cost of the insurance, the insurance shall be treated as having been required and improperly excluded from the finance charge. An adjustment will be ordered if it results in an understated APR or finance charge. The insurance will remain in effect for the remainder of its term.

Special Disclosures

Adjustments will not be required for violations involving the disclosures required by sections 106(c) and (d) of the Act, (15 U.S.C. 1605(c) and (d)).

Obvious Errors

If an APR was disclosed correctly, but the finance charge required to be disclosed was understated, or if the finance charge was disclosed correctly, but the APR required to be disclosed was understated, no adjustment will be required if the error involved a disclosed value which was 10 percent or less of the amount that should have been disclosed.

Agency Discretion

Adjustments will not be required if the agency determines that the disclosure error resulted from any unique circumstances involving a clearly technical and non-substantive disclosure violation which did not adversely affect information provided to the consumer and which did not mislead or otherwise deceive the consumer.

Safety and Soundness

In some cases, an agency may order, in place of an immediate, full adjustment, either a partial adjustment, or a full adjustment in partial payments over an extended time period that the agency considers reasonable. The agency may do so if it determines that (1) the full, immediate adjustment would have a significantly adverse impact upon the safety and soundness of the creditor, and (2) a partial adjustment, or making partial payments over an extended period of time, is necessary to avoid causing the creditor to become undercapitalized.

a. The term ``undercapitalized'' will have the meaning as defined in section 38 of the Federal Deposit Insurance Act (12 U.S.C. 1831o).

Exemption from Restitution Orders

A creditor will not be subject to an order to make an adjustment if within 60 days after discovering a disclosure error, whether pursuant to a final written examination report or through the creditor's own procedures, the creditor notifies the person concerned of the error and adjusts the account to ensure that such person will not be required to pay a finance charge in excess of that actually disclosed or the dollar equivalent of the APR disclosed, whichever is lower. This 60-day period for correction of disclosure errors is unrelated to the provisions of the civil liability section of the Act.

Appendix B

QUESTIONS AND ANSWERS
Regarding Joint Interagency Statement Of Policy For Administrative Enforcement Of The Truth In Lending Act - Reimbursement Issued By The FFIEC On July 11, 1980 And Revised October 1998.

General

1. *Do the enforcement standards and accuracy tolerances in the Policy Guide supersede the requirements of the Truth in Lending Act (Act) and Regulation Z?*

   No, the Policy Guide applies only to agency enforcement procedures. It does not alter a creditor's responsibility to comply fully with all the requirements of the Act and Regulation Z, including finance charge and annual percentage rate (APR) accuracy requirements.

2. *When violations are discovered in purchased or assigned loans that are initially payable to a person other than the financial institution, will the financial institution be ordered to make the necessary adjustments to the accounts of affected customers?*

   No, the financial institution is not the creditor, even if the obligation by its terms is initially payable to a third party and simultaneously assigned to the financial institution. The violations will be referred to the creditor's enforcing agency.

3. *If the creditor must itemize the amount financed but fails to disclose or understates the prepaid finance charge, will reimbursement be required?*

   No, this violation of Regulation Z will require prospective corrective action only, assuming the prepaid finance charges are properly included in the computation of the APR and finance charge.

4. *If APR or finance charge disclosures not required by Regulation Z have been made, will reimbursement be required when such optional disclosures are understated?*

   No, however, errors in disclosures not required by Regulation Z for a particular transaction are violations of either 12 CFR 226.5(a)(1) or 12 CFR 226.17(a)(1), both of which require that credit disclosures be made clearly and conspicuously.

Definitions

"Current examination"

1. *How should the Policy Guide apply to a situation where an examiner, in an examination in progress discovers that reimbursement had not been undertaken as requested by the enforcement agency following the prior examination? What if the institution states that this examination is the "current examination" thereby requiring it to only make adjustments to those loans found to be in violation and consummated since the prior examination?*

   TILA does not limit the agencies' authority to require correction of violations detected in earlier examinations and that have not been corrected as of the date of the current examination [see §108(e)(3)(C)(i) of the Act, found at 15 USC 1607(e)(3)(c)(i)]. In addition, if the practice giving rise to the violations identified in the earlier examination has not been corrected, the institution will be required to make adjustments on any loans containing the violation that were consummated since the date it was first notified in writing of the violation and comply with the corrective action already ordered.

"Understated APR"

1. *What is meant by "actual APR" and "annual percentage rate calculated in accordance with the Act," as used in the Policy Guide?*

   Those terms mean the lowest permissible APR that can be computed, applying all applicable provisions of Regulation Z.

De Minimis Rule

1. *How should the de minimis rule be applied in closed-end credit transactions?*

   The de minimis rule should always be applied to the amount of the adjustment calculated under the "lump sum method" of reimbursement as of the maturity date of the transaction, regardless of which reimbursement method is ultimately used by the creditor.

2. *How should the de minimis rule be applied in open-end credit transactions?*

   The de minimis rule should be applied to the total amount of the adjustment calculated for each consumer's account under the "lump sum method" for the period of time from the date of the current examination back to the date of the first occurrence of the violation. However, the total time period may not exceed the two-year period prior to the date of the current examination.

Corrective Action Period

1. *Have the agencies changed their position on the time period required for taking corrective action for violations involving closed-end credit?*

   Yes. Prior to 1997, the agencies took the position that the statutory phrase "immediately preceding examination" (which serves as the cutoff date for retroactive application of a reimbursement requirement) referred to the most recent examination (prior to the current examination) in which compliance with Regulation Z and the Act was reviewed. Because of decisions reached by the Eighth and Eleventh Circuits of the United States Courts of Appeal, the agencies have adopted a new policy. The agencies by policy now interpret the phrase "immediately preceding examination" to mean an examination of any type conducted for any purpose by a federal regulatory agency with designated administrative enforcement responsibility under the TILA. However, supervisory visitations, inspections, or other reviews that are not considered examinations by the agencies are not considered examinations for purposes of applying retroactivity limitation. In addition, an examination of an affiliated entity, such as an operating subsidiary or an institution's holding company, is not considered an examination for purposes of determining the corrective action time period under the Act.

2. *What is the effective date of the new policy change regarding the time period for corrective action for violations involving closed-end credit?*

   The policy change regarding the corrective action time period was effective as of August 7, 1997.

3. *Can an institution terminate the remainder of its restitution obligation to a borrower in light of this change in policy?*

   No. The policy change applies to future and pending cases as of the effective date. There will be no change in reimbursement obligations arising in connection with restitution cases that have been previously resolved. Once the institution makes its decision about the restitution method that it will pursue, it is expected to complete its obligations to affected borrowers as agreed.

For example, under the “Lump Sum/Payment Reduction” method of reimbursement, an institution remits to the borrower a lump sum covering excess money paid to the point that restitution is made, and then reduces future payments to cover the remaining restitution obligation. Under the new policy, the agencies will not permit the institution to terminate its remaining restitution obligation by increasing the borrower’s payments to the level they were prior to the restitution action.

4. *How will the agencies apply the policy change when “concurrent” examinations are being conducted at a financial institution?*

   Concurrent examinations occur when several different types of examinations begin on the same day or when examinations begin in succession. Concurrent examinations may also begin several weeks or months apart but within the same examination cycle, based on factors such as the availability of working space for the examination teams, or the expressed preferences of the institution’s management.

   For purposes of applying the policy change regarding the corrective action time period, the agencies consider a concurrent examination to be one event. Assume, for example, the situation where a safety and soundness examination begins on Monday, a trust examination begins on Tuesday, and the compliance examination starts on Wednesday. Assume further that the compliance team identifies a pattern or practice of violations triggering the restitution provisions of the Act. The agencies will consider the immediately preceding examination to be the last completed examination, not the trust examination that began on Tuesday, or the safety and soundness examination that began on Monday.

   Similarly, assume an institution’s examination is to be conducted in succession, meaning that the compliance examination would begin after the safety and soundness and/or trust examination on site work in the institution is completed, which could be several months after the start date of the concurrent examination. The agencies will consider those concurrent examinations to be part of the same examination cycle for purposes of the policy.

5. *Does the policy change limit or otherwise affect the corrective action time period where a practice identified at a prior examination is not corrected by the date of the current examination?*

   No. The Policy Guide and statute provide that if a practice is identified during a current examination and the examiner determines that the same practice was identified during a prior examination but is not corrected by the date of the current examination, the corrective action time period is retroactive to the date of the prior examination in which the violation was identified. This will be true even if there have been intervening examinations that did not review for compliance with the Act and Regulation Z. [see § 108(e)(3)(c)(I) found at 15 USC 1107(e)(3)(c)(I)]

6. *Are there any differences in application of the policy change when restitution situations involve open-end credit rather than closed-end credit?*

   Yes. The Act provides different corrective action time periods for open-end and closed-end credit. The policy change applies to restitution situations involving closed-end credit. The corrective action time period for open-end credit covers the 24-month period preceding the date of the current examination, regardless of whether another examination intervenes during that period.

7. *What is the corrective action period with respect to terminated closed-end loans if an institution elects to comply voluntarily with the restitution provisions of the Policy Guide, absent a current examination?*

   The Policy Guide states that "for terminated loans ... an adjustment will not be ordered if the violation occurred in a transaction consummated more than two years prior to the date of the current examination." If an institution elects to comply voluntarily with the Policy Guide absent a current examination, the financial institution will have the option of either:

(1) Deferring reimbursement on any terminated loans until its regulatory agency conducts a current examination, or (2) Reimbursing on any terminated loans falling within the period prior to the discovery of the violation up to the date of the immediately preceding examination. If that time frame is in excess of two years, then reimbursement may be limited to the two-year period prior to the date of discovery of the violation.

8. *How will the Policy Guide apply when loans subject to reimbursement are acquired through a merger, consolidation, or in exchange for the assumption of deposit liabilities?*

   In the case of a merger or consolidation, the receiving institution or the consolidated institution is liable for all liabilities of the merged or consolidating institutions, and the Policy Guide will apply.

   In the case of loans acquired in exchange for the assumption of deposit liabilities, the Policy Guide will apply to the original creditor.

Calculating the Adjustment

1. *How will disclosures containing information properly estimated under 12 CFR 226.5(c), 12 CFR 226.17(c), and Appendix D be treated for reimbursement determinations and computations?*

   If an APR or finance charge is in error for any reason other than a properly made estimate, the determination of whether the error constitutes a reimbursable overcharge will be made using the estimated information as disclosed. At the creditor's option, reimbursement will be based on either:

   (1) The actual amount of loan advances, with consideration given to the amount and dates payments were actually made by the borrower; or

   (2) The disclosed amounts of time intervals between advances and between payments.

   The basis selected shall be applied, using the lump sum or lump sum-payment reduction method (at the creditor's discretion), to all loans of the same type subject to reimbursement.

2. *If a creditor has failed to reflect private mortgage insurance premiums in the APR or finance charge disclosures, may the institution cancel the insurance after it first reimburses the customer with a lump sum payment to cover the period up to the date of the reimbursement?*

   The creditor may elect to cancel the insurance if applicable laws and regulations are not violated. The effect of canceling the insurance will be to reduce the amount of the customer's future payments, as permitted by the "lump sum-payment reduction" method of reimbursement.

3. *If a creditor has failed to reflect private mortgage insurance premiums in the APR or finance charge disclosures and restitution is required, but the loan has been sold into the secondary market, how should reimbursement be made?*

   The creditor is responsible for reimbursement, even if the loan has been sold. If its ability to cancel the insurance is limited by terms of the loan sales agreement, the creditor may make payments either to the consumer directly or (if it is agreeable to all parties) to the new owner of the loan. The new owner of the loan would make appropriate adjustments to the account so that the consumer receives the full benefit of the reimbursement.

4. *If the creditor failed to include any component of the finance charge (e.g., a loan origination fee) in the APR or finance charge disclosures, may the amount of reimbursement be reduced to account for fees excludable from the finance charge under 12 CFR 226.4(c) which are paid for by such finance charge components?*

If the borrower has not otherwise paid such excludable fees (e.g., title insurance fees) to the creditor or to a third party, reimbursement may be computed after first deducting from the finance charge those fees qualifying under 12 CFR 226.4(c).

5. *A transaction involves a loan with a term of 36 months, a payment schedule where the first 35 payments are calculated using a 30-year amortization and a balloon amount for the final payment. What tolerance should be used when applying the Policy Guide? One eighth of one-percent or one quarter of one-percent?*

   The applicable tolerance is based on the amortization of the loan. Since the loan is completely amortized within a three-year period (i.e., the 36-month payment schedule), a tolerance of one quarter of one-percent should be used because the amortization period is less than ten years (15 USC 1607(e)(1)).

6. *How will the Policy Guide apply if a credit transaction has an interest rate or APR subject to increase and the variable rate feature was not provided on the disclosure statement?*

   If the disclosure statement did not state that the rate would be subject to change, the borrower may be charged only the original APR disclosed. Reimbursement under the Policy Guide will apply only to the period of time in which the borrower made payments at an increased rate.

7. *How will the Policy Guide apply if a creditor disclosed that a rate will be prospectively subject to increase, but the APR disclosed or the finance charge disclosed or both were originally understated?*

   The Policy Guide will apply as follows:

   (1) If only the APR is understated, reimbursement will be required only for the period of time before the first scheduled change in rate under the variable rate feature in the contract.

   The term “the first scheduled change in rate” refers to a date on which the rate will change to a level that is unknown or unpredictable at consummation. It does not include changes, such as step-rates, that are agreed upon before consummation.

   For example, if the loan terms provide for a 9 percent rate for the first year and a 10 percent rate for the second year, followed by a variable-rate feature to be invoked at the beginning of the third year, reimbursement will apply only to the initial 24-month period. The lump sum-payment reduction adjustment method may be used, using two payment streams for the initial two-year period. Payments after the 24th month would not be affected by the adjustment.

   (2) If only the finance charge is understated, reimbursement generally will be required for a period covering the entire life of the loan consistent with the following:

   - If a prepaid finance charge was not included in the disclosed finance charge (such as a loan origination fee paid separately by the consumer at loan closing), the entire loan fee (less the applicable dollar tolerance) must be refunded as a "lump sum" payment.
   - If, however, the loan fee was financed (included in the loan amount), the finance charge reimbursement may be prorated on a straight-line basis over the life of the loan and refunded under the lump sum/payment reduction method.

   However, a finance charge adjustment will be required only for the period of time before the first scheduled change in rate if the error occurred solely because the interest component of the disclosed finance charge was based on either:

   (a) The interest to be earned before the first scheduled change in rate, or

(b) The interest to be earned assuming an initial discounted rate over the life of the loan.

For example, the interest component of the disclosed finance charge might incorrectly reflect only loan interest for the first year on a transaction with variable-rate changes scheduled annually. Alternatively, it might incorrectly reflect interest calculated only at an initial discounted variable rate for the full term of the loan. In either case, if the loan terms in the example provide that the variable interest rate is subject to change annually, the finance charge reimbursement will apply only to the initial 12-month period.

The adjustment may be prorated on a straight-line basis over the life of the loan. Reimbursement of prorated amounts covering the period of time after the first scheduled change in rate (after month 12 in this example) would not be required.

(3) If both the APR and finance charge are understated, normally the lump sum finance charge adjustment is compared to the lump sum APR adjustment as of the loan maturity date and the larger adjustment determines which disclosure error is subject to reimbursement. In the case of variable-rate transactions, however, the lump sum APR adjustment used for comparison is calculated for the period of time before the first scheduled change in rate in the manner indicated by (1) above and the finance charge adjustment is calculated in the manner indicated by (2) above.

For example, assume a loan in which both the APR and finance charge are understated on a 30-year, variable-rate loan that calls for rate changes annually. If both understatements were caused by the same failure to take into account a prepaid loan origination fee:

- The APR reimbursement amount is the lump sum value for a 12-month period, which is determined by using the lump sum/payment reduction method and appropriate reimbursement tolerances.
- The finance charge reimbursement amount is the lump sum value for a 360-month period, which is determined by subtracting the appropriate reimbursement tolerance from the amount of the loan fee.

  The APR adjustment is compared to the finance charge adjustment to determine the larger of the two. In the example, the finance charge adjustment (and not the APR adjustment) would be reimbursable.

8. *If a creditor uses a simple interest rate, which is disclosed as the APR, to compute a monthly payment schedule, and the time interval from the date the finance charge begins to be earned to the date of the first payment is treated as if it were one month, even though that period is greater than one month and is not a "minor irregularity" under 12 CFR 226.17(c)(4), will the Policy Guide apply if the resulting application of the simple interest rate generates a higher finance charge than the one disclosed?*

   The Policy Guide will apply if:

   (1) The creditor's method used to compute the payment schedule, as previously described, is also used to compute the disclosed finance charge (i.e., the total of payments less the amount financed); and

   (2) The final payment collected or scheduled under the contract (as generated by the application of the simple interest rate to the unpaid principal balance over the life of the loan) is greater than the one disclosed; and

   (3) The finance charge resulting from the conditions described under (1) and (2) is understated.

9. *Will reimbursement be required for demand loans with disclosures based on a one-year maturity when the demand loan contract calls for periodic payments that will amortize the loan over a definite time period?*

   Yes. A formal amortization schedule recorded in the demand loan contract is, under 12 CFR 226.17(c)(5), equivalent to an alternate maturity date, and disclosures based on the amortization schedule should be made, as opposed to the one-year disclosure.

10. *Will reimbursement be required on demand loans when:*

    (1) An alternate maturity date is disclosed and reflected in the contract, but the finance charge disclosure is based on one year?

    (2) There is no alternate maturity date disclosed or reflected in the contract, but the finance charge disclosure is based on a period of time less than one year?

    In the first case, since there is an alternate maturity date in the contract, which is disclosed, the finance charge disclosure should have been based on that alternate maturity date, as required under 12 CFR 226.17(c)(5), not on the disclosure period to be used when the instrument has no alternate maturity date.

    In the second case, the actual finance charge disclosure should have been based on a one-year period, as required by 12 CFR 226.17(c)(5), not on some period less than that required when the instrument has no alternate maturity date.

    After considering appropriate tolerances, reimbursement will be required in both cases if:

    (1) The disclosed finance charge is less than the actual finance charge for the initial required disclosure period; and

    (2) The demand loan has been on the institution's books past the period for which finance charge disclosures were made.

    Reimbursement will be calculated for the required disclosure period only. The amount reimbursed to the consumer is the difference between the finance charge actually paid and the finance charge disclosed (which may be increased by the applicable finance charge reimbursement tolerance).

    If the demand loan has not been on the institution's books past the period for which finance charge disclosures were made (e.g., the finance charge was disclosed for a one-year period, but should have been disclosed for a five-year period, and only 10 months have elapsed), no reimbursement is required. However, if the institution takes no prospective corrective action (i.e., if it does not at least disclose in writing a refinancing of the original loan) and the loan remains on the institution's books past the period for which the original finance charge disclosures were made, reimbursement will be required as previously indicated.

    Those concepts apply both to straight and variable rate demand loans whenever the disclosed finance charge is less than the actual finance charge after considering appropriate tolerances.

11. *How will the Policy Guide apply to violations of the early disclosure requirements of 12 CFR 226.19(a)?*

    As a general rule, the Policy Guide will not apply to violations involving early Truth in Lending disclosures, but will apply to violations of the pre-consummation disclosures required by 12 CFR 226.17. However, if the creditor has provided erroneous early disclosures and has not made pre-consummation disclosures, the Policy Guide will apply to the erroneous early disclosures.

Methods of Adjustment

1. *Must reimbursements resulting from understated finance charges always be made as a single "lump sum" amount?*

    No. Reimbursements resulting from the creditor's failure to include prepaid finance charges in the total finance charge must always be refunded as a "lump sum" payment, but reimbursements resulting from failure to include finance charge components that accrue over time may be prorated on a straight-line basis (no time value) over the life of the loan and refunded under the lump sum/payment reduction method.

2. *Must a creditor use one reimbursement method consistently on all affected loans?*

   No. The creditor's right to choose between the two methods (lump sum or lump sum/payment reduction) applies to each transaction.

3. *May a creditor apply a lump sum reimbursement to the consumer's loan balance on a loan requiring reimbursement instead of making a cash payment to the consumer?*

   If the loan is a closed-end loan, the creditor must make a cash payment or a deposit into an existing unrestricted consumer asset account such as, an unrestricted savings, NOW, or demand deposit account. However, if the loan is delinquent, in default, or has been charged off, the creditor may apply all or part of the reimbursement to the amount past due, if permissible under law.

   If the reimbursement involves an open-end account, the creditor must make a cash payment or a deposit into an existing unrestricted consumer asset account such as an unrestricted savings, NOW, or demand deposit account. However, on a case-by-case basis, the agencies may permit the creditor to credit the consumer's open account by the amount of the reimbursement if the consumer consents. Creditors should be aware that crediting open-end accounts might create credit balances subject to the requirements of 12 CFR 226.11. In addition, if the open-end account is delinquent, in default, or has been charged off, the creditor may apply all or part of the reimbursement to the amount past due, if permissible under law.

4. *If a transaction involves more than one consumer, to whom must reimbursement be made?*

   The reimbursement is the property of, and is to be made to, the primary obligor in the credit transaction. If there is more than one primary obligor, reimbursement must be made jointly. If the primary obligor(s) is deceased, the payment should be made pursuant to the estate and unclaimed property laws of the state. If the creditor is unable to locate the primary obligor(s), after having at least mailed the reimbursement amount to the consumer's last known address, the amount of the reimbursement is subject to the unclaimed property laws of the state.

5. *How will the Policy Guide apply to residential mortgage transactions that have been assumed by a third party?*

   Reimbursement will be made only to the original borrower and only to the extent of overcharges that occurred before the assumption if:

   (1) A reimbursable violation is found on the original borrower's disclosure statement; and

   (2) The original borrower is not released from liability on the loan. The original transaction will be considered terminated with respect to the original borrower on the date of the assumption and the rules for application of the Policy Guide to terminated loans will apply.

   Reimbursement will be made to the original borrower for the period before the assumption occurred if:

   (1) A reimbursable violation is found on the original borrower's disclosure statement; and

   (2) The original borrower is not released from liability on the loan. However, in the event the subsequent borrower defaults and the original borrower must again assume payments on the loan, such payments will be based on the payment amount which would have been calculated under the lump sum-payment reduction method, at the time of reimbursement, had no assumption occurred.

   If a required disclosure to a subsequent borrower contains reimbursable violations, that borrower shall be reimbursed for the period after the assumption occurred, based on the new disclosure.

Non-Disclosure of the APR or Finance Charge

1. *How will the Policy Guide apply to loans for which no disclosure statements are on file?*

   If there is no evidence that the creditor furnished disclosures or if there is a preponderance of evidence that disclosures containing violations subject to reimbursements were destroyed before the record retention period expired, either violation will be treated as a failure to disclose the APR. The creditor will be given the opportunity to substantiate the claim that an accurate disclosure was made before final action is taken. The absence of compliance documentation will be viewed relative to known practices of the creditor for record retention and Regulation Z compliance.

2. *How will the Policy Guide apply if a creditor did not provide required disclosures to the consumer before consummation, but did supply them after consummation?*

   If required disclosures were not provided before consummation of the transaction, the transaction will be viewed as having no APR disclosed and the Policy Guide will apply. If the creditor's failure to provide disclosures included the credit life, accident, and health insurance disclosures, the insurance premiums must be treated as finance charges.

3. *Will the Policy Guide apply when a creditor has disclosed the APR as "2% OP" to mean a fluctuating rate of two percent over the prime rate, or has disclosed similar prime rate terminology instead of the APR?*

   If the disclosure statement (not the note) clearly provides the numerical value of the prime rate as it pertains to the credit transaction, as of the time disclosures are given to the consumer, that rate (the prime rate or 2% OP) will be considered to be the disclosed APR under the Policy Guide. If the prime rate is not provided on the disclosure statement, the transaction will be viewed under the Policy Guide as if no APR has been disclosed.

4. *Will reimbursement be required on demand loans when the variable rate feature has not been disclosed and the rate is increased?*

   Yes. If the consumer has not been notified in writing of the rate change on or before the date of the change, reimbursement will be required if the financial institution has not made the variable rate disclosures.

   Each time the rate is changed and the customer is not given written notification of the new rate, the rate change period(s) will be treated as if no APR had been disclosed, and the Policy Guide will apply. The rate on the most recent notification will serve as the contract rate.

Improper Disclosure of Credit Life, Accident, Health, or Loss of Income Insurance

1. *Are the credit insurance provisions of the Policy Guide applicable to terminated loans?*

   Yes. The credit insurance provisions apply if such loans originated within the Policy Guide's corrective action period for terminated loans.

2. *How will the Policy Guide apply if the cost of credit insurance premiums is disclosed as a rate (e.g., as a percentage or in dollars and cents per hundred per month) in a closed-end transaction?*

   Regulation Z permits creditors to disclose credit insurance premiums on a unit-cost basis in closed-end transactions by mail or telephone under 12 CFR 226.17(g), and in certain closed-end transactions involving an insurance plan that limits the total amount of indebtedness subject to coverage.

In all other closed-end credit transactions, however, the dollar amount of insurance premiums must be disclosed. If the premium cost in those cases is disclosed as dollars or cents per hundred or as a percentage, it will be treated as if no disclosure of the cost had been made and the Policy Guide will apply accordingly.

3. *How will the Policy Guide apply if:*

   (1) The creditor does not include premiums for credit life, accident and health insurance in the APR or finance charge disclosures; and

   (2) The creditor fails to disclose the optional nature of the insurance; but

   (3) The creditor has afforded the borrower the option of taking or refusing the insurance by checking a block or initialing a line opposite a statement similar to the following, both of which are disclosed in writing to the borrower: "I desire credit life, accident and health insurance" and "I do not desire credit life, accident and health insurance?"

   In those cases, the Policy Guide will apply because the creditor has not disclosed to the customer in writing, as required by 12 CFR 226.4(d)(1)(i), that the credit life, accident and health insurance are optional.

4. *How will the Policy Guide apply if:*

   (1) The consumer is charged for credit life, accident and health insurance premiums; and

   (2) The creditor did not include the premiums in the APR or finance charge disclosures; and

   (3) The creditor disclosed the optional nature and cost of credit life insurance to the consumer in writing and the customer signed or initialed close to those disclosures; and

   (4) Either no affirmative statement indicating a desire to obtain the insurance was provided or the appropriate box or line was not checked or otherwise marked to indicate whether the customer did or did not desire the insurance?

   If the disclosure provided a choice to the customer through statements such as "I desire the insurance" and "I do not desire the insurance" and neither choice has been marked to designate the customer's selection, the Policy Guide will apply because the creditor did not meet the requirements of 12 CFR 226.4(d)(1)(iii).

   If no affirmative statement indicating a desire to purchase the insurance has been provided, and the customer has only signed or initialed near the optional nature statements or cost disclosures, the Policy Guide will apply because the creditor did not meet the requirements of 12 CFR 226.4(d)(1)(iii).

5. *How will the Policy Guide apply if:*

   (1) The creditor does not include premiums for credit life, accident and health insurance in the APR or finance charge disclosures; and

   (2) The creditor provides disclosures stating that the insurance is not required; and

   (3) The creditor provides the cost of each type of insurance, with a statement that the customer's signature will indicate a desire to purchase the insurance listed below and the customer signs once, below the cost disclosure, but does not initial each type of insurance desired?

   If the disclosures clearly indicate that the customer, by signing where indicated, elects to purchase each type of insurance for which the cost has been provided, the Policy Guide will not apply. However, prospectively the creditor shall clarify such disclosures, by obtaining the customer's initials for each type of insurance selected, or by changing the manner in which the customer signs for credit insurance when more than one type is offered.

6. *If vendor's single interest (VSI) insurance is written in connection with a credit transaction, the insurance premiums are not included in the finance charge, and the creditor does not obtain a waiver of the right of subrogation from the insurer, is the resulting finance charge understatement subject to reimbursement under the Policy Guide?*

   Yes. However, if the insurer has not exercised such right of subrogation and agrees to prospectively waive that right for outstanding loans, the Policy Guide will not apply to those loans.

Obvious Errors

6. *What are examples of Obvious Errors described in the Policy Guide?*

   Consider a situation where the APR is disclosed correctly and the correct finance charge is $600, no adjustment would be required if the amount of the disclosed finance charge is shown as $60 or less. Likewise, if the finance charge is correctly disclosed and the correct APR is 18.568%, no adjustment would be required if the disclosed APR is shown as 1.

Introduction

The Office of Thrift Supervision's (OTS) home mortgage loan disclosure requirements are set forth in 12 C.F.R. 560.210. On July 17, 1998, OTS revised §560.210 to conform its adjustable rate mortgage disclosure requirements with a simple cross-reference to the Regulation Z disclosure provisions, which was issued by the Federal Reserve Board under the Truth-in-Lending Act. This revision does not affect the function of promoting safe and sound lending nor OTS's enforcement authority.

The revised §560.210 states that savings associations must provide the initial disclosures described in Regulation Z at 12 CFR 226.19(b) and the adjustment notices at 12 CFR 226.20(c) for variable-rate transactions. The Federal Reserve Board's Commentary to Regulation Z serves as the primary interpretive vehicle for §560.210. OTS still retains the discretion to issue its own interpretations as circumstances warrant.

Coverage

The disclosure and notice requirements of §560.210 apply to all closed-end adjustable- and fixed-rate mortgage loans secured by property occupied or to be occupied by the borrower. (A fixed-rate mortgage may or may not be fully amortizing and includes graduated payment loans on which the schedule of payment adjustments is fixed at the time of executing the original loan documents.)

Initial Disclosure Requirements for Adjustable-Rate Loans

In reference to §226.19(b), savings associations must provide the following two disclosures to prospective borrowers when an application is provided or before receiving payment of a non-refundable fee, whichever is earlier:

- the booklet entitled: *Consumer Handbook on Adjustable Rate Mortgages*, or a suitable substitute; and
- a loan program disclosure for each ARM program in which the consumer expresses an interest.

The program disclosure must include the following, as applicable:

- the fact that the interest rate, payment, or term may change;
- the index or formula used in making adjustments, and a source of information about the index or formula;
- an explanation of how the interest rate and payment will be determined, including how the index is adjusted;
- a statement indicating the consumer should inquire about the current margin value and interest rate;
- the fact that the interest rate will be discounted and a statement that the consumer should inquire as to the amount of the discount;
- the frequency of interest rate and payment changes;
- rules relating to changes in the index, interest rate, payment amount, and the outstanding loan balance;
- a historical example, based on a sample $10,000 loan amount. This example must illustrate all significant loan program terms, including, for example, how payments and the loan balance would be affected by changes in the interest rate implemented according to the terms of the loan.
- an explanation of how the consumer may calculate the payments for the loan amount to be borrowed based on the most recent payment shown in the historical example;

- the initial rate and payment and maximum interest rate and payment for a sample $10,000 loan originated at the most recent interest rate shown in the historical example assuming the maximum periodic increases in rates and payments;
- the fact that the loan contains a demand feature;
- the type of information that will be provided in notices of adjustments and the timing of such notices; and
- a statement that disclosure forms are available for the creditor's other variable-rate loan programs.

Adjustment Notice Requirements

The notice requirements for adjustments are referenced in §560.210. However, §560.35 contains certain limitations with respect to adjustments on home loans secured by borrower-occupied property, or property to be occupied by the borrower. Such limitations include:

- the requirement that the interest rate correspond directly with the movement of an index or a formula or schedule set forth in the loan contract that specifies the amount of the increase and the time at which it may be made; and,
- adjustments to the payment and the loan balance that do not reflect an adjustment to the interest rate may be made only if the adjustments reflect a change in a national or regional index, available to the borrower and outside the control of the association, that measure the rate of inflation or changes in consumer disposable income, or in the case of a payment adjustment, the adjustment reflects a change in the loan balance or is made pursuant to a formula or schedule set forth in the loan contract. (§560.35(d)(3) provides an exception to the index rules when certain procedures are followed).

Variable-rate Adjustments

Section 226.20(c) requires that adjustment notices be provided at least once each year in which an interest rate adjustment is implemented without an accompanying payment change, and at least 25, but not more than 120, calendar days prior to the due-date of a payment at the new level. Adjustment notices must either be delivered or placed in the mail within the time limitation and include the following:

- The current and prior interest rates;
- The index values upon which the current and prior interest rates are based;
- The extent to which the creditor has foregone any increase in the interest rate; the contractual effects of the adjustment, including the payment due after the adjustment is made, and a statement of the loan balance; and, the amount of the payment required to fully amortize the loan at the new interest rate over the remainder of the loan term if that amount is different from the payment resulting from the adjustment.

Examination Objectives

To determine whether the initial loan disclosures contain all of the required elements, as applicable, and are being provided to consumers within the time-frame set forth in the regulation.

To determine whether adjustment notices are complete and are being issued within the required time-frame.

To determine the adequacy of policies, procedures and internal controls for ensuring accurate rate-change adjustments on variable-rate loans.

To determine that the association's employees are operating consistent with established guidelines.

To determine whether the loan servicing system is tested periodically for accuracy by internal or external auditors or other staff.

To determine that the institution's rate change adjustments are accurate and made when required.

To determine whether the association has included in its loan contracts the maximum interest rate that may be imposed during the term of the obligation in its loan contracts.

Examination Procedures

Initial and Program Disclosures

1. Determine if the association utilizes the booklet entitled: *Consumer Handbook on Adjustable Rate Mortgages*, or a suitable substitute.

2. Review the association's disclosure policies, procedures, and practices to determine if the booklet entitled: *Consumer Handbook on Adjustable Rate Mortgages* and all appropriate loan program disclosures are provided when an application is provided or prior to the payment of a non-refundable fee, whichever is earlier.

3. Determine through a review of the association's loan program disclosures if they include all of the following required disclosures, as applicable:

   a. The fact that the interest rate, payment, or term may change;

   b. The index or formula used in making adjustments, and a source of information about the index or formula;

   c. An explanation of how the interest rate and payment will be determined, including how the index is adjusted;

   d. A statement indicating the consumer should inquire about the current margin value and interest rate;

   e. The fact that the interest rate will be discounted and a statement that the consumer should inquire as to the amount of the discount;

   f. The frequency of interest rate and payment changes;

   g. Rules relating to changes in the index, interest rate, payment amount, and the outstanding loan balance;

   h. A historical example, based on a sample $10,000 loan amount.

   i. An explanation of how the consumer may calculate the payments for the loan amount to be borrowed based on the most recent payment shown in the historical example;

   j. The maximum interest rate and payment for a sample $10,000 loan originated at the most recent interest rate shown in the historical example assuming the maximum periodic increases in rates and payments;

   k. The fact that the loan contains a demand feature;

   l. The type of information that will be provided in notices of adjustments and the timing of such notices; and

   m. A statement that disclosure forms are available for the creditor's other variable-rate loan programs.

Adjustment Procedures and Notices

The following procedures can be performed in connection with the review of compliance with the Federal Reserve's Regulation Z and the OTS' Mortgage Loan Disclosure Regulations. It may be possible to use the same sample(s) of document files drawn to review compliance with other provisions relating to open- and closed-end credit. Consequently, it may not be necessary to draw additional samples of adjusted loans for analysis.

To validate the findings of the analysis performed by management, we recommend an initial sample of recent adjustments for two loans of each variable-rate type in which an association or its subsidiaries holds an ownership interest, only to the extent necessary to reach a supportable conclusion with respect to compliance. If, for example, an association has 30 different loan products and it has reviewed its adjustment procedures for each type and found no exceptions, the examiner should use judgment in determining how many of those products should be reviewed to validate the association's own analysis. In situations where an association has not conducted any internal review, the examiner will have to conduct a more detailed analysis. However, that analysis should be limited to the number and variety of samples necessary to assure the examiner that no problems exist or, if there are problems, the nature and extent of them.

In choosing loan programs for sampling purposes, minor variations in variable-rate loan documents should be ignored. For example, an institution may separate loan programs by minor differences in loan features such as the initial discounted rate or assumability. In identifying loan types, consideration should be given to significant features such as the frequency and timing of adjustments and the index to which the interest rate is tied. A lender may refer to “three-year ARMs” as those loans that are adjusted annually after an initial three year period as well as loans that adjust every three years. In this case, both represent significantly different loan types and both would be reviewed.

For the purposes of compliance examinations, the review should be limited to transactions covered by Regulation Z and the OTS' Mortgage Loan Disclosure Regulations. The review for each adjustment should focus on compliance with the notification provisions, such as timing and content, and whether the adjustment calculations conform to the underlying obligation. The examiner's judgment should be used to determine appropriate expansion of initial samples, and to identify the extent and underlying causes of any problems noted.

The type of review outlined above involves recently originated loans which have adjusted. For loans which have had interest rate changes, but not payment adjustments, such as loans with negative amortization features, the interest rate adjustments should be reviewed. Examiners should also review a sample of loan conversions, from variable to fixed rate, since the same types of errors may occur in this process, as in calculating periodic adjustments for variable-rate loans. For recently originated loans which have not yet adjusted the existence and adequacy of adjustment procedures should be evaluated.

4. Determine through a review of the association's policies, procedures, and practices if adjustment notices are provided (delivered or placed in the mail):

   a. At least once each year when an interest rate adjustment is implemented without an accompanying payment change; and

   b. At least 25, but not more than 120, calendar days prior to the due date of a payment at a new level.

5. Review a sample of the association's adjustment notices to determine if they contain the following required provisions, as applicable:

   a. The current and prior interest rates;

   b. The index values upon which the current and prior interest rates are based;

   c. The extent to which the creditor has foregone any increase in the interest rate;

   d. The contractual effects of the adjustment, including the payment due after the adjustment is made, and a statement of the loan balance; and

   e. The amount of the payment required to fully amortize the loan at the new interest rate over the remainder of the loan term if that amount is different from the payment resulting from the adjustment.

6. Review the adequacy of the computer system's or servicer's ability to handle the institution's variable rate products. Determine if operating procedures and internal controls are adequate.

7. Verify whether internal or external auditors or other staff periodically test the accuracy of

the association's variable interest rate adjustment system.

8. Determine the extent and adequacy of the instruction and training received by those individuals who implement rate changes.

9. Determine whether the association has retained records of index values (e.g. copies of the Federal Reserve Statistical Release).

10. Verify that when the account was opened or loan was consummated that loan data was recorded correctly into the association's calculation systems (e.g., its computer). Determine the input accuracy of the:

    a. Index value.

    b. Method for calculating rate changes.

    c. Rounding method.

    d. Adjustment caps (periodic and lifetime).

11. Using a sample of periodic disclosures for open-end variable rate accounts (e.g., home equity accounts) and closed-end rate change notices for adjustable rate mortgage loans (ARMs):

    a. Compare the rate change date on the credit obligation to the actual rate change date and to any rate change notice.

    b. Determine that the index is determined based on the terms of the contract (e.g. the weekly average of 1-year Treasury constant maturities, taken 45 days prior to the change date).

    (Note: Rate changes must be made consistent with contractual terms. However, in some cases "readily available" or "currently available" index values at the time the notice was sent, subsequently used with the rate change, need not necessarily agree with the index value when that value was printed.)

    c. Determine that the new interest rate is correctly computed by adding the correct index value with the margin stated in the note, plus or minus any contractual fractional adjustment.

    d. Determine that the new payment was based on an interest rate and loan balance in effect at least 25 days before the payment change date (consistent with the contract).

References

(See Truth in Lending, Section 305.)

Introduction

The Real Estate Settlement Procedures Act of 1974 (RESPA) (12 USC §§2601-17) became effective on June 20, 1975. The act requires lenders, mortgage brokers, or servicers of home loans to provide borrowers with pertinent and timely disclosures regarding the nature and costs of the real estate settlement process. The Act also protects borrowers against certain abusive practices, such as kickbacks, and places limitations upon the use of escrow accounts. The Department of Housing and Urban Development (HUD) promulgated Regulation X (24 CFR §3500) which implements RESPA. The National Affordable Housing Act of 1990 amended RESPA to require detailed disclosures concerning the transfer, sale, or assignment of mortgage servicing. It also requires disclosures for mortgage escrow accounts at closing and annually, thereafter, itemizing the charges to be paid by the borrower and what is paid out of the account by the servicer.

In October 1992 Congress amended RESPA to cover subordinate lien loans. HUD, however, decided not to enforce these provisions until Regulation X was amended to cover these loans. On February 10, 1994, Regulation X was amended to extend coverage to subordinate lien loans. The amendments were effective August 9, 1994. Exemptions from coverage of RESPA and Regulation X, set forth in section 3500.5(b), were effective March 14, 1994. Technical corrections and amendments to the rule were issued on March 30, 1994 and July 22, 1994.

On June 7, 1996, HUD amended Regulation X to clarify certain exemption provisions of RESPA, amend the controlled business disclosure requirements, and to address specific comments raised in the 1994 rule. These amendments became effective on October 7, 1996. Congress further amended RESPA by changes made by the Economic Growth and Regulatory Paperwork Reduction Act of 1996 in September 1996, to clarity certain definitions including the controlled business disclosure requirements which were changed to the new term affiliated business arrangements. The changes also reduced the disclosures under the Mortgage Servicing provisions of RESPA effective on May 30, 1997.

Coverage (§3500.5(a))

RESPA is applicable to all "federally related mortgage loans." Federally related mortgage loans include:

Loans including refinances secured by a first or subordinate lien on residential real property upon which:

- A 1-4 family structure is located or is to be constructed using proceeds of the loan (including individual units of condominiums and cooperatives); or
- A manufactured home is located or is to be constructed using proceeds of the loan, and to which any of the following applies:
- Loans made by a lender[1], creditor[2], dealer[3];
- Loans made or insured by an agency of the federal government;
- Loans made in connection with a housing or urban development program administered by an agency of the federal government;

[1] A lender includes financial institutions either regulated by, or whose deposits or accounts are insured by, any agency of the Federal Government.

[2] A creditor is defined in section 103(f) of the Consumer Credit Protection Act (15 USC §1602(f)). RESPA covers any creditor that makes or invests in residential real estate loans aggregating more than $1,000,000 per year.

[3] Dealer is defined in Regulation X to mean a seller, contractor, or supplier of goods or services. Dealer loans are covered by RESPA if the obligations are to be assigned, before the first payment is due to any lender or creditor otherwise subject to the regulation.

Approved-FFIEC

- Loans made and intended to be sold by the originating lender or creditor to FNMA; GNMA, or FHLMC (or its successor)[4];
- Loans which are the subject of a home equity conversion mortgage or reverse mortgage issued by a lender or creditor subject to the regulation; or
- Installment sales contracts, land contracts or contracts for deed on otherwise qualifying residential property if the contract is funded in whole or in part by proceeds of a loan made by a lender, dealer or creditor subject to the regulation.

Exemptions (§3500.5(b))

The following transactions are exempt from coverage:

- A loan on property of 25 acres or more (whether or not a dwelling is located on the property).
- A loan primarily for business, commercial or agricultural purposes (definition identical to Regulation Z, 12 CFR §226.3(a)(1)).
- A temporary loan, such as a construction loan. (The exemption does not apply if the loan is used as, or may be converted to permanent financing by the same financial institution). If the lender issues a commitment for permanent financing, it is covered by the regulation. Any construction loan with a term of two years or more is covered by the regulation, unless it's made to a bonafide contractor. “Bridge” or “swing” loans are not covered by the regulation.
- A loan secured by vacant or unimproved property where no proceeds of the loan will be used to construct a 1-4 family residential structure. If the proceeds will be used to locate a manufactured home or construct a structure within two years from the date of settlement, the loan is covered.
- An assumption, unless the mortgage instruments require lender approval for the assumption and the lender actually approves the assumption.
- A renewal or modification where the original obligation (note) is still in effect but modified.
- A bona fide transfer of a loan obligation in the secondary market. (However, the mortgage servicing transfer disclosure requirements of 24 CFR 3500.21 still apply.) Mortgage broker transactions which are table funded (the loan is funded by a contemporaneous advance of loan funds and an assignment of the loan to the person advancing the funds) are not secondary market transactions and therefore covered by RESPA.

The exemption does not apply if there is a transfer of title to the property.

Requirements

<u>Special Information Booklet (§3500.6)</u>

A financial institution is required to provide the borrower with a copy of the Special Information Booklet at the time a written application is submitted, or no later than three-business days after the application is received. If the application is denied before the end of the three business-day period, the institution is not required to provide the booklet. If the borrower uses a mortgage broker, the broker rather than the institution, must provide the booklet.

- An application includes the submission of a borrower's financial information, either written or computer-generated, for a credit decision on a federally related mortgage loan. To be considered a written application, the submission must state or identify a specific property. The subsequent addition of an identified property to the submission converts the submission to an application for a federally related mortgage loan. [§3500.2(b)].
- A financial institution that complies with Regulation Z (12 CFR (226.5b) for open-end

[4] FNMA - Federal National Mortgage Association; GNMA - Government National Mortgage Association; FHLMC - Federal Home Loan Mortgage Corporation.

home equity plans is deemed to have complied with this section.

- The booklet does not need to be given for refinancing transactions, closed-end subordinate lien mortgage loans and reverse mortgage transactions, or for any other federally related mortgage loan not intended for the purchase of a one-to-four family residential property.

Part one of the booklet describes the settlement process, the nature of charges, and suggests questions to be asked of lenders, attorneys and others to clarify what services they will provide for the charges quoted. It also contains information on the rights and remedies available under RESPA and alerts the borrower to unfair or illegal practices.

Part two of the booklet contains an itemized explanation of settlement services and costs, as well as sample forms and worksheets for costs comparisons. The appendix has a listing of consumer literature on home purchasing, maintenance protection, and other related topics.

Good Faith Estimates (GFE) of Amount or Range of Settlement Costs (§3500.7)

A financial institution must provide, in a clear and concise form, a good faith estimate of the amount of settlement charges that the borrower is likely to incur. The GFE must include all charges that will be listed in section L of the HUD-1 Settlement Statement, and must be provided no later than three-business days after the written application is received. This can be an estimate of the dollar amount or range of dollar amounts for each settlement service. The estimate of the amount or range for each charge: (1) must bear a reasonable relationship to the borrower's ultimate cost for each settlement charge; and (2) must be based upon experience in the locality or area in which the property involved is located. A suggested form is set forth in Appendix C. If the application is denied before the end of the three-business-day period, the institution is not required to provide the disclosure.

- A financial institution that complies with Regulation Z (12 CFR §226.5b) for open-end home equity plans is deemed to have complied with this section.
- For “no cost” or “no point” loans, the GFE must disclose any payments to be made to affiliated or independent settlement service providers. These payments should be shown as P.O.C. (Paid Outside of Closing).
- For dealer loans, the institution is responsible for providing the GFE either directly or by the dealer.
- For brokered loans, if the mortgage broker is the exclusive agent of the institution either the institution or the broker shall provide the GFE within three business days after the broker receives or prepares the application. When the broker is not the exclusive agent of the institution, the institution is not required to provide the GFE if the broker has already provided the disclosure, but the funding lender must ascertain that the GFE has been delivered.

When the financial institution requires the use of a particular settlement service provider and requires the borrower to pay all or a portion of the cost of those services, the institution must include with the GFE the following disclosures:

- A statement that use of the provider is required and that the estimate is based on the charges of the designated provider.
- The name, address and telephone number of the designated provider.

A description of the nature of any relationship between each such provider and the institution. relationship exists if:

- The provider is an associate of the institution, as defined in Section 3(8) of RESPA (12 USC 2602(8);
- The provider has maintained an account with the institution or had an outstanding loan or credit arrangement with the institution within the last twelve months; or,
- The institution has repeatedly used or required borrowers to use the provider's services within the last twelve months.

The statement that, except for a provider that is the institution's chosen attorney, credit reporting agency, or appraiser, if the institution is in an affiliated business relationship with the provider, the institution may not require use of that provider (24 CFR §3500.15).

If the institution maintains a controlled list of required providers (five or more for each discrete service) or relies on a list maintained by others and at the time of application has not decided which provider will be selected, the institution may comply with this section by:

- Providing a written statement that the institution will require a particular provider from an approved list, and
- Disclosing in the GFE the range of costs for the required providers and providing the name of the specific provider and the actual cost on the HUD settlement statement.

If the list is less than 5 providers of service the names, addresses, telephone numbers, and costs are required along with the business relationship.

Uniform Settlement Statement (HUD-1 or HUD-1A) (§3500.8)

The HUD-1 and HUD-1A must be completed by the person (settlement agent) conducting the closing and must conspicuously and clearly itemize all charges related to the transaction. The HUD-1 is used for transactions in which there is a borrower and seller. For transactions in which there is a borrower and no seller (refinancings and subordinate lien loans), the HUD-1 may be completed by using the borrower's side of the settlement statement. Alternatively, the HUD-1A may be used. However, no settlement statement is required for home equity plans subject to the Truth in Lending Act and Regulation Z. Appendix A contains the instructions for completing the forms.

Printing and Duplication of the Settlement Statement (§3500.9)

Financial institutions have numerous options for layout and format in reproducing the HUD-1 and HUD-1A that do not require prior HUD approval such as size of pages; tint or color of pages; size and style of type or print; spacing; printing on separate pages, front and back of a single page or on one continuous page; use of multi-copy tear-out sets; printing on rolls for computer purposes; addition of signature lines; and translation into any language. Other changes may be made only with the approval of the Secretary of Housing and Urban Development.

One-Day Advance Inspection of the Settlement Statement (§3500.10)

Upon request by the borrower, the HUD-1 or HUD-1A must be completed and made available for inspection during the business day immediately preceding the day of settlement, setting forth those items known at that time by the person conducting the closing.

Delivery (§3500.10(a) and (b))

The completed HUD-1 or HUD-1A must be mailed or delivered to the borrower, the seller (if there is one) and the lender (if the lender is not the settlement agent) and/or their agents at or before settlement. However, the borrower may waive the right of delivery by executing a written waiver at or before settlement. The HUD-1 or HUD-1A shall be mailed or delivered as soon as practicable after settlement if the borrower or borrower's agent does not attend the settlement.

Retention (§3500.10(e))

The financial institution must retain each completed HUD-1 or HUD-1A and related documents for five years after settlement, unless the institution disposes of its interest in the mortgage and does not service the mortgage. If the loan is transferred, the institution shall provide a copy of the HUD-1 or HUD-1A to the owner or servicer of the mortgage as part of the transfer. The owner or servicer shall retain the HUD-1 or HUD-1A for the remainder of the five-year period.

Prohibition of Fees for Preparing Federal Disclosures (§3500.12)

For loans subject to RESPA, no fee may be charged for preparing the Settlement Statement or the Escrow Account statement or any disclosures required by the Truth in Lending Act.

Prohibition Against Kickbacks and Unearned Fees (§3500.14)

Any person who gives or receives a fee or a thing of value (payments, commissions, fees, gifts or special privileges) for the referral of settlement business is in violation of Section 8 of RESPA. Payments in excess of the reasonable value of goods provided or services rendered are considered kickbacks. Appendix B provides guidance on the meaning and coverage of the prohibition against kickbacks and unearned fees.

Penalties and Liabilities

Civil and criminal liability is provided for violating the prohibition against kickbacks and unearned fees including:

- Civil liability to the parties affected, equal to three times the amount of any charge paid for such settlement service.
- The possibility that the costs associated with any court proceeding together with reasonable attorney's fees could be recovered.
- A fine of not more than $10,000 or imprisonment for not more than 1 year or both, for each violation.

Affiliated Business Arrangements (§3500.15)

If a financial institution has either an affiliate relationship or a direct or beneficial ownership interest of more than 1% in a provider of settlement services and the lender directly or indirectly refers business to the provider it is an affiliated business arrangement. An affiliated business arrangement is not a violation of section 8 of RESPA and of §3500.14 of Regulation X if the following conditions are satisfied.

Prior to the referral, the person making each referral has provided to each person whose business is referred an Affiliated Business Arrangement Disclosure Statement (Appendix D). This disclosure shall specify the following:

- The nature of the relationship (explaining the ownership and financial interest) between the provider and the financial institution; and
- The estimated charge or range of charges generally made by such provider.

This disclosure must also be provided on a separate piece of paper either at time of loan application, or with the GFE, or at the time of the referral.

The institution may not require the use of such a provider, with the following exceptions; the institution may require a buyer, borrower or seller to pay for the services of an attorney, credit reporting agency or real estate appraiser chosen by the institution to represent it's interest. The institution may only receive a return on ownership or franchise interest or payment otherwise permitted by RESPA.

Title Companies (§3500.16)

Financial institutions that hold legal title to the property being sold are prohibited from requiring borrowers, either directly or indirectly, to use a particular title company.

Civil liability for violating the provision that a financial institution (seller) cannot require a borrower to use a particular title company is an amount equal to three times that of all charges made for such title insurance.

Escrow Accounts (§3500.17)

On October 26, 1994, HUD issued its final rule changing the accounting method for escrow accounts, which was originally effective April 24, 1995. The rule establishes a national standard accounting method, known as aggregate accounting. Existing escrow accounts were allowed a three-year phase-in period to convert to the aggregate accounting method. The final rule also established formats and procedures for initial and annual escrow account statements.

The amount of escrow funds that can be collected at settlement or upon creation of an escrow account is restricted to an amount sufficient to pay charges, such as taxes and insurance, that are attributable to the period from the date such payments were last paid until the initial payment date. Throughout the life of an escrow account, the servicer may charge the borrower a monthly sum equal to one-twelfth of the total annual escrow payments that the servicer reasonably anticipates paying from the account. In addition, the servicer may add an amount to maintain a cushion no greater than one-sixth of the estimated total annual payments from the account.

Escrow Account Analysis (§3500.17(c)(2) and (3))

Before establishing an escrow account, a servicer must conduct an analysis to determine the periodic payments and the amount to be deposited. The servicer shall use an escrow disbursement date that is on or before the earlier of the deadline to take advantage of discounts, if available, or the deadline to avoid a penalty.

HUD published a proposed rule on September 3, 1996, to address and clarify its existing escrow accounting procedures. Specifically, the proposed rule addresses mortgage escrow account disbursement requirements where the payee (i.e., the entity to which escrow items are owed, such as a taxing jurisdiction) offers a choice of annual or installment disbursements. In the supplementary Federal Register material accompanying this proposal, HUD indicates that until it publishes a final rule, servicers should follow the following approach:

- Where a payee offers the option of installment disbursements or a discount for annual disbursements, the servicer should make disbursements on an installment basis, but may, at the servicers discretion make annual disbursements, in order to take advantage of the discount for the borrower; HUD encourages servicers to follow the preference of the borrower.

- Where the payee offers the option of either annual disbursements with no discount or installment payments, the servicer is required to make installment payments.

The servicer shall also analyze each account at the completion of the computation year to determine the borrowers monthly payments for the next computation year.

Escrow Accounting Methods

Servicers may use either single-item analysis or aggregate analysis method during the phase-in period for pre-rule accounts. On the conversion date (10/27/97), all pre-rule accounts must comply with the requirements for post-rule accounts. During the phase-in period, the transfer of servicing of a pre-rule account to another servicer does not convert the account to a post-rule account. After May 24, 1995, refinancing transactions must comply with the requirements for post-rule accounts.

Servicers must use the aggregate accounting method to conduct an escrow analysis of post-rule accounts.

Transfer of Servicing (§3500.17(e))

If the new servicer changes either the monthly payment amount or the accounting method used by the old servicer, then it must provide the borrower with an initial escrow account statement within 60 days of the date of transfer. When the new servicer provides an initial escrow account statement, it shall use the effective date of the transfer of servicing to establish the new escrow account computation year. In addition, if the new servicer retains the monthly payments and accounting method used by the old servicer, then the new servicer may continue to use the same computation year established by the old servicer or it may choose a different one, using a short-year statement.

Shortages, Surpluses, and Deficiency Requirements (§3500.17(f))

The servicer shall conduct an annual escrow account analysis to determine whether a surplus, shortage, or deficiency exists as defined under Section 3500.17(b).

If the escrow account analysis discloses a surplus, the servicer shall, within 30 days from the date of the analysis, refund the surplus to the borrower if the surplus is greater than or equal to $50. If the surplus is less than $50, the servicer may refund such amount to the borrower, or credit such amount against the next year's escrow payments. These provisions apply as long as the borrower's mortgage payment is current at the time of the escrow account analysis.

If the escrow account analysis discloses a shortage of less than one month's escrow payments, then the servicer has three possible courses of action:

- the servicer may allow the shortage to exist and do nothing to change it;
- the servicer may require the borrower to repay the shortage amount within 30 days; or,
- the servicer may require the borrower to repay the shortage amount in equal monthly payments over at least a 12-month period.

If the shortage is more than or equal to one month's escrow payment, then the servicer has two possible courses of action:

- the servicer may allow the shortage to exist and do nothing to change it; or,
- the servicer may require the borrower to repay the shortage in equal monthly payments over at least a 12-month period.

If the escrow account analysis discloses a deficiency, then the servicer may require the borrower to pay additional monthly deposits to the account to eliminate the deficiency.

If the deficiency is less than one month's escrow account payment, then the servicer;

- may allow the deficiency to exist and do nothing to change it;
- may require the borrower to repay the deficiency within 30 days; or,
- may require the borrower to repay the deficiency in two or more equal monthly payments.

If the deficiency is greater than or equal to one month's escrow payment, the servicer may allow the deficiency to exist and do nothing to change it or require the borrower to repay the deficiency in two or more equal monthly payments.

These provisions apply as long as the borrower's mortgage payment is current at the time of the escrow account analysis.

A servicer must notify the borrower at least once during the escrow account computation year if a shortage or deficiency exists in the account.

Initial Escrow Account Statement (§3500.17(g))

After analyzing each escrow account, the servicer must submit an initial escrow account statement to the borrower at settlement or within 45 calendar days of settlement for escrow accounts that are established as a condition of the loan.

The initial escrow account statement must include the monthly mortgage payment; the portion going to escrow; itemize estimated taxes, insurance premiums, and other charges; the anticipated disbursement dates of those charges; the amount of the cushion; and a trial running balance.

Annual Escrow Account Statement (§3500.17(i))

A servicer shall submit to the borrower an annual statement for each escrow account within 30 days of the completion of the computation year. The servicer must conduct an escrow account analysis before submitting an annual escrow account statement to the borrower.

The annual escrow account statements must contain the account history; projections for the next year; current mortgage payment and portion going to escrow; amount of past year's monthly mortgage payment and portion that went into the escrow account; total amount paid into the escrow account during the past year; amount paid from the account for taxes, insurance premiums, and other charges; balance at the end of the period; explanation of how the surplus, shortage, or deficiency is being handled; and, if applicable, the reasons why the estimated low monthly balance was not reached.

Short-year Statements (§3500.17(i)(4))

Short-year statements can be issued to end the escrow account computation year and establish the beginning date of the new computation year. Short-year statements may be provided upon the transfer of servicing and are required upon loan payoff. The statement is due to the borrower within 60 days after receiving the pay-off funds.

Timely Payments (§3500.17(k))

The servicer shall pay escrow disbursements by the disbursement date. In calculating the disbursement date, the servicer must use a date on or before the earlier of the deadline to take advantage of discounts, if available, or the deadline to avoid a penalty.

Record Keeping (§3500.17(l))

Each servicer shall keep records that are easily retrievable, reflecting the servicer's handling of each borrower's escrow account. The servicer shall maintain the records for each escrow account for at least five years after the servicer last serviced the account.

Penalties (§3500.17(m))

Failure to provide an initial or annual escrow account statement to a borrower can result in the financial institution or the servicer being assessed a civil penalty of $55 for each such failure, with the total for any 12 month period not to exceed $110,000. If the violation is due to intentional disregard, the penalty is $110 for each failure without any annual cap on liability.

Mortgage Servicing Disclosures (§3500.21)

The disclosures related to the transfer of mortgage servicing are required for first mortgage liens, including all refinancing transactions. Subordinate lien loans and open-end lines of credit (home equity plans), that are covered under the TILA and Regulation Z are exempt from this section.

A financial institution that receives an application for a federally related mortgage loan is required to provide the servicing disclosure statement to the borrower at the time of application if there is a face-to-face interview, otherwise within three business days after receipt of the application.

When a federally related mortgage loan is assigned, sold or transferred, the transferor (present servicer) must provide a disclosure at least 15 days before the effective date of the transfer. The same notice from the transferee (new servicer) must be provided not more than 15 days after the effective date of the transfer. Both notices may be combined in one notice if delivered to the borrower at least 15 days before the effective date of the transfer. The disclosure must include:

- The effective date of the transfer.
- The name, address for consumer inquiries, and toll-free or collect-call telephone number of the transferee servicer.
- A toll-free or collect-call telephone number for an employee by the transferor servicer that can be contacted by the borrower to answer servicing questions.
- The date on which the transferor servicer will cease accepting payments relating to the loan and the date on which the transferee servicer will begin to accept such payments. The dates must either be the same or consecutive dates.
- Any information concerning the effect of the transfer on the availability of optional insurance and any action the borrower must take to maintain coverage.
- A statement that the transfer does not affect the terms or conditions of the mortgage (except as related to servicing).
- A statement of the borrower's rights in connection with complaint resolution.

During the 60-day period beginning on the date of transfer, no late fee can be imposed on a borrower who has made the payment to the wrong servicer.

The following transfers are not considered an assignment, sale, or transfer of mortgage loan servicing for purposes of this requirement if there is no change in the payee, address to which payment must be delivered, account number, or amount of payment due:

- Transfers between affiliates.
- Transfers resulting from mergers or acquisitions of service or subservicers.
- Transfers between master servicers, when the subservicer remains the same.

Servicers Must Respond to Borrower's Inquiries (§3500.21(e))

A financial institution servicer must respond to a borrower's qualified written inquiry and take appropriate action within established time frames after receipt of the inquiry. Generally, the financial institution must provide written acknowledgment within 20 business days, and take certain specified actions within 60 business days of receipt of such inquiry. The inquiry must include the name and account number of the borrower and the reasons the borrower believes the account is in error.

During the 60 business day period following receipt of a qualified written request from a borrower relating to a disputed payment, a financial institution may not provide information regarding any overdue payment, and relating to this period or the qualified written request, to any consumer reporting agency.

Relationship to State Law (§3500.21(h))

Financial institutions complying with the mortgage servicing transfer disclosure requirements of RESPA are considered to have complied with any State law or regulation requiring notice to a borrower at the time of application or transfer of a mortgage. State laws shall not be affected by the act, except to the extent that they are inconsistent and then only to the extent of the inconsistency. The Secretary of Housing and Urban Development is authorized, after consulting with the appropriate federal agencies, to determine whether such inconsistencies exist.

Penalties and Liabilities (§3500.21(f))

Failure to comply with any provision of section 3500.21 will result in actual damages, and where there is a pattern or practice of noncompliance any additional damages in an amount not to exceed $1,000. In class action cases, each borrower will receive actual damages and additional damages, as the court allows, up to $1,000 for each member of the class, except that the total amount of damages in any class action may not exceed the lesser of $500,000 or one percent of the net worth of the servicer. In addition, costs of the action and attorney fees in case of any successful action.

Examination Objectives

1. To determine if the financial institution has established procedures to ensure compliance with RESPA.
2. To determine that the financial institution does not engage in any practices prohibited by RESPA, such as kickbacks, payment or receipt of referral fees or unearned fees, or excessive escrow assessments.
3. To determine if the Special Information Booklet, Good Faith Estimate, Uniform Settlement Statement (Form HUD-1 or HUD-1A), mortgage servicing transfer disclosures, and other required disclosures are in a form that complies with Regulation X, are properly completed, and provided to borrowers within prescribed time periods.
4. To determine if the institution is submitting the required initial and annual escrow account statements to borrowers as applicable and complying with established limitations on escrow account arrangements.
5. To determine whether the institution is responding to borrower inquiries for information relating to the servicing of their loans in compliance with the provisions of RESPA.

Examination Procedures

If the financial institution has loans covered by the act, determine whether the institution's policies, practices and procedures are in compliance.

1. Review the types of loans covered by RESPA and applicable exemptions.

2. Review the Special Information Booklet, good faith estimate (GFE) form, Uniform Settlement Statement form (HUD-1 or HUD-1A), mortgage servicing transfer disclosure forms, and affiliated business arrangement disclosure form for compliance with the requirements of Regulation X. Review model forms in the appendices to the regulation and after §3500.21.

3. Review written loan policies and operating procedures in connection with federally related mortgage loans and discuss them with institution personnel.

4. Interview mortgage lending personnel to determine:

   a. Identity of persons or entities referring federally related mortgage loan business;

   b. The nature of services provided by referral sources, if any;

   c. Settlement service providers used by the institution;

   d. When the Special Information Booklet is given;

   e. The timing of the good faith estimate and how fee information is determined;

   f. Any providers whose services are required by the institution;

   g. How borrower inquiries regarding loan servicing are handled and within what time frames; and

   h. Whether escrow arrangements exist on mortgage loans;

5. Assess the overall level of knowledge and understanding of mortgage lending personnel.

Special Information Booklet

6. Determine through discussion with management and review of credit files whether the Special Information Booklet, if required, is provided within 3 business days after the financial institution or broker receives a written application for a loan. [§3500.6(a)(1)].

Good Faith Estimate

7. Determine whether the financial institution provides a good faith estimate of charges for settlement services, if required, within three business days after receipt of a written application. [§3500.7(a)].

8. Review Appendix C of Regulation X to determine if the good faith estimate appears in a similar form and contains the following required elements: [§3500.7(c) and (d)].

   a. The lender's name. If the GFE is being given by a broker, instead of the lender, the GFE must contain a legend in accordance with Appendix C.

   b. An estimate of all charges listed in Section L of the HUD-1 or HUD-1A, expressed either as a dollar amount or range. For “no cost” or “no point” loans, charges to be shown on the GFE including payments to be made to affiliated or independent settlement service providers (shown on HUD-1 or HUD-1A as “paid outside of closing”).

   c. An estimate of any other charge the borrower will pay based upon common practice in the locality of the mortgaged property.

9. Review Form HUD-1 or HUD-1A prepared in connection with the transaction to determine if amounts shown on the GFE are reasonably similar to fees actually paid by the borrower. [§3500.7(c)(2)]. Note: the definition of “reasonably” is subject to interpretation by HUD.

10. Determine through review of the institution's good faith estimates, HUD-1 and HUD-1A forms, and discussions with management whether the financial institution requires the borrower to use the services of a particular individual or firm for settlement services. [§3500.7(e)].

    a. In cases where the lender requires the use of a particular provider of a settlement service (except the lender's own employees) AND requires the borrower to pay any portion of the cost, determine if the GFE includes:

        1. The fact that the particular provider is required;

        2. The fact that the estimate is based on the charges of the designated provider;

        3. The name, address, and telephone number of each provider; and

        4. The specific nature of any relationship between the provider and the lender [see §3500.7(e)(2)].

11. If the lender maintains a list of required providers (five or more for each service) and, at the time of application has not chosen the provider to be selected from the list, determine that the lender satisfies the GFE requirements by providing a written statement that the lender will require a particular provider from a lender-controlled list and by providing the range of costs for the required providers. The name and actual cost must be reflected on the HUD-1 or HUD-1A.

Uniform Settlement Statement Form (HUD-1 and HUD-1A)

12. Determine if the financial institution uses the current Uniform Settlement Statement (HUD-1 or HUD-1A) as appropriate [§3500.8 (a)] and that:

    a. Charges are properly itemized for both borrower and seller in accordance with the instructions for completion of the HUD-1 or HUD-1A (Appendix A).

    b. All charges paid to one other than the lender are itemized and the recipient named. [§3500.8(b); Appendix A].

    c. Charges required by the financial institution but paid outside of closing are itemized on the settlement statement, marked as "paid outside of closing" or "P.O.C.," but not included in totals. [§3500.8(b); Appendix A].

13. If the financial institution conducts settlement, determine whether:

    a. The borrower, upon request, is allowed to inspect the HUD-1 or HUD-1A at least one business day prior to settlement. [§3500.10(a)].

    b. The HUD-1 or HUD-1A is provided to the borrower and seller at or before settlement. [§3500.10(b)].

    c. In cases where the right to delivery is waived or the transaction is exempt, the statement is mailed as soon as possible after settlement. [(3500.10(b),(c), and (d)].

14. Determine whether HUD-1 and HUD-1A forms are retained for 5 years. If the financial institution disposes of its interest in the mortgage and does not service the loan, the HUD-1 or HUD-1A form must be transferred with the loan file. [§3500.10(e)].

Mortgage Servicing Transfer Disclosure

15. Determine whether the disclosure form is substantially in conformity with the model disclosure in Appendix MS-1.

16. Determine that the applicant received the mortgage servicing transfer disclosure at the time of application. If the application was not taken face-to-face, the disclosure must have been provided within three business days after receipt of the application. [§3500.21(c)].

17. Determine that the disclosure states whether the loan may be assigned or transferred while outstanding. [§3500.21(b)(3)].

Notice to Borrower of Transfer of Mortgage Servicing

18. Determine whether the institution has transferred or received mortgage servicing rights.

19. If it has transferred servicing rights, determine whether notice to the borrower was given at least 15 days prior to the transfer. [§3500.21(d)(2)].

20. If it has received servicing rights, determine whether notice was given to the borrower within 15 days after the transfer. [§3500.21(d)(2)].

21. Determine whether the notice by transferor and transferee include the following information. Sample language for the notice of transfer is contained in Appendix B to [§3500.21(d)(3)].

    a. The effective date of the transfer;

    b. The name, consumer inquiry addresses (including, at the option of the servicer, a separate address where qualified written requests must be sent), and a toll-free or collect call telephone number for an employee or department of the transferee servicer;

    c. A toll-free or collect call telephone number for an employee or department of the transferor servicer that can be contacted by the borrower for answers to servicing transfer inquiries,

    d. The date on which the present servicer will cease accepting payments and the date the new servicer will begin accepting payments relating to the transferred loan;

    e. Any information concerning the effect of the transfer on the availability of terms of optional insurance and any action the borrower must take to maintain coverage;

    f. A statement that the transfer does not affect the terms or conditions of the mortgage, other than terms directly related to its servicing; and,

    g. A statement of the borrowers rights in connection with compliant resolution (Appendix MS-2.)

Responsibilities of Servicer

22. Through a review of late notices or otherwise if the transferor servicer received payment, determine that no late fees have been imposed and that no payments have been treated as late within 60 days following a transfer of servicing. [§3500.21(d)(5)].

23. Determine that the institution, as loan servicer for mortgage loans and refinancings subject to RESPA, responds to borrower inquiries relating to these loans as prescribed in the regulation, including:

    a. Provide the notice of receipt of inquiry for qualified written correspondence from borrowers within 20-business days (unless the action requested is taken within that period and the borrower is notified in writing of that action), [§3500.21(e)(1)].

    b. Provide written notification of the corrections taken on the account, or statement of the reasons the account is correct or explanation why the information requested is unavailable not later than 60-business days after receipt of the qualified written correspondence from the borrower, [§3500.21(e)(3)]

    c. Determine that the institution does not provide information to any consumer reporting agency regarding overdue payment when investigating a qualified written request from borrower regarding disputed payments during this 60-business day period. [§3500.21(e)(4)(i)].

No Fees for RESPA Disclosures

24. Determine whether the financial institution charges a fee specifically for preparing and distributing the HUD-1 forms, escrow statements or documents required under the Truth in Lending Act. [§3500.12].

Purchase of Title Insurance

25. When the financial institution owns the property being sold, determine whether it requires or gives the impression that title insurance is required from a particular company. [§3500.16]

Payment or Receipt of Referral or Unearned Fees

26. Determine if management is aware of the prohibitions against payment or receipt of kickbacks and unearned fees. [RESPA 8; §3500.14].

27. Through interviews with institution management and personnel, file reviews, review of good faith estimates, and HUD-1 and HUD-1A, determine if federally related mortgage loan transactions are referred by brokers, affiliates, or other parties. Identify those parties. Also, identify persons or entities to which the institution refers services in connection with a federally related mortgage transaction.

    a. Identify the types of services rendered by the broker, affiliate, or service provider.

    b. By a review of the institution's general ledger or otherwise, determine if fees were paid to the institution or any parties identified.

c. Confirm that any fees paid to the broker, affiliate, service provider, or other party meet the requirements of section 3500.14(g) and are for goods or facilities actually furnished or services actually an attorney, credit reporting agency or appraiser representing the lender, was the use of a provider required. [§3500.15(b)(2)].

Affiliated Business Arrangements

28. Determine from the HUD-1 or HUD-1A and from interviews with institution management if an affiliated business arrangement exists between a referring party and any provider of settlement services. (§3500.15). If so, determine which providers the lender requires and that the Affiliated Business Arrangement disclosures statement (Appendix D) was provided as required by section 3500.15(b)(1).

29. An attorney, credit reporting agency, or appraiser representing the lender, was the use of a provider required. [§3500.15(b)(2)].

Escrow Accounts

If the institution maintains escrow accounts in connection with a federally related mortgage loan, complete the following procedures.

30. Determine whether the institution performed an initial escrow analysis [§3500.17(c)(2)] and provided the initial escrow statement required by section 3500.17(g). The statement must contain the following:

    a. Amount of monthly payment;

    b. Portion of the monthly payment being placed in escrow;

    c. Charges to be paid from the escrow account during the first 12 months;

    d Disbursement dates; and,

    e Amount of cushion.

31. Determine if the statement was given to the borrower at settlement or within 45 days after the escrow account was established. This statement may be incorporated into the HUD-1 statement. [§3500.17(g)(1)].

32. Determine whether the institution performs an annual analysis of the escrow account [§3500.17(c)(3) and (7), and 3500.17(i)].

33. Determine whether the annual escrow account statement is provided to the borrower within 30 days of the end of the computation year [§3500.17(i)].

34. Determine if the annual escrow statement contains the following:

    a. Amount of monthly mortgage payment and portion that went placed in escrow;

    b. Amount of past year's monthly mortgage payment and portion that went into escrow;

    c. Total amount paid into escrow during the past computation year;

    d. Total amount paid out of escrow account during same period for taxes, insurance, and other charges;

    e. Balance in the escrow account at the end of the period;

    f. How a surplus, shortage, or deficiency is to be paid/handled; and,

    g. If applicable, the reason why estimated low monthly balance was not reached.

35. Determine whether monthly escrow payments following settlement are within the limits of (3500.17(c).

I. Background

The Homeowners Protection Act of 1998 (the Act) was signed into law on July 29, 1998, and became effective on July 29, 1999. The Act was amended on December 27, 2000 to provide technical corrections and clarification. The Act, also known as the "PMI Cancellation Act," addresses homeowners' difficulties in canceling private mortgage insurance (PMI)[1] coverage. It establishes provisions for canceling and terminating PMI, establishes disclosure and notification requirements, and requires the return of unearned premiums.

PMI is insurance that protects lenders from the risk of default and foreclosure. PMI allows prospective buyers who cannot, or choose not to, provide significant down payments to obtain mortgage financing at affordable rates. It is used extensively to facilitate "high-ratio" loans (generally, loans in which the loan to value (LTV) ratio exceeds 80 percent). With PMI, the lender can recover costs associated with the resale of foreclosed property, and accrued interest payments or fixed costs, such as taxes or insurance policies, paid prior to resale.

Excessive PMI coverage provides little extra protection for a lender and does not benefit the borrower. In some instances, homeowners have experienced problems in canceling PMI. At other times, lenders may have agreed to terminate coverage when the borrower's equity reached 20 percent, but the policies and procedures used for canceling or terminating PMI coverage varied widely among lenders. Prior to the Act, homeowners had limited recourse when lenders refused

Approved – FFIEC

refused

to cancel their PMI coverage. Even homeowners in the few states that had laws pertaining to PMI cancellation or termination noted difficulties in canceling or terminating their PMI policies. The Act now protects homeowners by prohibiting life of loan PMI coverage for borrower-paid PMI products and establishing uniform procedures for the cancellation and termination of PMI policies.

II. Scope and Effective Date

The Act applies primarily to "residential mortgage transactions," defined as mortgage loan transactions consummated on or after July 29, 1999, to finance the acquisition, initial construction or refinancing[2] of a single-family dwelling that serves as a borrower's principal residence.[3] The Act also includes provisions for annual written disclosures for "residential mortgages," defined as mortgages, loans or other evidences of a security interest created for a single-family dwelling that is the principal residence of the borrower (12 USC 4901(14) and (15)). A condominium, townhouse, cooperative or mobile home is considered to be a single-family dwelling covered by the Act.

The Act's requirements vary depending on whether a mortgage is:

- A "residential mortgage" or a "residential mortgage transaction";
- Defined as high risk (either by the lender in the case of nonconforming loans, or Fannie Mae

[1] The Act does not apply to mortgage insurance made available under the National Housing Act, title 38 of the United States Code, or title V of the Housing Act of 1949. This includes mortgage insurance on loans made by the Federal Housing Administration and guarantees on mortgage loans made by the Veterans Administration.

[2] For purposes of these procedures, "refinancing" means the refinancing of loans any portion of which was to provide financing for the acquisition or initial construction of a single-family dwelling that serves as a borrower's principal residence. *See* 15 USCC 1601 et. seq. and 12 CFR 226.20.

[3] For purposes of these procedures, junior mortgages that provide financing for the acquisition, initial construction or refinancing of a single-family dwelling that serves as a borrower's primary residence are covered.

and Freddie Mac in the case of conforming loans);

- Financed under a fixed rate or an adjustable rate; or
- Covered by borrower-paid private mortgage insurance (BPMI) or lender-paid private mortgage insurance (LPMI).[4]

III. Cancellation and Termination of PMI for Non-High Risk Residential Mortgage Transactions

A. Borrower Requested Cancellation

A borrower may initiate cancellation of PMI coverage by submitting a written request to the servicer. The servicer must take action to cancel PMI when the cancellation date occurs, which is when the principal balance of the loan reaches (based on actual payments) or is first scheduled to reach 80 percent of the "original value,"[5] irrespective of the outstanding balance, based upon the initial amortization schedule (in the case of a fixed rate loan) or amortization schedule then in effect (in the case of an adjustable rate loan),[6] or any date thereafter that:

- the borrower submits a written cancellation request;
- the borrower has a good payment history;[7]
- the borrower is current;[8] and
- the borrower satisfies any requirement of the mortgage holder for: (i) evidence of a type established in advance that the value of the property has not declined below the original value; and (ii) certification that the borrower's equity in the property is not subject to a subordinate lien (12 USC 4902(a)(4)).

Once PMI is canceled, the servicer may not require further PMI payments or premiums more than 30 days after the later of: (i) the date on which the written request was received or (ii) the date on which the borrower satisfied the evidence and certification requirements of the mortgage holder described previously (12 USC 4902(e)(1)).

B. Automatic Termination

The Act requires a servicer to automatically terminate PMI for residential mortgage transactions on the date that:

- the principal balance of the mortgage is first scheduled to reach 78 percent of the original value of the secured property (based solely on the initial amortization schedule in the case of a fixed rate loan or on the amortization schedule then in effect in the case of an adjustable rate loan, irrespective of the outstanding balance) if the borrower is current; or
- if the borrower is not current on that date, on the first day of the first month following the date that the borrower becomes current (12 USC 4902(b)).

[4] All sections of these procedures and manual apply to BPMI. For LPMI, relevant sections begin under that heading the follow thereafter.

[5] "Original value" is defined as the lesser of the sales price of the secured property as reflected in the purchase contract or, the appraised value at the time of loan consummation. In the case of a refinancing, the term means the appraised value relied upon by the lender to approve the refinance transaction.

[6] The Act includes as an adjustable rate mortgage, a balloon loan that "contains a conditional right to refinance or modify the unamortized principal at the maturity date." Therefore, if a balloon loan contains a conditional right to refinance, the initial disclosure for an adjustable rate mortgage would be used even if the interest rate is fixed.

[7] A borrower has a good payment history if the borrower: (1) has not made a payment that was 60 days or more past due within the first 12 months of the last 2 years prior to the later of the cancellation date, or the date that the borrower request cancellation; or (2) has not made a payment that was 30 days or more past due within the 12 months prior to the later of the cancellation date or the date that the borrower requests cancellation.

[8] The Act does not define current.

If PMI is terminated, the servicer may not require further payments or premiums of PMI more than 30 days after the termination date or the date following the termination date on which the borrower becomes current on the payments, whichever is sooner (12 USC 4902(e)(2)).

There is no provision in the automatic termination section of the Act, as there is with the borrower-requested PMI cancellation section, that protects the lender against declines in property value or subordinate liens. The automatic termination provisions make no reference to good payment history (as prescribed in the borrower-requested provisions), but state only that the borrower must be *current* on mortgage payments (12 USC 4902(b)).

C. Final Termination

If PMI coverage on a residential mortgage transaction was not canceled at the borrower's request or by the automatic termination provision, the servicer must terminate PMI coverage by the first day of the month immediately following the date that is the midpoint of the loan's amortization period if, on that date, the borrower is current on the payments required by the terms of the mortgage. (If the borrower is not current on that date, PMI should be terminated when the borrower does become current).

The midpoint of the amortization period is halfway through the period between the first day of the amortization period established at consummation and ending when the mortgage is scheduled to be amortized. The servicer may not require further payments or premiums of PMI more than 30 days after PMI is terminated (12 USC 4902(e)(3)).

D. Loan Modifications

If a borrower and mortgage holder agree to modify the terms and conditions of a loan pursuant to a residential mortgage transaction, the cancellation, termination or final termination dates shall be recalculated to reflect the modification (12 USC 4902(d)).

E. Exclusions

The Act's cancellation and termination provisions do not apply to residential mortgage transactions for which Lender Paid Mortgage Insurance (LPMI) is required (12 USC 4905(b).

F. Return of Unearned Premiums

The servicer must return all unearned PMI premiums to the borrower within 45 days after cancellation or termination of PMI coverage. Within 30 days after notification by the servicer of cancellation or termination of PMI coverage, a mortgage insurer must return to the servicer any amount of unearned premiums it is holding to permit the servicer to return such premiums to the borrower (12 USC 4902(f)).

G. Accrued Obligations for Premium Payments

The cancellation or termination of PMI does not affect the rights of any lender, servicer or mortgage insurer to enforce any obligation of a borrower for payments of premiums that accrued before the cancellation or termination occurred (12 USC 4902 (h)).

IV. Exceptions to Cancellation and Termination Provisions for High Risk Residential Mortgage Transactions

The borrower-requested cancellation at 80 percent LTV and the automatic termination at 78 percent LTV requirements of the Act do not apply to "high risk" loans. However, high risk loans are subject to final termination and are divided into two categories - conforming (Fannie Mae/Freddie Mac-defined high-risk loans) and nonconforming (lender-defined high-risk loans) (12 USC 4902(g)(1)).

A. Conforming Loans (Fannie Mae/Freddie Mac-Defined High Risk Loans)

Conforming loans are those loans with an original principal balance not exceeding Freddie Mac's and

Fannie Mae's conforming loan limits.[9] Fannie Mae and Freddie Mac are authorized under the Act to establish a category of residential mortgage transactions that are not subject to the Act's requirements for borrower-requested cancellation or automatic termination, because of the high risk associated with them.[10] They are, however, subject to the final termination provision of the Act. As such, PMI on a conforming high risk loan must be terminated by the first day of the month following the date that is the midpoint of the loan's initial amortization schedule (in the case of a fixed rate loan) or amortization schedule then in effect (in the case of an adjustable rate loan) if, on that date, the borrower is current on the loan. (If the borrower is not current on that date, PMI should be terminated when the borrower does become current.)

B. Nonconforming Loans (Lender-Defined High Risk Loans)

Nonconforming loans are those residential mortgage transactions that have an original principal balance exceeding Freddie Mac's and Fannie Mae's conforming loan limits. Lender-defined high risk loans are not subject to the Act's requirements for borrower-requested cancellation or automatic termination. However, if a residential mortgage transaction is a lender-defined high risk loan, PMI must be terminated on the date on which the principal balance of the mortgage, based solely on the initial amortization schedule (in the case of a fixed rate loan) or the amortization schedule then in effect (in the case of an adjustable rate loan) for that mortgage and irrespective of the outstanding balance for that mortgage on that date, is first scheduled to reach 77 percent of the original value of the property securing the loan.

Like conforming loans that are determined to be high risk by Freddie Mac and Fannie Mae, a residential mortgage transaction that is a lender-defined high risk loan is subject to the final termination provision of the Act.

[9] The limit was $322,700 in 2003.

[10] Fannie Mae and Freddie Mac have not defined high-risk loans as of the date of this publication.

C. Notices

The lender must provide written initial disclosures at consummation for all high-risk residential mortgage transactions (as defined by the lender or Fannie Mae or Freddie Mac), that in no case will PMI be required beyond the midpoint of the amortization period of the loan, if the loan is current. More specific notice as to the 77 percent LTV termination standards for lender defined high-risk loans is not required under the Act.

V. Basic Disclosure and Notice Requirements Applicable to Residential Mortgage Transactions and Residential Mortgages

The Act requires the lender in a residential mortgage transaction to provide to the borrower, at the time of consummation, certain disclosures that describe the borrower's rights for PMI cancellation and termination. A borrower may not be charged for any disclosure required by the Act. Initial disclosures vary, based upon whether the transaction is a fixed rate mortgage, adjustable rate mortgage or high-risk loan. The Act also requires that the borrower be provided with certain annual and other notices concerning PMI cancellation and termination. Residential mortgages are subject to certain annual disclosure requirements.

A. Initial Disclosures for Fixed Rate Residential Mortgage Transactions

When PMI is required for non-high risk fixed rate mortgages, the lender must provide to the borrower at the time the transaction is consummated: (i) a written initial amortization schedule, and (ii) a written notice that discloses:

- The borrower's right to request cancellation of PMI, and, based on the initial amortization schedule, the date the loan balance is scheduled to reach 80 percent of the original value of the property;
- The borrower's right to request cancellation on an earlier date, if actual payments bring the loan balance to 80 percent of the original value

of the property sooner than the date based on the initial amortization schedule;

- That PMI will automatically terminate when the LTV ratio reaches 78 percent of the original value of the property and the specific date that is projected to occur (based on the initial amortization schedule); and
- The Act provides for exemptions to the cancellation and automatic termination provisions for high-risk mortgages and whether these exemptions apply to the borrower's loan (12 USC 4903(a)(1)(A)).

B. Initial Disclosures for Adjustable Rate Residential Mortgage Transactions

When PMI is required for non-high risk adjustable rate mortgages, the lender must provide to the borrower, at the time the transaction is consummated, a written notice that discloses:

- The borrower's right to request cancellation of PMI on (i) the date the loan balance is first scheduled to reach 80 percent of the original value of the property based on the amortization schedule then in effect or (ii) the date the balance actually reaches 80 percent of the original value of the property based on actual payments. The notice must also state that the servicer will notify the borrower when either (i) or (ii) occurs;
- That PMI will automatically terminate when the loan balance is first scheduled to reach 78 percent of the original value of the property based on the amortization schedule then in effect. The notice must also state that the borrower will be notified when PMI is terminated (or that termination will occur when the borrower becomes current on payments); and
- That there are exemptions to the cancellation and automatic termination provisions for high risk mortgages and whether such exemptions apply to the borrower's loan (12 USC 4903(a)(1(B)).

C. Initial Disclosures for High Risk Residential Mortgage Transactions

When PMI is required for high risk residential mortgage transactions, the lender must provide to the borrower a written notice stating that PMI will not be required beyond the date that is the midpoint of the loan's amortization period if, on that date, the borrower is current on the payments as required by the terms of the loan. The lender must provide this notice at consummation. The lender need not provide disclosure of the termination at 77 percent LTV for lender defined high risk mortgages (12 USC 4903(a)(2)).

D. Annual Disclosures for Residential Mortgage Transactions

For all residential mortgage transactions, including high risk mortgages for which PMI is required, the servicer must provide the borrower with an annual written statement that sets forth the rights of the borrower to PMI cancellation and termination and the address and telephone number that the borrower may use to contact the servicer to determine whether the borrower may cancel PMI (12 USC 4903(a)(3)).

E. Disclosures for Existing Residential Mortgages

When PMI was required for a residential mortgage consummated before July 29, 1999, the servicer must provide to the borrower an annual written statement that:

- States that PMI may be canceled with the consent of the lender or in accordance with state law; and
- Provides the servicer's address and telephone number, so that the borrower may contact the servicer to determine whether the borrower may cancel PMI (12 USC 4903(b)).

VI. Notification Upon Cancellation or Termination of PMI Relating to Residential Mortgage Transactions

A. General

The servicer must, not later than 30 days after PMI relating to a residential mortgage transaction is cancelled or terminated, notify the borrower in writing that:[11]

- PMI has terminated and the borrower no longer has PMI; and
- No further premiums, payments or other fees are due or payable by the borrower in connection with PMI (12 USC 4904(a)).

B. Notice of Grounds/Timing

If a servicer determines that a borrower in a residential mortgage transaction does not qualify for PMI cancellation or automatic termination, the servicer must provide the borrower with a written notice of the grounds relied on for that determination. If an appraisal was used in making the determination, the servicer must give the appraisal results to the borrower. If a borrower does not qualify for cancellation, the notice must be provided not later than 30 days following the later of: (i) the date the borrower's request for cancellation is received; or (ii) the date on which the borrower satisfies any evidence and certification requirements of the mortgage holder. If the borrower does not meet the requirements for automatic termination, the notice must be provided not later than 30 days following the scheduled termination date (12 USC 4904(b)).

[11] For adjustable rate mortgages, the initial notice to borrowers must state that the servicer will notify the borrower when the cancellation and automatic termination dates are reached (12 USC 4903(a)(1)(B)). Servicers should take care that the appropriate notices are made to borrowers when those dates are reached.

VII. Disclosure Requirements for Lender Paid Mortgage Insurance

A. Definitions

Borrower paid mortgage insurance (BPMI) means PMI that is required for a residential mortgage transaction, the payments for which are made by the borrower.

Lender paid mortgage insurance (LPMI) means PMI that is required for a residential mortgage transaction, the payments for which are made by a person other than the borrower.

Loan commitment means a prospective lender's written confirmation of its approval, including any applicable closing conditions, of the application of a prospective borrower for a residential mortgage loan (12 USC 4905(a)).

B. Initial Notice

In the case of LPMI required for a residential mortgage transaction, the Act requires that the lender provide a written notice to the borrower not later than the date on which a loan ***commitment*** is made. The written notice must advise the borrower of the differences between LPMI and BPMI by notifying the borrower that LPMI:

- Differs from BPMI because it cannot be cancelled by the borrower or automatically terminated as provided under the Act;
- Usually results in a mortgage having a higher interest rate than it would in the case of BPMI; and
- Terminates only when the mortgage is refinanced, (as that term is defined in the Truth in Lending Act, 15 USC 1601 et seq., and Regulation Z, 12 CFR 226.20), paid off, or otherwise terminated.

The notice must also provide:

- That LPMI and BPMI have both benefits and disadvantages;

- A generic analysis of the costs and benefits of a mortgage in the case of LPMI versus BPMI over a ten-year period, assuming prevailing interest and property appreciation rates; and
- That LPMI may be tax-deductible for federal income taxes, if the borrower itemizes expenses for that purpose (12 USC 4905(c)(1)).

C. Notice at Termination Date

Not later than 30 days after the termination date that would apply in the case of BPMI, the servicer shall provide to the borrower a written notice indicating that the borrower may wish to review financing options that could eliminate the requirement for LPMI in connection with the mortgage (12 USC 4905(c)(2)).

VIII. Fees for Disclosures

As stated previously, no fee or other cost may be imposed on a borrower for the disclosures or notifications required to be given to a borrower by lenders or servicers under the Act (12 USC 4906).

IX. Civil Liability

A. Liability Dependent Upon Type of Action

Servicers, lenders and mortgage insurers that violate the Act are liable to borrowers as follows:

- *Individual Action*

  In the case of individual borrowers:

  — Actual damages (including interest accruing on such damages);

  — Statutory damages not to exceed $2,000;

  — Costs of the action; and

  — Reasonable attorney fees.

- *Class Action*

  In the case of a class action suit against a defendant that is subject to Section 10 of the Act, (i.e., regulated by the federal banking agencies, NCUA or the Farm Credit Administration):

  — Such statutory damages as the court may allow up to the lesser of $500,000 or 1 percent of the liable party's net worth;

  — Costs of the action; and

  — Reasonable attorney fees.

In the case of a class action suit against a defendant that is not subject to Section 10 of the Act, (i.e., not regulated by the federal banking agencies, NCUA, or the Farm Credit Administration):

  — Actual damages (including interest accruing on such damages);

  — Statutory damages up to $1,000 per class member but not to exceed the lesser of (i) $500,000; or (ii) 1 percent of the liable party's gross revenues;

  — Costs of the action; and

  — Reasonable attorney fees (12 USC 4907(a)).

B. Statute of Limitations

A borrower must bring an action under the Act within two years after the borrower discovers the violation (12 USC 4907(b)).

C. Mortgage Servicer Liability Limitation

A servicer shall not be liable for its failure to comply with the requirements of the Act if the servicer's failure to comply is due to the mortgage insurer's or lender's failure to comply with the Act (12 USC 4907(c)).

X. Enforcement

The Act directs the federal banking agencies to enforce the Act under 12 USC 1818 or any other authority conferred upon the agencies by law. Under the Act the agencies shall:

- Notify applicable lenders or servicers of any failure to comply with the Act;
- Require the lender or servicer, as applicable, to correct the borrower's account to reflect the date on which PMI should have been canceled or terminated under the Act; and
- Require the lender or servicer, as applicable, to return unearned PMI premiums to a borrower who paid premiums after the date on which the borrower's obligation to pay PMI premiums ceased under the Act (12 USC 4909).

Homeowners Protection Act Examination Objectives

1. To determine the financial institution's compliance with the Homeowners Protection Act of 1998 (HPA), as amended.
2. To assess the quality of the financial institution's policies and procedures for implementing the HPA.
3. To determine the reliance that can be placed on the financial institution's internal controls and procedures for monitoring the institution's compliance with the HPA.
4. To initiate corrective action when violations of HPA are identified, or when policies or internal controls are deficient.

Examination Procedures

1. Through discussions with management and review of available information, determine if the institution's internal controls are adequate to ensure compliance with the HPA. Consider the following:

   a. Organization charts

   b. Process flowcharts

   c. Policies and procedures

   d. Loan documentation

   e. Checklists

   f. Training

   g. Computer program documentation

2. Review any compliance audit material, including work papers and reports, to determine whether:

   a. The institution's procedures address all applicable provisions of HPA;

   b. Steps are taken to follow-up on previously identified deficiencies;

   c. The procedures used include samples covering all product types and decision centers;

   d. The compliance audit work performed is accurate;

   e. Significant deficiencies and their causes are included in reports to management and/or to the Board of Directors;

   f. Corrective action is taken in a timely and appropriate manner; and

   g. The frequency of compliance review is appropriate.

3. Review sample transactions, disclosure and notification forms, and the financial institution's policies and procedures to ensure the institution provides:

   - Initial Disclosures for (i) fixed rate mortgages, (ii) adjustable rate mortgages, (iii) high risk loans, and (iv) lender paid mortgage insurance;
   - Annual Notices for (i) fixed and adjustable rate mortgages and high risk

loans, and (ii) existing residential mortgages; and

- Notices of (i) cancellation, (ii) termination, (iii) grounds for not canceling PMI, (iv) grounds for not terminating PMI, (v) cancellation date for adjustable rate mortgages, and (vi) termination date for lender paid mortgage insurance.

(Refer to Appendix A for required content of the disclosure and notices.)

4. Using the above sample and bank policies and procedures, determine that borrowers are not charged for any required disclosures or notifications (12 USC 4906).

5. Obtain and review a sample of recent written requests from borrowers to cancel their private mortgage insurance (PMI) on "non-high risk" residential mortgage transactions. Verify that the insurance was cancelled on either (a) the date on which the principal balance of the loan was first scheduled to reach 80 percent of the original value of the property based on the initial amortization schedule (in the case of a fixed rate loan) or amortization schedule then in effect (in the case of an adjustable rate loan) or (b) the date on which the principal balance of the loan actually reached 80 percent of the original value of the property based on actual payments, in accordance with the applicable provisions in 12 USC 4902(a)of HPA (*i.e.*, good payment history, current payments and, if required by the lender, evidence that the value of the mortgaged property did not decline, and certification that the borrower's equity was unencumbered by a subordinate lien) (12 USC 4902(a)).

6. Obtain and review a sample of "non-high risk" PMI residential mortgage transactions where the borrower did not request cancellation. Select loans from the sample that have reached a 78 percent or lower LTV ratio based on the original value of the property and that are not current. Verify that PMI was <u>terminated</u>, based on the initial amortization schedule (in the case of a fixed rate loan) or the amortization schedule then in effect (in the case of an adjustable rate loan) on the date that the principal balance of the loan was first scheduled to reach 78 percent of the original value of the mortgaged property (if the borrower was current) or on the first day of the first month after the date that the borrower became current (12 USC 4902(b)).

7. Obtain a sample of PMI-covered residential mortgage transactions (including high-risk loans, if any) that are at or beyond the midpoint of their amortization period. Determine whether PMI was terminated by the first day of the following month if the loan was current. If the loan was not current at the midpoint, determine that PMI was terminated by the first day of the month following the day the loan became current. If, at the time of the examination, a loan at the midpoint is not current, determine whether the financial institution is monitoring the loan and has systems in place to ensure that PMI is terminated when the borrower becomes current (12 USC 4902(c) and 12 USC 4902(g)(2)).

8. Obtain a sample of any lender defined "high risk" PMI residential mortgage transactions that have a 77 percent or lower LTV based on the original value of the property. Verify that PMI was cancelled, based on the initial amortization schedule (in the case of a fixed rate loan) or the amortization schedule then in effect (in the case of an adjustable rate loan), on the date that the principal balance of the loan was scheduled to reach 77 percent of the original value of the mortgaged property (12 USC 4902(g)(1)(B)).

9. Obtain a sample of loans that have had PMI cancelled or terminated (the samples obtained above can be used). For PMI loans cancelled upon the borrowers' requests, determine that the financial institution did not require any PMI payment(s) beyond 30 days of the borrower satisfying the evidence and certification requirements to cancel PMI (12 USC 4902(e)(1). For the PMI loans that received automatic termination or final termination, determine that the financial institution did not require any PMI payment(s) beyond 30 days of

termination (12 USC 4902(e)(2) and 12 USC 4902(e)(3)).

10. Using the samples in steps 5, 6, and 7, determine if the financial institution returned unearned premiums, if any, to the borrower within 45 days after cancellation or termination (12 USC 4902(f)(1)).

Conclusions

11. Summarize all violations and internal deficiencies.

12. If the violation(s) and internal deficiencies noted above represent(s) a pattern or practice, determine the root cause by identifying weaknesses in internal controls, compliance review, training, management oversight, or other factors.

13. Identify action needed to correct violations and weaknesses in the institution's compliance system, as appropriate.

14. Discuss findings with the institution's management and obtain a commitment for corrective action.

15. Determine if enforcement action is appropriate. If so, contact appropriate agency personnel for guidance. Section 10(c) of the Act contains a provision requiring restitution of unearned PMI premiums.

This appendix provides guidance about the timing and required content of disclosures and notice to be made in connection with the Act.

1. Initial disclosures at consummation for **fixed rate** residential mortgage transactions must include:

   a. A written amortization schedule (§4(a)(1)(A)(i)).

   b. A notice that the borrower may submit a written request to cancel PMI as of the date that, based on the initial amortization schedule, the principal balance is first scheduled to reach 80% of the original value of the mortgaged property, irrespective of the outstanding balance of the mortgage, or such earlier date that, based on actual payments, the principal balance actually reaches 80% of the original value of the mortgaged property and the borrower has a good payment history and has satisfied the lender's requirements that the value of the mortgaged property has not declined and is unencumbered by subordinate liens (§4(a)(1)(A)(ii)(I) and (II)).

   c. The specific date, based on the initial amortization schedule, the loan balance is scheduled to reach 80% of the original value of the mortgaged property (§4(a)(1)(A)(ii)(I)).

   d. A notice that PMI will automatically terminate on the date that, based on the amortization schedule and irrespective of the outstanding balance of the mortgage, the principal balance is first scheduled to reach 78% of the original value of the mortgaged property if the loan is current (§4(a)(1)(A)(ii)(III)).

   e. The specific date the loan balance is scheduled to reach 78% LTV (§4(a)(1)(A)(ii)(III)).

   f. Notice that exemptions to the right to cancel and automatic termination exist for high-risk loans and whether such exemptions apply (§4(a)(1)(A)(ii)(IV)).

2. Initial disclosures at consummation for **adjustable rate** residential mortgage transactions must include a notice that:

   a. The borrower may submit a written request to cancel PMI as of the date that, based on the amortization schedule(s) and irrespective of the outstanding balance of the mortgage, the principal balance is first scheduled to reach 80% of the original value of the mortgaged property or such earlier date that, based on actual payments, the principal balance actually reaches 80% of the original value of the mortgaged property and the borrower has a good payment history and has satisfied the lender requirements that the value of the mortgaged property has not declined and is unencumbered by subordinate liens (§4(a)(1)(B)(i)).

   b. The servicer will notify the borrower when the cancellation date is reached, *i.e.,* when the loan balance represents 80% of the original value of the mortgaged property (§4(a)(1)(B)(I)).

   c. PMI will automatically terminate when the loan balance is first scheduled to reach 78% of the original value of the mortgaged property irrespective of the outstanding balance of the mortgage and the loan is current (§4(a)(1)(B)(ii)).

   d. On the termination date the borrower will be notified of the termination or the fact that PMI will be terminated when the loan is brought current (§4(a)(1)(B)(ii)).

   e. Exemptions to the right to cancel and automatic termination exist for high-risk loans and whether such exemptions apply (§ 4(a)(1)(B)(iii)).

3. Lender has established standards regarding the type of evidence it requires borrowers to provide to demonstrate that the value of the mortgage property has not declined and they are provided when a request for cancellation occurs (§ 3(a)(3)(A)).

4. Lender provides written initial disclosures at consummation for high risk residential mortgage transactions (as defined by the lender or Fannie Mae or Freddie Mac), that PMI will not be required beyond the midpoint of the amortization period of the loan, if the loan is current (4(a)(2)).

5. When the financial institution acts as servicer for residential mortgage transactions, it provides an annual written statement to the borrowers explaining their rights to cancel or terminate PMI and an address and telephone number to contact the servicer to determine whether they may cancel PMI (§4(a)(3)). (Note: This disclosure may be included on RESPA's annual escrow account disclosure or IRS interest payment disclosures.)

6. When the financial institution acts as servicer, it provides an annual written statement to each borrower who entered into a residential mortgage prior to July 29, 1999, that includes:

    a. A statement that PMI may, under certain circumstances, be canceled by the borrower with the consent of the lender or in accordance with applicable state law (§4(b)(1)).

    b. An address and telephone number that the borrower may use to contact the servicer to determine whether the borrower may cancel the PMI (§ 4(b)(2)). (Note: This disclosure may be included on RESPA's annual escrow account disclosure or IRS interest payment disclosure.)

7. When the financial institution acts as servicer for residential mortgage transactions, it provides borrowers written notices within 30 days after the date of cancellation or termination of PMI that the borrower no longer has PMI and that no further PMI payments or related fees are due (§ 5(a)).

8. When the financial institution services residential mortgage transactions, it returns all unearned PMI premiums to the borrower within 45 days of either termination upon the borrower's request or automatic termination under the HPA (§3(e)).

9. When the financial institution acts as servicer for residential mortgage transactions, it provides borrowers written notices of the grounds it relied on (including the results of any appraisal) to deny a borrower's request for PMI cancellation, no later than 30 days after the date the request is received, or the date on which the borrower satisfies any evidence and certification requirements established by the lender, whichever is later (§5(b)(1) and §5(b)(2)(A)).

10. When the financial institution acts as servicer for residential mortgage transactions, it provides borrowers written notices of the grounds it relied on (including the results of any appraisal) for refusing to automatically terminate PMI not later than 30 days after the scheduled termination date (§5(b)(2)(B)).

Note: The scheduled termination date is reached when, based on the initial amortization schedule (in the case of a fixed rate loan) or the amortization schedule(s) (in the case of an adjustable rate loan), the principal balance of the loan is first scheduled to reach 78% of the original value of mortgaged property, assuming the borrower is current on that date or the earliest date thereafter on which the borrower becomes current.

11. When the financial institution acts as a servicer for adjustable rate residential mortgage transactions, the financial institution notifies borrowers that the cancellation date has been reached (§4(a)(1)(B)(i)).

12. When the financial institution acts as a servicer for adjustable rate residential mortgage transactions, the financial institution notifies the borrowers on the termination date that PMI has been cancelled or will be cancelled as soon as the borrower is current on loan payments (§4(a)(1)(B)(ii)).

13. When the financial institution requires "Lender Paid Mortgage Insurance" (LPMI) for residential mortgage transactions, it provides a written notice to a prospective borrower on or before the loan commitment date that includes:

a. A statement that LPMI differs from borrower paid mortgage insurance (BPMI) in that the borrower may not cancel LPMI, while BPMI is subject to cancellation and automatic termination under the HPA (§6(c)(1)(A)).

b. A statement that LPMI usually results in a mortgage with a higher interest rate than BPMI (§6(c)(1)(B)(i)).

c. A statement that LPMI only terminates when the transaction is refinanced, paid off, or otherwise terminated (§6(c)(1)(B)(ii)).

d. A statement that LPMI and BPMI both have benefits and disadvantages and a generic analysis reflecting the differing costs and benefits of each over a 10-year period, assuming prevailing interest and property appreciation rates (§6(c)(1)(C)).

e. A statement that LPMI may be tax-deductible for federal income taxes if the borrower itemizes expenses for that purpose (§6(c)(1)(D)).

14. If the lender requires LPMI for residential mortgage transactions, and the financial institution acts as servicer, does it notify the borrower in writing within 30 days of the termination date that would have applied if it were a BPMI transaction, that the borrower may wish to review financing options that could eliminate the requirement for PMI (§6(c)(2)).

15. When the financial institution prohibits borrower paid fees for the disclosures and notifications required under the HPA (§7).

Introduction

Overview

For consumers, leasing is an alternative to buying either with cash or on credit. A lease is a contract between a lessor (the property owner) and a lessee (the property user) for the use of property subject to stated terms and limitations for a specified period and at a specified payment.

The Consumer Leasing Act (15 USC 1667 et. seq.) (CLA) was passed in 1976 to assure that meaningful and accurate disclosure of lease terms is provided to consumers before entering into a contract. It applies to consumer leases of personal property. With this information, consumers can more easily compare one lease with another, as well as compare the cost of leasing with the cost of buying on credit or the opportunity cost of paying cash. In addition, the CLA puts limits on balloon payments sometimes due at the end of a lease, and regulates advertising.

Originally, the CLA was part of the Truth in Lending Act, and was implemented by Regulation Z. When Regulation Z was revised in 1981, Regulation M was issued, and contained those provisions that govern consumer leases.

Today a relatively small number of banks engage in consumer leasing. The trend seems to be for leasing to be carried out through specialized bank subsidiaries, vehicle finance companies, other finance companies, or directly by retailers.

Key Definitions

The definition of certain terms is necessary to understand the requirements imposed by the CLA. These terms include lease, lessor, lessee, consumer lease, open-end lease, closed-end lease, realized value, residual value, gross capitalized cost, capitalized cost reduction, and adjusted capitalized cost.

Approved – FFIEC

Lessee

A lessee is a natural person who enters in to or is offered a consumer lease.

Lessor

A lessor is a natural person or organization who regularly leases, offers to lease, or arranges for the lease of personal property under a consumer lease. A person who leases or offers to lease more than five times in the preceding or current calendar year meets this definition.

Consumer Lease

A consumer lease is a contract between a lessor and a lessee:

- for the use of personal property by an individual (natural person),
- to be used primarily for personal, family, or household purposes,
- for a period of more than 4 months (week-to-week and month-to-month leases do not meet this criterion, even though they may be extended beyond 4 months), and
- with a total contractual cost of no more than $25,000.

Specifically *excluded* from coverage are leases that are:

- for business, agricultural or made to an organization or government,
- for real property,
- for personal property which are incidental to the lease of real property, subject to certain conditions, and
- for credit sales, as defined in Regulation Z §226.2(a)(16).

A lease meeting all of these criteria is covered by the CLA and the Federal Reserve Board's Regulation M. If any one of these criteria is not met, for example, if the leased property is used primarily for business purposes or if the total contractual cost exceeds $25,000, the CLA and Regulation M do not apply.

Consumer leases fall into one of two categories: closed end and open end. Since the information required to be disclosed to the consumer will vary with the kind of lease, it is important to note the difference between them. However, to properly understand the difference, realized value and residual value must first be defined.

Realized Value

The realized value is the price received by the lessor of the leased property at disposition, the highest offer for disposition of the leased property, or the fair market value of the leased property at the end of the lease term.

Residual Value

The residual value is the value of the leased property at the end of the lease, as estimated or assigned at consummation of the lease by the lessor.

Open-end Lease

An open-end lease is a lease in which the amount owed at the end of the lease term is based on the difference between the residual value of the leased property and its realized value. The consumer may pay all or part of the difference if the realized value is less than the residual value or he may get a refund if the realized value is greater than the residual value at scheduled termination.

Closed-end Lease

A closed-end lease is a lease other than an open-end lease. This type of lease allows the consumer to "walk away" at the end of the contract period, with no further payment obligation – unless the property has been damaged or has sustained abnormal wear and tear.

Gross Capitalized Cost

The gross capitalized cost is the amount agreed upon by the lessor and lessee as the value of the leased property, plus any items that are capitalized or amortized during the lease term. These items may include taxes, insurance, service agreements, and any outstanding prior credit or lease balance.

Capitalized Cost Reduction

This term means the total amount of any rebate, cash payment, net trade-in allowance, and noncash credit that reduces the gross capitalized cost.

Adjusted Capitalized Cost

This is the gross capitalized cost less the capitalized cost reduction and the amount used by the lessor in calculating the base periodic payment.

General Disclosure Requirements

Lessors are required by federal law to provide the consumer with leasing cost information and other disclosures in a format similar to the model disclosure forms found in Appendix A to the regulation. Certain pieces of this information must be kept together and must be segregated from other lease information. All of the information stated must be accurate, clear and conspicuous, and provided in writing in a form that the consumer may keep.[1] Disclosures are to be provided in the following circumstances.

Prior to or Due at Lease Signing

A dated disclosure must be given to the consumer before signing the lease and must contain all of the information detailed in Section 4 of the regulation.

Renegotiations and Extensions

New disclosures also must be provided when a consumer renegotiates, or extends a lease, subject to certain exceptions.

---

[1] Alternatively, the information may be provided electronically, where agreed to by the consumer. The provisions to provide disclosures electronically are currently not mandatory. (7/2002)

Multiple Lessors/Lessees

In the event of multiple lessors, one lessor on behalf of all the lessors may make the required disclosures. If the lease involves more than one lessee, the required disclosures should be given to any lessee who is primarily liable.

Advertising

Advertisements concerning consumer leases must also comply with certain disclosure requirements. All advertisements must be accurate. If a printed ad includes any reference to certain "trigger terms" – the amount of any payment, statement of a capitalized cost reduction (i.e., down payment), or other payment required prior to or at lease signing or delivery, or that no such payment is required – then the ad must also state the following:

- that the transaction is for a lease,
- the total amount due prior to or at lease signing or delivery,
- the number, amounts and due dates or periods of the scheduled payments, and
- a statement of whether or not a security deposit is required.

An advertisement for an open-end lease also must include a statement that extra charges may be imposed at the end of the lease based on the difference between the residual value and the realized value at the end of the lease term.

If lessors give a percentage rate in an advertisement, the rate cannot be more prominent than any of the other required disclosures. They must also include a statement that "this percentage may not measure the overall cost of financing this lease." The lessor cannot use the term "annual percentage rate," "annual lease rate," or any equivalent term.

Some fees (license, registration, taxes, and inspection fees) may vary by state or locality. An advertisement may exclude these third-party fees from the disclosure of a periodic payment or total amount due at lease signing or delivery, provided the ad states that these have been excluded. Otherwise, an ad may include these fees in the periodic payment or total amount due, provided it states that the fees are based on a particular state or locality and indicates that the fees may vary.

Limits on Balloon Payments

In order to limit balloon payments that may be required of the consumer, certain sections of the regulation call for reasonable calculations and estimates. These provisions protect the consumer at early termination of a lease, at the end of the lease term, or in delinquency, default, or late payment status. The provisions limit the lessee's liability at the end of the lease term and set reasonableness standards for wear and use charges, early termination charges, and penalties or fees for delinquency.

Penalties and Liability

Criminal and civil liability provisions of the Truth in Lending Act also apply to the CLA. Actions alleging failure to disclose the required information, or otherwise comply with the CLA, must be brought within one year of the termination of the lease agreement.

Record Retention

Lessors are required to maintain evidence of compliance with the requirements imposed by Regulation M, other than the advertising requirements under Section 7 of the regulation, for a period of not less than two years after the date of the disclosures are required to be made or an action is required to be taken.

Examination Objectives

1. To assess the quality of the institution's compliance management system for the Consumer Leasing Act.
2. To determine that lessees of personal property are given meaningful and accurate disclosures of lease terms.
3. To determine if the limits of liability are clearly indicated to the lessees and correctly enforced by the institution.

4. To ensure that the financial institution provides accurate disclosures of its leasing terms in all advertising.

Examination Procedures

General Disclosure Requirements

A. Review the institution's procedures for providing disclosures to ensure that there are adequate controls and procedures to effect compliance.

B. Review the disclosures provided by the institution.

   1. Are the disclosures clear and conspicuous and provided in writing in a form the consumer may keep? Alternatively, are they provided electronically where agreed to by the consumer? (§213.3(a) & §213.3(a)(5))[2]

   2. Are the disclosures given in a dated statement and in the prescribed format? (§213.3(a)(1))

   3. Is the information required by sections 213.4(b) through (f), (g)(2), (h)(3), (i)(1), (j), and (m)(1) segregated and in a form substantially similar to the model in Appendix A? (§213.3(a)(2))

   4. Are the disclosures timely? (§213.3(a)(3))

   5. If the lease involves more than one lessee, are the disclosures provided to any lessee who is primarily liable? (§213.3(c))

   6. If additional information is provided, is it provided in a manner such that it does not mislead or confuse the lessee? (§213.3(b))

   7. Are all estimates clearly identified and reasonable? (§213.3(d))

   8. Are the disclosures accurate and do the disclosures contain the information required by section 213.4 (a) through (t)? (§213.4)

   9. Are disclosures given to lessees when they "renegotiate" or "extend" their leases? (§213.5)

Lessee Liability

A. Review the lease estimates and calculations to ensure that there is not any unreasonable balloon payment expected of the lessee in the following circumstances:

   - at early termination,

     1. Does the lessor disclose the conditions under which the lease may be terminated early and the amount and method of determining the amount of any early termination charges? (§213.4(g)(1)

     2. Are any early termination charges reasonable? (§213.4(g)(1), (q))

   - at end of lease term, for wear and use,

     1. If the lessor sets standards for wear and use of the leased vehicle are the amounts or method of determining any charge for excess mileage disclosed? (§213.4(h)(3))

     2. Are standards for wear and use reasonable? (§213.4(h)(2))

   - at end of lease term (for open-end leases), and

     1. Does the lessor disclose the limitations on the lessee's liabilities at the end of the lease term? (§213.4(m)(2))

[2] The provisions to provide disclosures electronically are currently not mandatory. (7/2002)

2. Are the lessee and lessor permitted to make a mutually agreeable final adjustment regarding excess liability? (§213.4(m)(3))

- in delinquency, default or late payment.

1. Does the lessor disclose penalties or other charges for delinquency, default or late payments? (§213.4(q))

2. Are the penalties or other charges reasonable? (§213.4(q))

Advertising

A. Review advertising policies and procedures used by the institution to ensure that there are adequate controls and procedures to effect compliance.

B. Review a sample of the institution's advertisements.

1. Do the advertisements advertise terms that are usually and customarily available? (§213.7(a))

2. Are the disclosures contained in the advertisements clear and conspicuous? (§213.7(b))

3. Do catalog/multiple page advertisements comply with the page reference requirements? (§213.7(c))

4. When triggering terms are used, do the advertisements contain the additional required information? (§213.7(d))

5. Do merchandise tags which use triggering terms refer to a sign or display that contains the additional required disclosures? (§213.7(e))

6. If television or radio advertisements use triggering terms, if they do not contain the additional terms required by §7(d)(2), do they use alternative disclosure methods (direct consumers to a toll free number or written advertisement)? (§213.7(f))

Miscellaneous

1. Are records and other evidence of compliance retained for a period of no less than two years? (§213.8)

References

Laws

15 USC 1667	Consumer Leasing Act of 1976 Et. Seq.

Regulations

12 CFR 213	Federal Reserve System Regulation M

THIS PAGE INTENTIONALLY LEFT BLANK

Instructions for Completing Form:

This checklist is an aid to analysis of the institution's compliance program for consumer leasing operations. It is not a mandatory workpaper. It should be applied to the extent warranted by your risk-based scoping judgment. The columns correspond to the OTS Self-Assessment Guide summary of comprehensive compliance program components: Systems, Monitoring, Assessment, Accountability, Response, Training.

S	M	A	A	R	T	
						1. Does the Bank engage in consumer leasing or purchase consumer leases from lessors? (§213.2(h))
						(If no, there is no need to do further work on Consumer Leasing. If yes, complete the following checklist, answering yes (Y) or no (N) for each item.)
						2. Are the disclosures made prior to consummation of the lease, that is, at the time a binding order is made or the lease is signed? (§213.3(a)(3))
						3. Are the disclosures clear and conspicuous and provided in writing in a form the consumer may keep? (§213.3(a))
						4. Are the disclosures given in a dated statement and (i) made either in a separate statement that identifies the consumer lease transaction, (ii) in the contract or (iii) other document evidencing the lease? (§213.3(a)(1))
						5. Is the information required by sections 213.4(b) through (f), (g)(2), (h)(3), (i)(1), (j), and (m)(1) segregated and in a form substantially similar to the model in Appendix A? (§213.3(a)(2))
						6. If the lease involves more than one lessee, are the disclosures provided to any lessee who is primarily liable? (§213.3 (c))
						7. Alternatively, are they provided electronically where agreed to by the consumer? (§213.3(a)(5))[3]
						8. If additional information is provided, is it provided in a manner such that it does not mislead or confuse the lessee? (§213.3(b))
						9. Are disclosures provided to at least one lessee where there are multiple lessees and by at least one lessor when there are multiple lessors? (§213.3(c))
						10. Are all estimates clearly identified and reasonable? (§213.3(d))
						11. Are the following disclosures made in the lease?
						A. Description of property (§213.4(a))
						B. Amount due at lease signing or delivery (§213.4(b))
						C. Payment schedule and total amount of periodic payments (§213.4(c))

[3] The provisions to provide disclosures electronically are currently not mandatory. (7/2002)

S	M	A	A	R	T	
						D. Other charges (§213.4(d))
						E. Total of payments (§213.4(e))
						F. Regarding payment calculations:
						i. Gross capitalized cost (§213.4(f)(1))
						ii. Capitalized cost reduction (§213.4(f)(2))
						iii. Adjusted capitalized cost (§213.4(f)(3))
						iv. Residual value (§213.4(f)(4))
						v. Depreciation and any amortized amounts (§213.4(f)(5))
						vi. Rent charge (§213.4(f)(6))
						vii. Total of base periodic payments (§213.4(f)(7))
						viii. Lease payments (§213.4(f)(8))
						ix. Basic periodic payment (§213.4(f)(9))
						x. Itemization of other charges (§213.4(f) (10))
						xi. Total periodic payment (§213.4(f) (11))
						G. Regarding early termination:
						i. Conditions under which the lessee or lessor may terminate the lease prior to the end of the lease term (§213.4(g)(1))
						ii. The amount or description of the method for determining the amount of any penalty or other charges for early termination (§213.4(g)(1))
						iii. In a form substantially similar to the sample (§213.4(g)(2))
						H. Regarding notice of wear and use
						i. A statement specifying whether the lessor or the lessee is responsible for maintaining or servicing the leased property, with a description of the responsibility (§213.4(h)(1))
						ii. A statement of the lessor's standards for wear and use, which must be reasonable (§213.4(h)(2))
						iii. In a form substantially similar to the sample (§213.4(h)(3))
						I. Purchase option (§213.4(i))
						J. Statement referencing other nonsegregated disclosures (§213.4(j))
						K. Liability between residual and realized values (§213.4(k))

S	M	A	A	R	T	
						L. Right of appraisal (§213.4(l))
						M. For open-end leases,
						i. the rent and other charges paid by lessee (§213.4(m)(1))
						ii. liability at end of lease term based on residual value and any excess liability (§213.4 (m) and (m)(2))
						iii. mutually agreeable final adjustment (§213.4(m)(3))
						N. Fees and taxes (§213.4(n))
						O. Regarding insurance,
						i. Are the types and amounts of insurance that the lessee is required to have disclosed? (§213.4(o))
						ii. If the lessor provides insurance, are the types, amounts, and cost also disclosed? (§213.4(o)(1))
						P. Warranties or guarantees (§213.4 (p))
						Q. Penalties and other charges for late payments, delinquency, or default (§213.4(q))
						R. Security interest other than a security deposit (§213.4(r))
						S. Regarding any information on rate:
						i. Does the lessor use the term “annual percentage rate,” “annual lease rate,” or any equivalent term in the lease disclosure? (§213.4(s))
						ii. If so, does a statement that “this percentage may not measure the overall cost of financing this lease” accompany the rate? (§213.4(s))
						12. Are disclosures given to lessees when they “renegotiate” or “extend” their leases? (§213.5)
						13. Does the bank advertise its leasing program? If so,
						A. Do the advertisements advertise terms that are usually and customarily available? (§213.7(a))
						B. Are the advertisements clear and conspicuous? (§213.7(b))
						i. Are any affirmative or negative references to a charge that is part of the disclosure required under paragraph (d)(2)(ii) less prominent than the disclosure (except for the statement of a periodic payment? (§213.7(b)(1))

S	M	A	A	R	T	
						ii. Are the advertisements of lease rates less prominent than any disclosure required by section 4 (except the notice of the limitations on rate)? (§213.7(b)(2))
						C. Do catalog and multiple page advertisements comply with the page reference requirements? (§213.7(c))
						D. If any triggering terms are used, are all the following disclosures made (§213.7(d)(2))
						i. That the transaction advertised is a lease
						ii. The total amount due prior to or at consummation or by delivery, if delivery occurs after consummation
						iii. The number, amounts, and due dates or periods of scheduled payments under the lease
						iv. A statement of whether or not a security deposit is required
						v. A statement that an extra charge may be imposed at the end of the lease term where the lessee's liability (if any) is based on the difference between the residual value of the leased property and its realized value at the end of the lease term.
						14. Do merchandise tags which use triggering terms refer to a sign or display that contains the additional required disclosures. (§213.7(e))
						15. Do television or radio advertisements that do not contain the additional information required by section 4(d)(2) direct consumers to a toll-free number or written advertisement for additional information when triggering terms are used? (§213.7)
						A. Is the toll free number listed along with a reference that the number may be used by consumer to obtain the information? (§213.7(f)(1)(i))
						B. Does the written advertisement that is in general circulation in the community served by the station including the name and date of the publication, and is published beginning at least three days before and ending at least ten days after broadcast? (§213.7(f)(1)(ii))
						C. Has the toll-free telephone number been available for no fewer than ten days, beginning on the date of broadcast? (§213.7(f)(2)(i))
						D. Does the lessor provide the information required by paragraph (d)(2) over the toll-free number, orally or in writing upon request? (§213.7(f)(2)(ii))
						16. Are records and other evidence of compliance retained for a period of no less than two (2) years as required by the CLA? (§213.8)

Introduction

The Electronic Fund Transfer Act (EFTA) (15 USC 1693 et seq.) was enacted on November 10, 1978, and is implemented by Federal Reserve Regulation E (12 CFR 205). The EFTA provides a basic framework establishing the rights, liabilities and responsibilities of consumers who use electronic fund transfer (EFT) services and financial institutions that offer these services. Its primary objective is the protection of individual consumers in their dealings with these services. Examples of EFTs are automated teller machine (ATM) transfers, telephone bill-payment transfers, point-of-sale transfers, preauthorized transfers from or to a consumer's account (i.e. direct deposits or withdrawals of funds), and transfers resulting from debit card transactions, whether or not initiated through an electronic terminal.

As defined in the EFTA, and Section 205.3(b) of Regulation E, the term “electronic fund transfer,” refers to a transaction initiated through an electronic terminal, telephone, computer, or magnetic tape that orders, instructs, or authorizes a financial institution to either credit or debit a consumer's asset account. The term electronic terminal includes point-of-sale terminals, automated teller machines, and cash dispensing machines. The consumer is usually issued a card or a code (known as an access device), or both, that may be used to initiate such transfers.

Exemptions--Section 205.3(c)

The following types of electronic fund transfers are not covered by the EFTA:

Transfers originated by check.

- Check guarantee or authorization services that do not directly result in a debit or credit to a consumer's account.

Approved-FFIEC

- Any transfer of funds for a consumer within a system that is used primarily to transfer funds between financial institutions or businesses. An example is a wire transfer of funds for a consumer through the Fedwire or other similar network.

- Any transfer of funds which has as its primary purpose the purchase or sale of securities or commodities regulated by the Securities and Exchange Commission (SEC) or the Commodity Futures Trading Commission (CFTC), purchased or sold through a broker-dealer regulated by the SEC or through a future commission merchant regulated by the CFTC, or held in book-entry form by a Federal Reserve Bank or federal agency.

- Intra-institutional automatic transfers under an agreement between a consumer and a financial institution:
  - between the consumer's account and the institution itself (except that §205.10(e) regarding compulsory use and sections 915 and 916 of the EFTA regarding civil and criminal liability are applicable);
  - between two accounts of the consumer within the institution; or
  - from the consumer's account to a family member's account within the institution.

- Transfers initiated by telephone between a consumer and a financial institution making the transfer not under a written plan contemplating periodic or recurring transfers.

- Preauthorized transfers to or from an account held at a financial institution with assets of $100 million or less on the preceding December 31 (except that §205.10(e) and sections 915 and 916 of the EFTA are applicable).

Special Requirements--Section 205.4

Section 205.4(a) requires that disclosures be clear and readily understandable, in writing, and in a form the consumer may keep.

Section 205.4(b) permits, at the institution's option, the disclosure of additional information, and allows disclosures required by other laws (for example, Truth in Lending disclosures) to be combined with Regulation E disclosures.

Section 205.4(d)(1) permits the institution holding an account to combine required disclosures into a single statement if a consumer holds two or more accounts at an institution. Thus, a single periodic statement or error resolution notice is sufficient for multiple accounts. In order to comply with Section 205.4(d)(2), an institution need provide only one set of disclosures for a joint account.

Section 205.4(e) permits two or more institutions that jointly provide EFT services to contract among themselves to fulfill the requirements that the regulation imposes on any or all of them. When making disclosures under Section 205.7 (Initial Disclosures) and Section 205.8 (Change in Terms; Error Resolution Notice), an institution in a shared system need only make those required disclosures that are within its knowledge and the purview of its relationship with the consumer for whom it holds an account.

Issuance of Access Devices--Section 205.5

Section 205.5 governs the issuance of access devices. For access devices that also constitute credit cards, the issuance rules of Regulation E apply if the only credit feature is a preexisting credit line attached to the asset account to cover overdrafts (or to maintain a specified minimum balance). Regulation Z rules apply if there is another type of credit feature, for example, one permitting direct extensions of credit that do not involve the asset account. In general, an institution may issue an access device to a consumer only if:

- it is requested (in writing or orally) or applied for; or,
- it is a renewal of, or in substitution for, an accepted access device (as defined in §205.2(a)).

An institution may issue an access device to each account holder (on a joint account) for whom the requesting holder specifically requests an access device.

An institution may issue an unsolicited access device only if the following four conditions are satisfied:

- the access device is not validated, meaning, it cannot be used to initiate an EFT;
- the access device is accompanied by the explanation that it is not validated and of how it may be disposed of if the consumer does not wish to validate it;
- the access device is accompanied by a complete disclosure, in accordance with §205.7, of the consumer's rights and liabilities that will apply if the access device is validated; and
- the access device is validated only upon oral or written request from the consumer and after a verification of the consumer's identity by some reasonable means.

These conditions are intended to reduce the potential for unauthorized use if the access device is lost or stolen en route to the consumer and to ensure that the consumer is informed of account terms and conditions before deciding whether to accept the responsibilities of having an access device.

Liability of Consumers for Unauthorized Transfers--Section 205.6

A consumer may be held liable for unauthorized EFTs (as defined in §205.2(m)) only if:

- the institution has provided the following written disclosures to the consumer:
- a summary of the consumer's liability for unauthorized EFTs;
- the telephone number and address for reporting that an unauthorized EFT has been or may be made; and
- the institution's business days; and
- the access device is accepted (as defined in §205.2(a)); and
- the institution has provided a means to identify the consumer to whom the access device was issued.

Consumer Liability for Unauthorized Transfers:

Electronic Fund Transfer Act - Regulation E (12 CFR 205.6)

- Event
- Timing of consumer notification of bank
- Maximum liability

Loss or theft of access device

- Within two business days after learning of loss or theft.
- Lesser of $50, OR total amount of unauthorized transfers. Loss or theft of access device
- More than two business days after learning of loss or theft.

Lesser of $500, OR the sum of:

- $50 or the total amount of unauthorized transfers occurring in the first two business days, whichever is less, AND
- the amount of unauthorized transfers occurring after two business days and before notice to the institution.

Loss or theft of access device

- More than 60 calendar days after transmittal of statement showing first unauthorized transfer made with access device.
- For transfers occurring within the 60-day period, the lesser of $500, OR the sum of:
- lesser of $50 or the amount of unauthorized transfers in first two business days, AND
- the amount of unauthorized transfers occurring after two business days.

For transfers occurring after the 60-day period, unlimited liability (until the institution is notified).

- Unauthorized transfer(s) appearing on periodic statement (no use of access device)
- Within 60 calendar days after transmittal of the periodic statement.
- No liability.
- Unauthorized transfer(s) appearing on periodic statement (no use of access device)More than 60 calendar days after transmittal of the periodic statement showing first unauthorized transfer.
- Unlimited liability for unauthorized transfers occurring 60 calendar days after the periodic statement and before notice to the institution.

Section 205.6(b)(4) states that if a consumer's delay in notifying an institution was due to extenuating circumstances, such as extended travel or hospitalization, the time periods for notification specified above shall be extended to a reasonable time. Also, Section 205.6(b)(6) provides that if any lesser liability limits are imposed by applicable state law or by an agreement with the consumer, those limits shall apply instead of the limits set by this section.

These liability provisions apply to unauthorized EFTs initiated by a combined access device-credit card, including an access device with overdraft privileges. These provisions do not apply to the unauthorized use of a combined access device-credit card when no EFTs are involved (for example, when the card is used to draw cash advances directly from a credit line).

Notice to an institution about unauthorized use is considered given when the consumer takes whatever steps are reasonably necessary to provide the institution with the pertinent information, whether or not a particular employee actually receives the information. At the consumer's option, notice may be given in person, by telephone, or in writing. Notice in writing is considered given at the time the consumer deposits the notice in the mail or delivers the notice for transmission by any other usual means to the institution. Notice may also be considered given when the institution becomes aware of circumstances that indicate an unauthorized transfer has been or may be made.

Initial Disclosure of Terms and Conditions--Section 205.7

The institution must provide the consumer with the following disclosures, in written, retainable form, before the first EFT is made or at the time the consumer contracts for an EFT service:

- a summary of the consumer's liability under Section 205.6 or other applicable law or agreement;
- the telephone number and address of the person or office to notify in the event of loss or unauthorized use;
- the institution's business days;
- types of EFTs the consumer may make and any limitations on the frequency and dollar amount of transfers (the details of the limitations may be withheld if the security of the system requires confidentiality);
- any charges for EFTs or for the right to make EFTs;
- a summary of the consumer's right to receive documentation of EFTs as provided in Sections 205.9, 205.10(a) and 205.10(d);
- a summary of the consumer's right to stop payment of a preauthorized EFT and the procedure for initiating a stop-payment order;
- a summary of the institution's liability for its failure to make or stop certain transfers;
- the circumstances under which the institution in the ordinary course of business will disclose information concerning the consumer's account to third parties;
- a notice which is substantially similar to the notice in Appendix A of 12 CFR 205 concerning error resolution procedures and the consumer's rights under them.

Change in Terms; Error Resolution Notice--Section 205.8

If a change in terms is contemplated, the institution must mail or deliver a written notice to the consumer at least 21 days before the effective date of any change in a term or condition required to be disclosed under §205.7(b) if the change would result in any of the following:

- increased fees or charges;
- increased liability for the consumer;
- fewer types of available EFTs; or
- stricter limitations on the frequency or dollar amounts of transfers.

If an immediate change in terms or conditions is necessary to maintain or restore the security of an EFT system or account, prior notice need not be given by the institution. However, if such a change is to be permanent, the institution must provide written notice of the change to the consumer on or with the next regularly scheduled periodic statement or within 30 days, unless disclosures would jeopardize the security of the system or account.

For accounts to or from which EFTs can be made, an error resolution notice (as set forth in 12 CFR 205 Appendix A - Model Form A-3) must be mailed or delivered to the consumer at least once each calendar year. Alternatively, an abbreviated error resolution notice substantially similar to the notice set out in Appendix A (Model Form A-3) may be included with each periodic statement.

Documentation of Transfers--Section 205.9

Receipts given at electronic terminals are required to provide specific documentation. The receipt must be made available at the time the transfer is initiated at an electronic terminal and must include, as applicable:

- amount of the transfer--a charge for making the transfer may be included in the amount if the terminal is owned or operated by an entity other than the institution that holds the consumer's account, provided the charge is disclosed on the receipt and on a sign posted on or at the terminal;
- date--the date the consumer initiates the transfer;

- type of transfer and type of account--descriptions such as "withdrawal from checking" or "transfer from savings to checking" are appropriate. This is true even if the accounts are only similar in function to a checking account (such as a share draft or NOW account) or a savings account (such as a share account). If the access device used can only access one account, the type-of-account requirement does not apply.

- a number or code identifying the consumer's account(s), or the access device used to initiate the transfer. The number and code need not exceed four digits or letters to comply;

- location of the terminal--the location where the transfer is initiated may be given in the form of a code or terminal number;

- the name of any third party to or from whom funds are transferred--a code may be used to identify the party, but only if the code is explained on the receipt. This requirement does not apply if the name of the party is provided by the consumer in a manner the terminal cannot duplicate on the receipt, such as on a payment stub.

An electronic terminal receipt need not be provided for electronic transfers initiated by home banking equipment.

Section 205.9(b) provides the documentation requirements for periodic statements. Periodic statements must be sent monthly if an EFT has occurred, or quarterly if no EFT has occurred. For each EFT made during the cycle, the statement must include, as applicable:

- amount of the transfer--if a charge was imposed at an electronic terminal by the owner or operator of the terminal, that charge may be included in the amount;

- date the transfer was posted to the account;

- type of transfer(s) and type of account(s) to or from which funds were transferred;

- for each transfer (except deposits to the consumer's account) initiated at an electronic terminal, the location that appears on the receipt. If an identification code was used, that identification code must be given with one of the following descriptions:

  — street address of the terminal and the city, state, or foreign country;

  — a generally accepted name for the location of the terminal (such as an airport, shopping center, or branch of an institution), and the city, state, or foreign country;

  — name of the entity (except the institution providing the statement) at whose place of business the terminal is located, such as a store, and the city, state, or foreign country;

- the name of any third party payee or payor;

- the account number(s);

- the total amount of any fees and charges, other than a finance charge as defined by Regulation Z, assessed during the period for making EFTs, the right to make EFTs, or for account maintenance;

- the balance in the account at the beginning and close of the statement period;

- the address and telephone number to be used by the consumer for inquiries or notice of errors. If the institution has elected to send the abbreviated error notice with every periodic statement, the address and telephone number may appear on that document;

- if the institution has provided a telephone number which the consumer can use to find out whether or not a preauthorized transfer has taken place, that telephone number.

Where a consumer's passbook may not be accessed by an EFT other than preauthorized transfers to the account, a periodic statement need not be sent, provided that the financial institution updates the consumer's passbook or provides the required information on a separate document at the consumer's request. To update the passbook, the amount and date of each EFT made since the passbook was last presented must be listed.

If the consumer has a non-passbook account that may not be accessed by an EFT other than preauthorized transfers to the account, a periodic statement must be sent at least quarterly.

Preauthorized Transfers--Section 205.10

Section 205.10(a)(1) covers preauthorized transfers to a consumer's account. This section requires that, when an account is scheduled to be credited by a preauthorized EFT from the same payor at least once every 60 days, some form of notice must be provided to the consumer so that the consumer can find out whether or not the transfer occurred.

The notice requirement will be satisfied by the payor's providing notification to the consumer that the transfer has been initiated. If the payor does not provide notice to the consumer, the burden is on the institution to adopt one of the three alternative procedures for supplying the notice.

1. The institution can choose to give the consumer oral or written notice every time a preauthorized transfer occurs or fails to occur.

2. The second alternative is that the institution can notify the consumer within 2 business days after the preauthorized transfer occurred.

3. As a third alternative, the institution can establish a telephone line that the consumer may call to find out whether a preauthorized transfer has occurred. The telephone number must be disclosed on the initial disclosures and on each periodic statement. The telephone line must be “readily available” so that consumers calling to inquire about transfers are able to have their calls answered with little difficulty. In addition, it is expected that these telephone notice systems will be designed so that consumers do not have to bear the cost of long-distance calls within the institution's service area to inquire about their transfers. Therefore, a multi-branch institution with a statewide customer base could provide consumers with either a toll-free number or designate local numbers for different communities within the state.

Section 205.10(a)(3) requires an institution that receives a preauthorized transfer to credit the consumer's account as of the day the funds are received.

Section 205.10(b) states that preauthorized transfers from a consumer's account may only be authorized by the consumer in writing, signed or similarly authenticated by the consumer. Written authorizations include electronic authorizations (such as via a home banking system) which are similarly authenticated by the consumer as long as there are means to identify the consumer (such as a security code) and to make available a paper copy of the authorization (automatically or upon request). In all cases, the party that obtains the authorization from the consumer must provide a copy to the consumer.

Section 205.10(c) gives the consumer the right to stop payment of a preauthorized transfer from an account. The consumer must notify the institution orally or in writing at any time up to three business days before the scheduled date of the transfer. The institution may require written confirmation of an oral stop payment order to be made within 14 days of the consumer's oral notification. However, the institution may only impose the written confirmation requirement if, at the time the consumer made the oral stop payment order, the institution informed the consumer that written confirmation is required and told the consumer the address to which the confirmation should be sent. If the consumer fails to provide the written confirmation, the oral stop payment order ceases to be binding after 14 days.

Section 205.10(d) deals with a preauthorized transfer from a consumer's account that varies in amount from the previous transfer under the same authorization or the preauthorized amount. In the event such a transfer is scheduled to occur, the institution or designated payee must mail or deliver to the consumer a written notice, at least 10 days before the scheduled transfer date, containing the amount and scheduled date of the transfer. However, if the institution or the payee informs the consumer of the right to receive advance notice of varying transfers, the consumer may elect to receive notice only when the amount varies from the most recent transfer by more than an agreed upon amount or when it falls outside a specified range.

Section 205.10(e) prohibits the institution from conditioning an extension of credit on the condition of repayment by means of preauthorized EFT, except for credit extended under an overdraft credit plan or extended to maintain a specified minimum balance in the consumer's account. The section also prohibits anyone from requiring the establishment of an account for receipt of EFTs with a particular institution either as a condition of employment or the receipt of a government benefit.

Procedures for Resolving Errors--Section 205.11

Section 205.11 sets forth the definition of "error", the steps the consumer must take when alleging an error in order to receive the protection of the EFTA and Regulation E, and the procedures that an institution must follow to resolve an alleged error.

Section 205.11(a), defines the term "error" to mean:

- an unauthorized EFT;
- an incorrect EFT to or from the consumer's account;
- the omission from a periodic statement of an EFT to or from the consumer's account that should have been included;
- a computational or bookkeeping error made by the institution relating to an EFT;
- the consumer's receipt of an incorrect amount of money from an electronic terminal;
- an EFT not identified in accordance with the requirements of Sections 205.9 or 205.10(a); or
- a consumer's request for any documentation required by Sections 205.9 or 205.10(a), or for additional information or clarification concerning an EFT.

The term "error" does not include a routine inquiry about the balance in the consumer's account or a request for duplicate copies of documentation or other information that is made only for tax or other record-keeping purposes.

A notice of error is an oral or written notice indicating why the consumer believes an error exists that is received by the institution not later than 60 days after a periodic statement or other documentation which first reflects the alleged error is provided. The notice of error must also enable the institution to identify the consumer's name and account number, and, to the extent possible, the type, date and amount of the error. An institution may require a consumer to give written confirmation of an error within 10 business days of giving oral notice. The institution shall provide the address where confirmation must be sent. If written confirmation is not received, the institution must still comply with the error resolution procedures, but it need not provisionally credit the account if it takes longer than 10 business days to resolve the matter.

After receiving a notice of error, the institution is required to promptly investigate the alleged error and transmit the results to the consumer within 10 business days. As an alternative to this, the institution may take up 45 calendar days to complete its investigation provided it:

- provisionally credits the funds (including interest, where applicable) to the consumer's account within the 10 business-day period;
- advises the consumer within 2 business days of the provisional crediting; and
- gives the consumer full use of the funds during the investigation.

An institution need not provisionally credit the account if:

1. the consumer fails to provide the required written confirmation of an oral notice of an error; or
2. the notice of error involves an account subject to the margin requirements or other aspects of Regulation T (12 CFR 220).

If, after investigating the alleged error, the institution determines that an error has occurred, it shall promptly (within one business day after such determination) correct the error, including the crediting of interest (if applicable). The institution shall provide within three business days of the completed investigation an oral or written report of the correction to the consumer and, as applicable, notify the consumer that the provisional credit has been made final.

If the institution determines that no error occurred or that an error occurred in a different manner or amount from that described by the consumer, the institution must mail or deliver a written explanation of its findings within three business days after concluding its investigation. The explanation must include a notice of the consumer's rights to request the documents upon which the institution relied in making its determination.

Upon debiting a provisionally credited amount, the institution shall notify the consumer of the date and amount of the debit, of the fact that the institution will honor (without charge) checks, drafts or similar paper instruments payable to third parties and preauthorized debits for five business days after transmittal of the notice. The institution need honor only items that it would have paid if the provisionally credited funds had not been debited. Upon request from the consumer, the institution must promptly mail or deliver to the consumer copies of documents upon which it relied in making its determination.

If a notice of an error involves an EFT that was not initiated within a state (as defined in

§205.2(l)) or involves an EFT resulting from a point-of-sale debit card transaction, the applicable time periods are 20 business days (instead of 10) and 90 business days (instead of 45).

Relation to State Law--Section 205.12

Section 205.12 sets forth the relationship between the EFTA and the Truth in Lending Act (TILA) with regard to the issuance of access devices, consumer liability, and investigation of errors. This section also provides standards for determination and procedures for applying for state exemptions.

The EFTA governs:

- the issuance of debit cards and other access devices with EFT capabilities;
- the addition of EFT features to credit cards; and
- the issuance of access devices whose only credit feature is a pre-existing agreement to extend credit to cover account overdrafts or to maintain a minimum account balance.

The TILA governs:

- the issuance of credit cards as defined in Regulation Z, 12 CFR 226.2(a)(15);
- the addition of a credit feature to a debit card or other access device; and
- the issuance of dual debit/credit cards except for access devices whose only credit feature is a pre-existing agreement to cover account overdrafts or to maintain a minimum account balance.

The EFTA and Regulation E preempt inconsistent state laws, but only to the extent of the inconsistency. The Federal Reserve Board is given the authority to determine whether or not a state law is inconsistent. An institution, state, or other interested party may request the Board to make such a determination. A state law will not be deemed inconsistent if it is more protective of the consumer than the EFTA or Regulation E. Upon application, the Board has the authority to exempt any state from the requirements of the Act or the regulation for any class of EFTs within a state with the exception of the civil liability provision.

Administrative Enforcement--Section 205.13 and Section 917

Section 917 specifically directs the federal financial institution supervisory agencies to enforce compliance with the provisions of the EFTA.

Institutions are required to maintain evidence of compliance with the EFTA and Regulation E for a period of not less than two years. This period may be extended by the agency supervising the institution. It may also be extended if the institution is subject to an action filed under Sections 910, 915 or 916(a) of the EFTA which generally apply to the institution's liability under the EFTA and Regulation E. Persons subject to the EFTA who have actual notice that they are being investigated or subject to an enforcement proceeding must retain records until disposition of the proceeding. Records may be stored on microfiche, microfilm, magnetic tape, or in any other manner capable of accurately retaining and reproducing the information.

Services Offered by Provider Not Holding Consumer's Account--Section 205.14

This section applies in limited situations where the institution provides EFT services and issues access devices, but does not hold the asset account and no agreement exists between the service provider and the account at the institution. The transfers initiated by the service-providing institution are often cleared through an automated clearinghouse (ACH). This section divides the responsibilities between the two institutions with the greater responsibility placed on the service-providing institution.

The responsibilities of the service-providing institution are set forth in Section 205.14(b)(1) and (2). The duties of the account-holding institution are found in Section 205.14(c)(1) and (2).

Electronic Fund Transfer of Government Benefits--Section 205.15

Section 205.15 contains the rules that apply to electronic benefit transfer (EBT) programs. It provides modified rules on the issuance of access devices, periodic statements, initial disclosures, liability for unauthorized use, and error resolution notices.

Section 205.15(a) provides that a government agency is deemed to be a financial institution and subject to the regulation, if it directly or indirectly issues an access device to a consumer for use in initiating an EFT of government benefits from an account. Needs-tested EBT programs established under state or local law or administered by a state or local agency (such as food stamp programs) are exempt. Federally administered EBT programs and state and local employment-related EBT programs (such as retirement and unemployment benefits) remain covered by Regulation E. The term account means an account established by a government agency for distributing government benefits to a consumer electronically, such as through ATMs or point-of-sale terminals.

A government agency need not furnish the periodic statement required by §205.9(b) if the agency makes available to the consumer:

- the consumer's account balance through a readily available telephone line and at a terminal; and
- a written history of the consumer's account transactions that covers at least 60 days preceding the date of the consumer's oral or written request.

A government agency that does not furnish periodic statements in accordance with the above shall be subject to special modified requirements as set forth in §205.15(d).

Suspension of Obligations--Section 912;

Waiver of Rights--Section 914

Section 912 suspends, under certain conditions, a consumer's obligation to another person in the event a malfunction in an EFT system prevents payment to the person, until the malfunction is corrected and the EFT may be completed.

Section 914 states that no writing or other agreement between a consumer and any other person may contain any provision that constitutes a waiver of any right conferred or cause of action created by the EFTA. However, Section 914 does not prohibit any writing or other agreement that grants a consumer greater protection or a more extensive right or remedy than that provided by the EFTA or a waiver agreement to settle a dispute or action.

Liability of Financial Institutions--Section 910;

Civil Liability--Section 915;

Criminal Liability--Section 916

Section 910 provides that institutions subject to the EFTA are liable for all damages proximately caused by failure to make an EFT in accordance with the terms and conditions of an account, in a timely manner, or in the correct amount, when properly instructed to do so by a consumer. However, Section 910 also sets forth certain exceptions when an institution would not be liable for failing to make an EFT. Section 910 also provides that institutions are liable in certain circumstances for failure to make an electronic fund transfer due to insufficient funds and failure to stop payment of preauthorized debits.

A financial institution may also be liable for civil damages if it fails to comply with the EFTA. The civil liability provisions are found in §915. The damages an institution would have to pay in a successful individual action are actual damages and statutory damages between $100 and $1,000, as determined by the court. In a successful class action suit, the institution would have to pay actual damages and statutory damages up to the lesser of $500,000 or 1% of the institution's net worth. In both successful individual and class actions, court costs and a reasonable attorney's fee would be recovered by the consumer.

The institution generally will not be liable for violations caused by unintentional bona fide errors that occurred despite the maintenance of procedures reasonably adopted to avoid such errors. Also, the institution will not be liable if it acted in accordance with an official interpretation issued by the Board of Governors of the Federal Reserve System or its authorized staff. An institution cannot be held liable for improper disclosure if it utilized in an appropriate manner a model clause approved by the Board of Governors. Further, an institution can avoid liability by notifying the consumer of a violation, taking corrective action, including adjustment to the consumer's account and payment of appropriate damages prior to a court case.

Section 916 sets forth provisions for criminal liability. Penalties under these provisions run from a $5,000 fine or imprisonment of not more than one year, or both, for knowing and willful failures to comply with the EFTA, up to a $10,000 fine or imprisonment of not more than ten years, or both, for the fraudulent use of a debit card.

Examination Objectives

1. To determine that the institution has procedures in place to ensure compliance with the Electronic Fund Transfer Act.

2. To determine that the institution is in compliance with the provisions of the Electronic Fund Transfer Act.

Examination Procedures

1. Determine if access devices contain credit privileges in order to evaluate compliance with applicable portions of Truth in Lending. [§205.12(a)]

2. Obtain and review copies of the following:

   a. Disclosure forms.

   b. Account agreements.

   c. Procedural manuals and written policies.

   d. Merchant agreements.

   e. Automated teller machine receipts and periodic statements.

   f. Error resolution statements/files.

   g. Form letters used in case of errors or questions concerning an account.

   h. Any agreements with third parties allocating compliance responsibilities.

   i. Consumer complaint file.

3. Test for compliance with written policies and internal controls while performing the examination procedures.

4. For each type of EFT service provided, review items given to customers at the time an account is opened, or prior to the first EFT transaction, to determine that all required disclosures are furnished. [§205.7]

5. If the institution has changed the terms or conditions since the last examination that required a written notice to the customer, determine that the proper notice was provided in a timely manner. [§205.8(a)]

6. Review a sample of periodic statements to determine that they contain sufficient information for the consumer to adequately identify transactions and that they otherwise comply with regulatory requirements. [§205.9]

7. Review consumer complaints regarding EFT transactions to determine compliance with the error resolution procedures and to isolate any apparent deficiencies in the institution's operations. [§205.11]

8. Review policies regarding liability for unauthorized transfers. [§205.6]

9. Verify that the policies comply with the regulation, and determine whether they are applied in practice.

10. Review policies regarding issuance of access devices, ascertain whether they comply with the requirements of the regulation, and determine whether they are applied in practice. [§205.5]

11. Review policies regarding preauthorized debits and credits, ascertain whether they comply with the requirements of the regulation, and determine whether they are applied in practice. [§205.10]

12. Verify that the financial institution does not require compulsory use of EFTs, except as authorized. [§205.10(e)]

13. Determine that the financial institution is maintaining records of compliance for a period of not less than two years from the date disclosures are required to be made or action is required to be made. [§205.13(b)]

Introduction

The Expedited Funds Availability Act (EFA) (Title VI of Public Law 100-86) was enacted on August 10, 1987 and became effective on September 1, 1988. Regulation CC (12 C.F.R. Part 229) issued by the Board of Governors of the Federal Reserve System implements the EFA. The act and regulation set forth the requirements that depository institutions make funds deposited into transaction accounts available according to specified time schedules and disclose funds availability policies to their customers. The regulation also establishes rules designed to speed the collection and return of unpaid checks.

Regulation CC contains three subparts. Subpart A defines terms and provides for administrative enforcement. Subpart B specifies availability schedules or time frames within which banks must make funds available for withdrawal. It also includes rules regarding exceptions to the schedules, disclosure of funds availability policies, and payment of interest. (Appendix C contains model forms and clauses that may be used by banks to meet their disclosure responsibilities under the regulation). Subpart C sets forth the rules to ensure the expeditious return of checks, the responsibilities of paying and returning banks, authorization of direct returns, notification of nonpayment of large-dollar returns by the paying bank, check endorsement standards, and other related charges to the check collection system. (Appendices A and B provide routing number guides. Appendix D provides standards on how a bank shall indorse a check).

Subpart A—General Definitions—§229.2

The term "bank" refers to all banks, mutual savings banks, savings banks and savings associations that are insured by the FDIC, and federally-insured credit unions. "Bank" also applies to non-federally insured banks, credit unions and thrifts, as well as branches of foreign banks. The term "paying bank" applies to any bank at which or through which a check is payable and to which it is sent for payment or collection.

A "local" check is a check deposited in a depository bank that is located in the same Federal Reserve check processing region as the paying bank. A "non-local" check is a check deposited in a different check processing region than the paying bank. (A payable-through draft is considered local or non-local based on the location of the bank where the draft is payable-not the location of the bank identified in the MICR line of the draft. After February 1, 1991, all drafts must identify a 4 or 9 digit routing number.)

An "account," as defined in §229.2(a) of Regulation CC, is a demand deposit or other "transaction account", such as a NOW account. It includes consumer and corporate accounts with general third party payment powers and includes:

- Accounts from which the holder is permitted to make transfers or withdrawals by negotiable or transferable instruments;
- Payment order of withdrawals;
- Telephone transfers; and
- Electronic payments or other similar means such as the use of ATMs, remote service units or other electronic devices for the purpose of making payments or transfers to third persons.

For the purpose of EFA, "account" does not include:

- Savings deposits including time deposits and money market deposit accounts as defined in 12 C.F.R 204.2(d)(2);
- Accounts where the holder is a bank;
- Accounts where the holder is an office of an institution described in §§229.2(e)(1) through 229.2(e)(6);

*Approved-FFIEC

- Accounts where the holder is an office of a foreign bank as defined in §l(b) of the International Banking Act (12 U.S.C. 3101) that is located outside of the United States; and
- Accounts where the holder is the Treasury of the United States.

For purposes of Subparts B and C, "business day" and "banking day" are defined as follows:

- "Business day"-any day excluding Saturdays, Sundays and legal holidays (standard Federal Reserve holiday schedule).
- "Banking day"-a business day in which a bank is open for substantially all of its banking activities.

Even though a bank may be open for regular business on a Saturday, it is not a banking day for the purpose of Regulation CC because Saturday is never a 'business day' under the regulation. The fact that one branch is open to the public for substantially all of its banking activities does not necessarily mean that day is a banking day for other branches.

Administrative Enforcement—§229.3

The regulation is to be enforced for banks through Section 8 of the Federal Deposit Insurance Act (12 U.S.C. 1818) and through the Federal Credit Union Act (12 U.S.C. 1751 et seq.). In addition, a supervisory agency may enforce compliance though any other authority conferred on it by law. The Federal Reserve Board shall enforce the requirements of the regulation for depository institutions that are not specifically committed to some other government agency.

Subpart B—Availability of Funds And Disclosure of Funds Availability Policies

Next-Day Availability—§229.10

Cash, electronic payments, and certain check deposits must generally be made available for withdrawal the business day after the banking day on which they were received. Among the covered check deposits are cashier's, certified, and teller's checks, government checks (including U.S. Treasury checks, U.S. Postal money orders, state and local government checks, checks drawn on Federal Reserve or Federal Home Loan Banks), and certain "on us" checks (checks drawn on the same bank or a branch thereof).

Generally, to qualify for next-day availability, the deposit must be:

- Made at a staffed teller station; and
- Deposited into an account held by the payee of the check.

However, two types of deposits, U.S. Treasury checks and "on us" checks, must receive next-day availability even if the deposit is not made at a staffed teller station. Other next-day check deposits, and cash deposits, that are not made at staffed teller stations must be available for withdrawal on the second business day after the day of deposit under 229.10(a)(2) and 229.10(c)(2).

Additional Rules

A few additional rules also apply. Under §229.10 (c)(1)(iv-v) for state and local government checks to receive next-day availability, the depository bank must be located in the same state as the governmental unit issuing the check. Further, under §229.10(c)(3) the depository bank may require special deposit slips or envelopes for these deposits, as well as for cashier's, certified and teller's check deposits. If the depository bank requires the use of special deposit slips, it must either provide the slips or inform customers how they may be obtained.

For "on us" checks to receive next-day availability, the checks must be drawn on the same or another branch of the bank where the check is deposited. In addition, both branches must be located in the same state or check processing region.

$100 Rule

Section 229.10(c)(1)(vii) of the regulation contains a special $100 rule for check deposits not subject to next-day availability. Under the rule, the depository bank must make available for withdrawal the lesser of $100 or the aggregate amount deposited to all accounts, including individual and joint accounts, held by the same customer on any one banking day. The $100 rule does not apply to deposits received at nonproprietary ATMs.

Availability Schedule—§229.12

The permanent availability schedule became effective on September 1, 1990. (See Permanent Funds Availability Schedule-Figures A & B). Under this schedule local check deposits must be made available no later than the second business day following the banking day of deposit. Deposits of nonlocal checks must be made available no later than the fifth business day following the banking day of deposit. Funds, including cash and all checks, deposited at nonproprietary ATMs must be made available no later than the fifth business day following the banking day on which the funds are deposited.

Checks that would normally receive next-day availability are treated as local or non-local check deposits if they do not meet all the criteria for next-day availability under §229.10(c). (As mentioned earlier, certain checks generally deposited at a staffed teller station and into an account held by the payee of the check receive next-day availability. However, state, local government and certain "on us" checks are subject to additional rules.)

U.S. Treasury checks and U.S. Postal Money orders that do not meet all the requirements for next-day or second day availability as outlined in §229.10(c) receive funds availability as if they were "local" checks. Cashiers, certified, teller's, state and local government and checks drawn on the Federal Reserve or Federal Home Loan Banks which do not meet all the requirements in §229.10(c), receive funds availability as either local or non-local checks, according to the location of the bank on which they are drawn.

Cash Withdrawals

Special rules apply to cash withdrawals from local and non-local check deposits. While §229.12 (d) allows the depository bank to extend the availability schedule for cash or similar withdrawals by one day, the customer must still be allowed to withdraw the first $100 of any check deposit not subject to next-day availability on the business day following the day of deposit. In addition to the first $100, a customer must also be allowed to withdraw $400 of the deposited funds (or the maximum amount that can be withdrawn from an ATM, but not more than $400) no later than 5 p.m. on the day funds become available for check withdrawals. The remainder of deposited funds would be available for cash withdrawal on the following business day.

Extension of the Schedule for Certain Deposits

Section 229.12(e) provides that banks in Alaska, Hawaii, Puerto Rico, or the Virgin Islands receiving checks drawn on or payable through banks located in another state may extend the availability schedules for local and non-local checks by one day. This exception, however, does not apply to checks drawn on banks in these states or territories and deposited in banks located in the continental U.S.

Exceptions—§229.13

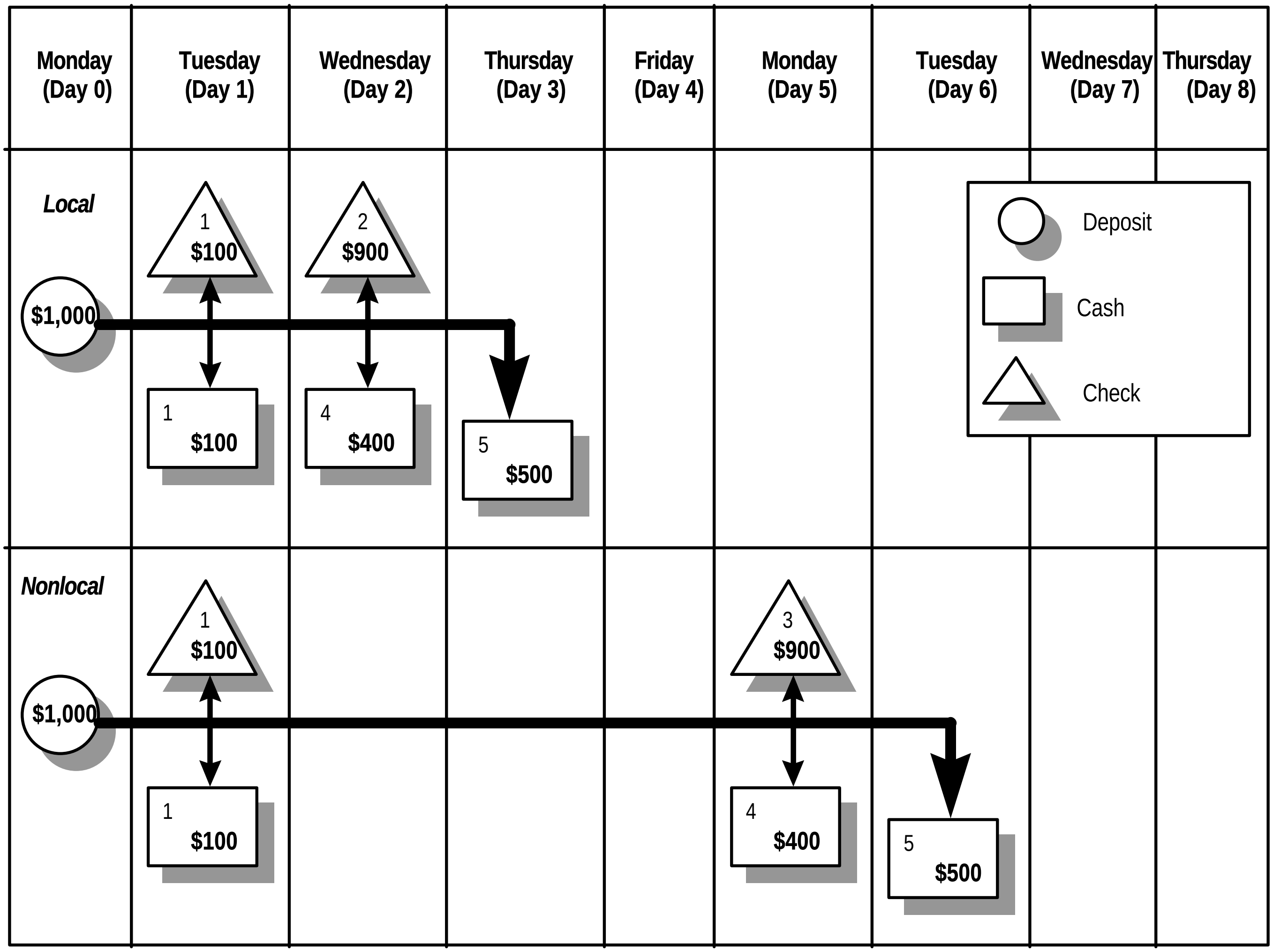
The regulation provides six exceptions that allow banks to exceed the maximum hold periods in the availability schedules. The statute regards the exceptions as "safeguards" to the maximum availability time frames because they are intended to offer the institution a means of reducing risk based on the size of the deposit, past performance of the depositor, lack of depositor performance history, or belief that the deposit may not be collectible. These exceptions include:

- New accounts;
- Deposits in excess of $5,000 on any one day;
- Checks that have been returned unpaid and are being redeposited;
- Deposits to accounts that have been repeatedly overdrawn;

Availability Schedules

Figure A

Illustrates availability of different types of checks deposited the *same* day, under the schedules.



1 The first $100 of a day's deposit must be made available for either cash withdrawal or check writing purposes at the start of the next business day § 229.10(c)(1)(vii).

2 Local checks must be made available for check writing purposes by the second business day following deposit § 229.12(b).

3 Nonlocal checks must be made available for check writing purposes by the fifth business day following deposit § 229.12(c).

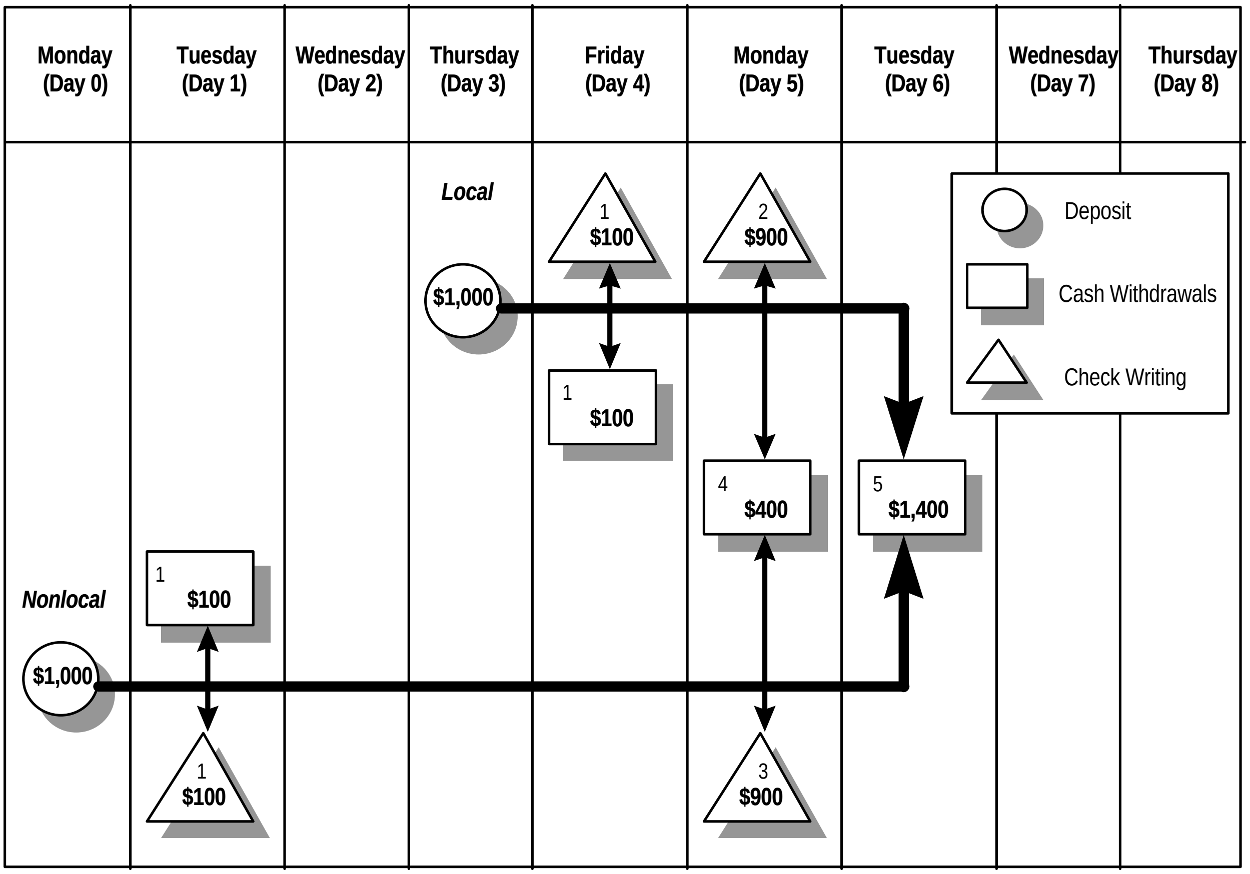
4 $400 of the local deposit must be made available for cash withdrawal no later than 5:00 p.m. on the day specified in the schedule. This is in addition to the $100 that must be made available on the business day following deposit § 229.12(d).

5 The remainder of the deposit must be made available for cash withdrawal at the start of business the following day § 229.12(d).

Availability Schedules

Figure B

Illustrates availability of different types of checks deposited on *separate* days, under the schedules.



1 The first $100 of a day's deposit must be made available for either cash withdrawal or check writing purposes at the start of the next business day § 229.10(c)(1)(vii).

2 Local checks must be made available for check writing purposes by the second business day following deposit § 229.12(b).

3 Nonlocal checks must be made available for check writing purposes by the fifth business day following deposit § 229.12(c).

4 $400 of the local deposit must be made available for cash withdrawal no later than 5:00 p.m. on the day specified in the schedule. This is in addition to the $100 that must be made available on the business day following deposit § 229.12(d).

5 The remainder of the deposit must be made available for cash withdrawal at the start of business the following day § 229.12(d).

- Cases in which the bank has a reasonable cause to believe the check being deposited is uncollectable; and
- Emergency conditions.

While banks may exceed the time frames for availability in these cases, the exceptions may generally not be invoked if the deposit would ordinarily receive next-day availability.

New Accounts Exception

An account is considered a “new account”, under §229.13(a), for the first 30 days after it is established. An account is not considered “new' if each customer on the account had another established account at the bank for at least 30 calendar days. The new account exception applies only during the 30-day period, beginning on the date the account is established, and does not cover all deposits made to the account.

Although the regulation exempts new accounts from the availability schedules for local and non-local checks, next-day availability is required for deposits of cash, and for electronic payments. Additionally, the first $5,000 of a day's aggregate deposits of government checks (including federal, state, and local governments), cashier's, certified, teller's, depository or traveler's checks must be given next-day availability. The amount in excess of $5,000 must be made available no later than the ninth business day following the day of deposit.

To qualify for next-day availability, deposits into a new account must generally be made in person to an employee of the depository bank. If the deposits are not made in person to an employee of the depository bank, such as an ATM deposit, availability may be provided on the second business day after the day of deposit. Treasury check deposits, however, must be given next-day availability regardless of whether they are made at staffed teller stations or proprietary ATMs. Banks are not required to make the first $100 of a day's deposits of local and non-local checks or funds from “on us” checks available on the next business day.

Large Deposit Exception (Deposits over $5000)

Under §229.13(b), the large deposit exception, a depository bank may extend hold schedules when deposits other than cash or electronic payments

exceed $5000 on any one day. A hold may be applied to the amount in excess of $5,000. To apply the rule, the depository bank may aggregate deposits made to multiple accounts held by the same customer, even if the customer is not the sole owner of the accounts.

Redeposited Check Exception

Under §229.13(c), the depository bank may delay the availability of funds from a check if the check had previously been deposited and returned unpaid. This exception does not apply to checks that were previously returned unpaid because of a missing endorsement or because the check was postdated when presented.

Repeated Overdraft Exception

Section 229.13(d) provides that if a customer's account, or accounts, have been repeatedly overdrawn during the preceding six months, the bank may delay the availability of funds from checks. A customer's account may be considered “repeatedly overdrawn” in two ways. First, the exception may be applied if the account (or accounts) have been overdrawn, or would have been overdrawn had checks or other charges been paid, for six or more banking days during the preceding six months.

Second, the exception may be applied to customers who incur overdrafts on two banking days within the preceding six month period if the negative balance in the account(s) is equal to or greater than $5000. This exception may also apply if the account would have been overdrawn by $5000 or more had checks or other charges been paid.

Reasonable Cause to Doubt Collectability Exception

This exception, in §229.13(e), may be applied to all checks. To trigger this exception, the depository institution must have “reasonable cause” to believe that the check is not collectible and must disclose the basis for the extended hold to the customer. For example, reasonable cause may include communication with the paying bank indicating that:

- There has been a stop payment placed on the check;
- There are insufficient funds in the drawer's account to cover the check; or
- The check will be returned unpaid.

The "reasonable cause" exception may also be invoked in cases where:

- The check is deposited six months after the date of the check (stale date);
- The check is postdated (future date);
- The depository bank believes that the depositor may be engaged in check kiting.

The "reasonable cause" exception may not be invoked because of:

- The race or national origin of the depositor; or
- The fact that the paying bank is located in a rural area and the depository bank will not have time to learn of nonpayment of the check before the funds have to be made available under the availability schedules in place.

Whenever this exception is used, the bank must notify the customer, in writing, at the time of deposit. If the deposit is not made in person or the decision to place the hold is based on facts that become known to the bank at a later date, the bank must mail the notice by the business day after the day the deposit is made or the facts become known. The notice must indicate that availability is being delayed and must include the reason that the bank believes the funds are uncollectable. If a hold is placed on the basis of confidential information, as when check kiting is suspected, the depository bank need only disclose to the customer that the hold is based on confidential information that the check may not be paid.

If the bank asserts that the hold was placed due to confidential information, the bank must note the reason on the notice it retains as a record of compliance. The depository bank must maintain a record of each exception notice for a period of two years. This record should contain a brief description of the facts, or any documents, supporting the "reasonable cause" exception.

Overdraft and Returned Check Fees

Under §229.13(e)(2), if a depository bank invokes the "reasonable cause" exception and does not inform the customer, in writing at the time of the deposit, the bank may not charge the customer any overdraft or returned check fees resulting from the hold if:

- The deposited check is paid by the paying bank; and
- The overdraft or returned check would not have occurred had the depository bank not imposed the reasonable cause hold.

However, the depository bank may assess overdraft or returned check fees if, on the exception hold notice, it states that the customer may be entitled to a refund of any overdraft or return check fees imposed and describes how the customer may obtain such a refund. It must then refund the fees upon request.

Emergency Conditions

Section 229.13(f) of the regulation also permits institutions to suspend the availability schedules under emergency conditions. Emergency situations include:

- Any interruption of communication facilities;
- Suspension of payments by another depository institution;
- War; or
- Any emergency condition beyond the control of the receiving depository institution.

Notice of Exception

Whenever a bank invokes one of the exceptions (excluding new accounts) to the availability schedules, it must notify the customer in writing in accordance with §229.13(g). Banks may send notices that comply solely with §229.13(g)(1), or may comply with two alternative notice requirements discussed below.

General Notice Requirements

Banks complying with §229.13(g)(1) must send notices which include:

- The customer's account number;
- The date and amount of the deposit;
- The amount of the deposit that will be delayed;
- The reason the exception was invoked;
- The day the funds will be available for withdrawal (unless unknown, as in an emergency situation).

If the deposit is made at a staffed facility, the written exception notice may be given to the person making the deposit regardless of whether the "depositor" is the customer who holds the account. If the deposit is not made at a staffed facility, the exception notice may be mailed to the customer no later than the business day following the banking day of deposit. If however, the depository bank discovers a reason to delay the funds, subsequent to the time the notice should have been given, the bank must notify the customer of the hold as soon as possible, but not later than the business day after the facts become known. In certain instances, exception holds based on "emergency" situations do not require notification to customers. For example, if deposited funds, subject to holds placed during an "emergency", become available for withdrawal before the notices are required to be sent, the depository bank is not required to send the notices to its customers.

Exception notice for nonconsumer accounts

If most check deposits to a nonconsumer account permit the bank to invoke either the large dollar or redeposited check exception, the bank may send a notice complying with §229.13(g)(1), or may send a one-time notice in accordance with §229.13(g)(2). The one-time notice must be sent when the first exception is invoked, or can be delivered before that time. The notice must state:

- The reason the exception may be invoked; and
- The time period when the funds will generally be made available.

Exception notice for repeated overdrafts

If most check deposits to an account permit the bank to invoke the repeated overdraft exception, the bank may send a notice complying with §229.13(g)(1), or may send a notice in accordance with §229.13(g)(3). The notice must be sent when the overdraft exception is first invoked. The notice must state:

- The customer's account number;
- The fact that funds are being delayed because the repeated overdraft exception will be invoked;
- The time period the exception will be invoked; and
- The time period when the funds will generally be made available

Availability of Deposits Subject to Exceptions

For exceptions (other than new accounts), §229.13(h) allows the depository bank to delay availability for a "reasonable" time beyond the schedule. Generally, a "reasonable" period will be considered to be no more than one business day for "on-us" checks, five business days for local checks and six business days for non-local checks. If a depository bank extends its availability beyond these time frames, it must be able to prove that such a delay is "reasonable."

Payment of Interest—§229.14

General Rule

A depository bank must begin accruing interest on interest-bearing accounts no later than the business day on which it receives provisional credit for the deposited funds. A depository bank typically receives credit on checks within one or two days following deposit. A bank receives credit on a cash deposit, an electronic payment, and a check that is drawn on itself on the day the cash, check or electronic payment is received. If a nonproprietary ATM is involved, credit is usually received on the day the bank that operates the ATM credits the depository bank for the amount of deposit.

Section 229.14(a)(1) permits a bank to rely on the availability schedule from its Federal Reserve Bank, Federal Home Loan Bank, or correspondent to determine when the depository bank receives credit. If availability is delayed beyond what is specified in the schedule, a bank may charge back interest, erroneously paid or accrued, on the basis of that schedule.

Section 229.14(a)(2) permits a depository bank to accrue interest, on checks deposited to all of its interest-bearing accounts, based on an average of when the bank receives credit for all checks sent for payment or collection. For example, if a bank receives credit on 20 percent of the funds deposited by check as of the business day of deposit (e.g. "on us" checks), 70 percent as of the business day following deposit, and 10 percent on the second business day following deposit, the bank can apply these percentages to determine the day interest must begin to accrue for check deposits on all interest-bearing accounts, regardless of when the bank received credit for funds deposited in any particular account. Consequently, a bank may begin accruing interest on a uniform basis for all interest-bearing accounts, without having to track the type of check deposited to each account.

Nothing in §229.14(a) limits a depository bank policy which provides that interest can only accrue on balances that exceed a specified amount, or on the minimum balance maintained in the account during a given period. However, the balance must be determined according to the date the depository bank receives credit for the funds. This section also does not limit any policy providing that interest can accrue sooner than required by the regulation.

Money market deposit accounts, savings deposits, and time deposits, are not subject to the general rule concerning the timing of interest payment.

However, for simplicity of operation, a bank may accrue interest on such deposits in the same manner that it accrues interest on transaction accounts.

Exemption for Certain Credit Unions

Section 229.14(b) contains an exemption, from the payment of interest requirements, for credit unions that do not begin to accrue interest or dividends on their member accounts until a later date than the day the credit union receives credit for those deposits, including cash deposits. These credit unions are exempt from §229.14(a) as long as they provide notice of their interest accrual policies in accordance with §229.16(d).

Section 229.14(c) provides an exception to the general rule in §229.14(a) for checks that are returned unpaid. Essentially, interest need not be paid on funds deposited in an interest-bearing account by a check that has been returned unpaid, regardless of the reason for return.

General Disclosure Requirements—§229.15

Form of disclosure

A bank must disclose its specific availability policy to its customers. The required disclosures must be clear and conspicuous, and must also be in writing under §229.15(a). Disclosures, other than those posted at locations where employees accept consumer deposits, at ATMs or on preprinted deposit slips, must be in a form that the customer may keep. These disclosures must not contain information unrelated to the requirements of the regulation. If other account terms are included in the same document, disclosures pertinent to this regulation should be highlighted such as, under a separate heading.

Uniform Reference to Day of Availability
§229.15(b) requires banks to refer to the day funds

will be available for withdrawal in a uniform manner in all of their disclosures. Disclosures must refer to when funds will be available for withdrawal as on “the______ business day after” the day of deposit. The first business day is the business day following the banking day the deposit was received, and the last business day is the day on which the funds are made available.

Multiple Accounts and Multiple Account Holders

The bank does not need to give multiple disclosures to customers who have more that one account if the accounts are subject to the same availability policies. In addition, the bank does not have to give separate disclosures to joint account holders. A single disclosure to one of the holders of the joint account is permissible under §229.15(c).

Dormant or Inactive Accounts

Section 229.15(d) provides the bank does not have to give disclosures to customers who have dormant or inactive accounts.

Specific Availability Policy Disclosure—§229.16

A bank must provide its customers with a disclosure that describes its funds availability policy. The disclosure must reflect the policy followed by the institution in most cases; however, the institution may impose longer delays on a case-by-case basis or by invoking one of the exceptions in §229.13, provided this is reflected in the disclosure.

Content of Specific Availability Policy Disclosure

The specific availability policy disclosure in §229.16(b) must include, as applicable, the following:

- A summary of the bank's availability policy;
- A description of the categories of deposits or checks used by the bank when it delays availability, such as local or nonlocal checks; how to determine the category to which a particular deposit or check belongs; and when each category will be available for withdrawal (including a description of the bank's business days and when a deposit is considered received);
- A description of any of the exceptions in Section 229.13 that may be invoked by the bank, including the time the deposited funds will generally become available for withdrawal and a statement that the bank will notify the customer if the bank invokes one of the exceptions;
- A description of any case-by-case policy of delaying availability which may result in deposited funds being available for withdrawal later than the time periods stated in the bank's availability policy (see specific requirements under §229.16(c)(1));
- A description of the categories of deposits or checks used by the bank when it delays availability, such as local or nonlocal checks; how to determine the category to which a particular deposit or check (such as payable through drafts) belongs; and when each category will be available for withdrawal (including a description of the bank's business days and when a deposit is considered received).

Longer Delays on A Case-by-Case Basis

A bank that has a policy of making deposited funds available for withdrawal sooner than required, may extend the time when funds are available up to the time periods allowed under the regulation on a case-by-case basis. However, the bank must include the following in its specific policy disclosure under §229.16(c):

- A statement that the time when deposited funds are available for withdrawal may be extended in some cases, and the latest time deposited funds will be available for withdrawal;
- A statement that the bank will notify the customer if funds deposited in the customer's account will not be available for withdrawal until after the time periods stated in the bank's availability policy; and

- A statement that customers should ask if they need to know when a particular deposit will be available for withdrawal.

When a depository bank extends the time that funds will be available for withdrawal, on a case-by-case basis, it must provide the depositor with a written notice. The notice shall include the following information:

- The customer's account number;
- The date and amount of the deposit;
- The amount of the deposit being delayed; and
- The day the funds will be available for withdrawal.

The notice must be provided at the time of the deposit, unless the deposit is not made in person to an employee of the depository bank, or when the decision to delay availability is made after the time of the deposit. If notice is not given at the time of the deposit, the depository bank must mail or deliver the notice to the customer no later than the first business day following the banking day the deposit is made.

A depository bank that extends the time when funds will be available for withdrawal on a case-by-case basis and does not furnish the depositor with written notice at the time of deposit may not assess any fees for any subsequent overdrafts (including use of a line of credit) or return of checks or other debits to the account, if:

- The overdraft or return of the check or other debit would not have occurred except for the fact that the deposited funds were delayed under §229.16(c)(1) of the regulation; and
- The deposited check was paid by the paying bank.

However, the depository bank may assess an overdraft or returned check fee if it includes a notice concerning overdraft and returned check fees with the disclosure required in §229.16(c)(2) and, when required, refunds any such fees upon the request of the customer. The overdraft and returned check notice must state that the customer may be entitled to a refund of overdraft or returned check fees that are assessed if the check subject to the delay is paid and state how to obtain a refund.

Credit Union Notice of Interest Payment Policy

Under §229.16(d), if a credit union begins to accrue interest or dividends on all deposits made in an interest-bearing account, including cash deposits, at a later time than the day specified in §229.14(a), the institution's specific policy disclosures must contain an explanation of when interest or dividends on deposited funds will begin to accrue.

Initial Disclosures—§229.17

New Accounts

Section 229.17(a) states a bank must provide potential customers with the disclosures described in §229.16 before an account is opened.

Additional Disclosure Requirements—§229.18

Deposit Slips

Under §229.18(a), all preprinted deposit slips given to customers must include a notice that deposits may not be available for immediate withdrawal.

Location Where Employees Accept Consumer Deposits

Section 229.18(b) provides a bank must post, at a conspicuous place at each location where its employees receive deposits to consumer accounts, a notice that sets forth the time periods applicable to the availability of funds deposited.

Automated Teller Machines. Under §229.18(c) a depository bank must post or provide a notice at each ATM location that funds deposited in the ATM may not be available for immediate withdrawal. A depository bank that operates an off-premises ATM from which deposits are removed not more than two times each week, as described in §229.19(a)(4), must disclose at or on the ATM the days in which deposits made at the ATM will be considered received.

Upon Request

Section 229.18(d) states a bank must provide a copy of its specific availability policy disclosure described in §229.16 to any person who requests it.

Changes in Policy

Thirty days prior to implementation, a bank must send notification of a change to the bank's availability policy to all account holders, if adversely affected by the change. Under §229.18(e) changes that result in faster availability may be disclosed no later than 30 days after implementation.

Miscellaneous—§229.19

When Funds are Considered Deposited

Section 229.19(a) provides rules which govern when funds are considered deposited for purposes of Subpart B of the regulation. The time that funds must be made available for withdrawal is measured from the day the deposit is "received." Funds received at a staffed teller station or ATM are considered deposited when received by the teller or placed in the ATM. Funds mailed to the depository bank are considered deposited on the banking day they are received by the depository bank. The funds are received by the depository bank at the time the mail is delivered to the bank, even if the mail is initially delivered to a mail room, rather than the check processing area.

Funds, however, may also be deposited at an unstaffed facility such as a night depository, lock box or ATM. Funds deposited at a night depository are considered deposited on the banking day the deposit is removed, and the contents of the deposit are accessible to the depository bank for processing. For example, some businesses deposit their funds in a locked bag at the night depository late in the evening and return to the bank the following day to open the bag. Other depositors may have an agreement with their bank that the deposit bag must be opened under the dual control of the bank and the depositor. In these cases, the funds are considered deposited when the customer returns to the bank and opens the deposit bag.

Funds deposited through a lock box arrangement are considered deposited on the day the deposit is removed from the lock box and are accessible to the depository bank for processing. A lock box is a post office box that is typically used by a corporation for the collection of bill payments or other check receipts.

The regulation contains a special rule for off-premise ATMs that are not serviced daily. Funds deposited at these ATMs are considered deposited on the day they are removed from the ATM, if the ATM is not serviced more than two times each week. This special provision is geared toward those banks' whose practice is to service remote ATMs infrequently. If a depository bank uses this provision, it must post a notice at the ATM informing depositors that funds deposited at the ATM may not be considered received on the date of deposit.

Funds deposited on a day the depository bank is closed, or after the bank's cut-off hour, may be considered made on the next banking day. Generally, a bank may establish a cut-off hour of 2:00 p.m. or later for receipt of deposits at its main office or branch offices. A cut-off hour of 12:00 noon or later may be established for deposits made to ATMs, lock boxes, night depositories, or other off-premises facilities. (As specified in the commentary to §229.19(a), the noon cut-off period relates to: the local time of the branch or other location of the depository bank where the account is maintained or the local time of the ATM or off-premise facility.)

Different cut-off hours may be established for different types of deposits. For example, a 2:00 p.m. cut-off for receipt of check deposits and a later time for receipt of wire transfers is permissible. Location can also play a role in the establishment of cut-off hours. For example, a different cut-off hour may be established for ATM deposits than for over-the-counter deposits, or for different teller stations at the same branch. With the exception of the 12:00 noon cut-off hour for deposits at ATMs and off-premise facilities, no cut-off hour for receipt of deposits can be established earlier than 2:00 p.m.

When Funds Must Be Made Available

Section 229.19(b) discusses funds availability at the start of a business day. Generally, funds must be available for withdrawal by the later of 9:00 a.m. or the time a depository bank's teller facilities including ATMs are available for customer account withdrawals. (Under certain circumstances, there is a special exception for cash withdrawals-see §229.12(d)). Thus, if a bank has no ATMs and its branch facilities are available for customer transactions beginning at 10:00 a.m., funds must be available for withdrawal by 10:00 a.m. If a bank has 24 hour ATM service, funds must be available by 9:00 a.m. for ATM withdrawals.

The start of business is determined by the local time where the branch or depository bank holding the account is located. For example, if funds in an account at a west coast bank are first made available at the start of business on a given day, and a customer attempts to withdraw the funds at an east coast ATM, the depository bank is not required to make funds available until 9:00 a.m. west coast time (12:00 noon east coast time).

Effects of the Regulation on Policies

Section 229.19(c) describes the effects of the regulation on the policies of a depository bank. Essentially, depository banks are permitted to provide availability to its customers in a shorter time than that prescribed in the regulation. It may also adopt different funds availability policies for different segments of its customer base, as long as each policy meets the schedules in the regulation. For example, it may differentiate between its corporate and consumer customers, or may adopt different policies for its consumer customers based on whether a customer has an overdraft line of credit associated with the account.

The regulation does not affect a depository bank's right to accept or reject a check for deposit, to charge back the customer's account based on a returned check or notice of nonpayment, or to claim a refund for any credit provided to the customer.

Nothing in the regulation requires a depository bank to have its facilities open for customers to make withdrawals at specific times or on specific days. For example, even though the special cash withdrawal rule set forth in §229.12(d) states that a bank must make up to $400 available for cash withdrawals no later than 5:00 p.m. on specific business days, if a bank does not participate in an ATM system and does not have any teller windows open at or after 5:00 p.m., the bank need not join an ATM system or keep offices open. In this case, the bank complies with this rule if the funds that are required to be available for cash withdrawal at 5:00 p.m. on a particular day are available for withdrawal at the start of business on the following day. Similarly, if a depository bank is closed for customer transactions, including ATMs, on a day funds must be made available for withdrawal, the regulation does not require the bank to open.

If a bank has a policy of limiting cash withdrawals at ATMs to $250 per day, the regulation would not require that the bank dispense $400 of the proceeds of the customer's deposit that must be made available for cash withdrawal on that day.

Some small financial institutions do not keep cash on their premises and offer no cash withdrawal capability to their customers. Others limit the amount of cash on-premises for bonding purposes, and reserve the right to limit the amount of cash that a customer can withdraw on a given day, or require advance notice for large cash withdrawals. Nothing in the regulation is intended to prohibit these practices if they are applied uniformly and are based on security, operating, or bonding requirements, and is not dependent upon the length of time the funds have been in the customer's account, as long as the permissible hold has expired. The regulation, however, does not authorize such policies if they are otherwise prohibited by statutory, regulatory, or common law.

Calculated Availability for Nonconsumer Accounts

Section 229.19(d) contains the rules for using calculated availability on nonconsumer accounts. Under calculated availability, a specified percentage of funds from check deposits may be made available to the customer on the next business day, with the remaining percentage deferred until subsequent days. The determination of the percentage of deposited funds that will be made available each day is based on the customer's typical deposit mix as determined by a sample of the customer's deposits. Use of calculated availability is permitted only if, on average, the availability terms that result from the sample are equivalent or more prompt than the requirements of this regulation.

Holds on Other Funds

Section 229.19(e) clarifies that, if a customer deposits a check, the bank may place a hold on any of the customer's funds to the extent that the funds held do not exceed the amount of the check deposited, and the total amount of funds held are made available for withdrawal within the times required in this regulation. For example, if a customer cashes a check (other than an "on us" check) over-the-counter, the depository bank may place a hold on any of the customer's funds to the extent that the funds held do not exceed the amount of the cashed check.

Employee Training and Compliance

Section 229.19(f) contains the requirements for employee training and compliance. EFA requires banks to inform each employee who performs duties subject to the Act about its requirements. The act and regulation also require banks to establish and maintain procedures designed to assure and monitor employee compliance with such requirements.

Effects of Mergers

Section 229.19(g) explains the effect of a merger transaction. Merged banks may be treated as separate banks for a period of up to one year after consummation of the merger transaction. However, a customer of any bank that is a party to the merger transaction, and has an established account with the merging bank, may not be treated as a new account holder under the new account exception of §229.13(a). A deposit in any branch of the merged bank is considered deposited in the bank for purposes of the availability schedules in accordance with §220.19(a). This rule affects the status of the combined entity in a number of areas. For example:

- When the resulting bank is a "participant" in a check clearinghouse association;
- When an ATM is a "proprietary ATM"; and
- When a check is drawn on a branch of the depository bank.

Relation to State Law 229.20

General Rule

Section 229.20(a) contains the general rule as to how Regulation CC relates to state laws addressing expedited funds availability.

If a state has a shorter hold for a certain category of checks than is provided for under federal law, that state requirement will supersede the federal provision. For example, most state laws base some hold periods on whether the check deposited is drawn on an in-state or out-of-state bank. If a state contains more than one check processing region, the state's hold period for in-state checks may be shorter than the federal maximum hold period for nonlocal checks. Accordingly, the state schedule would supersede the federal schedule to the extent that is applies to in-state, nonlocal checks.

EFA also indicates that any state law providing availability in a shorter period of time, than required by federal law, is applicable to all federally insured institutions in that state, including federally chartered institutions. If a state law provides shorter availability only for deposits in accounts in certain categories of banks, such as commercial banks, the superseding state law continues to apply only to those categories of banks, rather than to all federally insured banks in the state.

Preemption of Inconsistent Law

Section 229.20(b) provides that other provisions of state laws which are inconsistent with federal law are preempted. State laws requiring disclosure of availability policies for transaction accounts are preempted by the regulation. Preemption does not require a determination of the Federal Reserve Board in order to be effective.

Preemption Standards and Determinations

The Federal Reserve Board may issue a preemption determination upon the request of an interested party in a state. The determination will only relate to the provisions of Subparts A and B of the regulation.

Civil Liability—§229.21

Statutory Penalties

Section 229.21(a) sets forth the statutory penalties that can be imposed as a result of a successful individual or class action suit brought for violations of Subpart B of the regulation. Basically, a bank could be held liable for:

- Actual damages;
- Not less than $100 nor more than $1,000 in the case of an individual action;
- The lesser of $500,000 or one percent of the net worth of the bank involved in the case of a class action; and/or
- The costs of the action together with reasonable attorney's fees as determined by the court.

These penalties also apply to provisions of state law that supersede provisions of this regulation such as requirements that funds deposited in accounts at banks be made available more promptly than required by this regulation, but they do not apply to other provisions of state law. (See Commentary to Appendix D, §229.20) Bona Fide Errors.

Section 229.21(c) state that a bank will not be considered liable for violations of the regulation if it can demonstrate, by a preponderance of evidence, that violations resulted from bona fide errors and that it maintains procedures designed to avoid such errors.

Reliance on Federal Reserve Board Rulings

Section 229.21(e) provides that a bank will not be held liable if it acts in good faith in reliance on any rule, regulation, model form (if the disclosure actually corresponds to the bank's availability policy), or interpretation of the Federal Reserve Board, even if it were subsequently determined to be invalid. Banks may rely on the commentary as well as on the regulation itself.

Exclusions

The liability established by this section does not apply to violations of Subpart C (Collection of Checks) of the regulation, or to actions for wrongful dishonor of a check by a paying bank's customer. (Separate liability provisions applying to Subpart C are found in §229.38)

Subpart C—Collection of Checks

Subpart C covers the check collection system and includes rules to speed the collection and return of checks. Basically, these rules cover the return responsibilities of paying and returning banks, authorization of direct returns, notification of nonpayment on large-dollar returns of the paying bank, and mandatory check endorsement standards.

Sections 229.30 and 229.31 require paying and returning banks to return checks expeditiously using one of two standards: the “two-day/four-day” test and the “forward collection” test. Under the “two-day/four-day” test a local check is received by the depository bank two business days after presentment and a nonlocal bank four business days after presentment. The “forward collection” test is when the paying bank uses comparable transportation methods and banks, for returns, as those used for forward collection. The paying bank can return checks directly to the depository bank of any bank agreeing to process the returns, including the Federal Reserve.

Subpart C also requires in §229.33 a bank to provide notification of nonpayment if it determines not to pay a check of $2,500 or more, regardless of the channel of collection. The regulation addresses the depository bank's duty to notify its customers that a check is being returned and the paying bank's responsibility for giving notice of nonpayment.

Other areas that are covered in Subpart C are endorsement standards, warranties by paying and returning banks, bona fide errors and liability, variations by agreement, insolvency of banks, and the effect of merger transactions.

The provisions of Subpart C §229.41 supersede any state law, but only to the extent that it is consistent with Regulation CC.

The expeditious return requirements of §229.42 do not apply to checks drawn on the United States Treasury, U.S. Postal Service money orders, and checks drawn on states and units of general local government that are presented directly to the state or units of general local government and that are not payable through or at a bank.

Examination Objectives

Subparts A and B

1. To determine that the financial institution's funds availability policies are in compliance with the Regulation CC.

2. To determine that the financial institution has established internal controls for compliance with Regulation CC.

3. To determine that the financial institution has established a training program for applicable employees concerning their duties with respect to the regulation.

4. To determine that the financial institution maintains records of compliance with Regulation CC for a period of two years.

Examination Procedures

A financial institution may delay funds availability for some deposits on a case-by-case basis and on other deposits on an automatic basis. In addition, the institution may make decisions concerning holds and may maintain records at branches, as well as the main office. Therefore, to check for compliance with the holds policies, the examiner must determine not only the types of holds policies employed, but how the decisions are made and where the records are maintained. If a branch makes its decision and maintains its own records, such as in a decentralized structure, sampling may be done at the branch. If the “decision to delay availability is either centralized or made at a regional processing center and records are maintained there, sampling for compliance may be made at that location.

General

1. Determine the types of transaction accounts, as defined in Regulation D [204.2(e)] (demand deposits, NOW accounts, ATS accounts) offered by the financial institution.

2. Obtain copies of the forms used by the financial institution for transaction accounts, as applicable:

   - Specific Availability Policy Disclosures
   - Exception Hold Notices
   - Case-by-Case Hold Notices
   - Special Deposit Slips
   - Change in Terms Notices

3. Determine, by account type, the institution's specific funds availability policies with regard to deposits.

4. Determine which individuals actually perform the various activities necessary to comply with the different provisions of Regulation CC, Subpart B. This would include, for example, personnel engaged in:

   - Distributing disclosure statements
   - Employee training
   - Internal reviews

- Computer program development for deposit accounts (not necessarily a computer programmer)
- Deposit operations
- Overdraft administration
- ATM deposit processing
- Determining case-by-case holds or exceptions

5. Review the financial institution's training manual, internal audit or similar reports for Regulation CC, written procedures given to employees detailing their responsibilities under the regulation, and other similar materials.

6. Determine the extent and adequacy of the instruction and training received by those individuals to enable them to carry out their assigned responsibilities in conformance with Regulation CC.

7. Verify that the institution provides employees with a written statement regarding the financial institution's procedures which pertain to that employee's function. [229.19(f)]

Initial Disclosures and Subsequent Changes

1. Review the financial institution's specific availability policy disclosures. Determine if the disclosures accurately reflect the financial institution's funds availability policies and meet the requirements under §229.16 for content.

2. Determine if the financial institution provides the initial disclosure statement prior to accepting funds to open a new transaction account, or mails the disclosures within one business day of receiving a written request by mail, or a telephone request, to open a new account. [§229.17(a)]

3. Determine if the financial institution provides its funds availability policy upon an oral or written request within a reasonable time period. [§229.18(d)]

4. Determine if the financial institution has made changes to its availability policies since the last examination. If yes, determine whether the depositor was notified in accordance with §229.18(e).

Automatic (and/or Automated) Hold Policies

1. Review the financial institution's schedules or other materials relating to its funds availability time periods for the following types of deposits:

   a. cash [§229.10(a)]

   b. electronic payments [§229.10(b)]

   c. U.S. Treasury checks [§229.10(c)(1)(i) and 229.12(b)(2)]

   d. U.S. Postal Service Money Orders [§229.10(c)(1)(ii), 229.10(c)(2) and 229.12(b)(3)]

   e. checks drawn on Federal Reserve Banks or Federal Home Loan Banks [§229.10(c)(1)(iii), 229.10(c)(2), 229.12(b)(4) and 229.12(c)(1)(ii)]

   f. state or local government checks [§229.10(c)(1)(iv), 229.10(c)(2), 229.12(b)(4) and 229.12(c)(1)(ii)]

   g. cashier's, certified and teller's checks [§229.10(c)(1)(v), 229.10(c)(2), 229.12(b)(4) and 229.12(c)(1)(ii)]

   h. on us checks [§229.10(c)(1)(vi) and 229.11(c)(1)(ii)]

   i. local checks [§229.12(b)(1)]

   j. nonlocal checks [§229.12(c)(1)(i)]

   k. credit union share draft accounts [commentary to §229.16(b)]

2. Determine that the financial institution's policy for providing funds availability is in accordance with regulatory requirements.

3. Determine the financial institution's procedures for placing holds.

4. Selectively sample each of the types of deposits listed in question 1 and verify the funds availability time frames. Determine, for each deposit category, whether the financial institution's procedures provide funds availability within the required time periods. Determine that the procedures and disclosed policy are the same.

ATM Deposits - Nonproprietary [§229.12(f)]

(See also §§229.19(a)(4), 229.19(a)(5)(ii) and commentary to 229.19(a), (b) for off-premise ATMs.)

1. Determine that the institution makes funds deposited in an account at a nonproprietary ATM by cash or check available for withdrawal not later than the fifth business day following the day of deposit.

Availability Rules¾$100 and $400 [§229.10(c)(1)(vii), and 229.11(b)(2)]

1. Determine the financial institution's procedures for complying with the $100 availability rule and, if applicable, the $400 cash withdrawal rule.

2. Review records which detail holds placed on accounts. Determine if holds are in accordance with the regulation.

3. Sample deposit accounts with deposits subject to these rules and verify the institution's compliance with the rules. Verify that actual practices and policies match.

Extended Holds

Case-by-Case Holds

1. Determine if the financial institution places holds on a case-by-case basis. If yes, review the institution's procedures for placing case-by-case holds.

2. Review the specific availability policy disclosures to determine whether the case-by-case hold policy has been disclosed.

3. Review any physical records and/or reports generated from holds placed. (Sample should include records from the main office, as well as branch offices, depending on type of branch system operated.)

4. Sample a few of the case-by-case holds and determine whether the financial institution makes the funds available for withdrawal within the required time frames.

5. Determine whether the financial institution provides the customer with a notice of the case-by-case hold as required by §229.16(c)(2). Determine if the notices meet the timing and content requirements.

6. If the institution does not provide the notice at the time of deposit, determine whether it either discloses the availability of refunds of overdraft and returned check fees, or does not assess these fees, when the requirements of §229.16(c)(3) are met.

Exception Holds [§229.13]

1. Determine whether the financial institution places holds on an exception basis. If yes, review procedures for placing exception holds.

2. Review the specific availability policy disclosures to determine whether the institution has disclosed its exception holds policy.

3. Review any physical records and/or reports generated from holds placed. (Sample should include records from the main office, as well as branch offices, depending on type of branch system operated.)

4. Sample a few of the exception holds and determine when the financial institution makes the funds available for withdrawal. Determine that the financial institution does not add more than one business day for “on-us” checks, five business days for local checks, and six business days for nonlocal checks to the maximum

time periods in the federal availability schedule for the deposit, unless it can show that a longer delay is reasonable. [§229.13(h)]

5. With the exception of new accounts, determine whether the financial institution provides the customer with an exception hold notice as required by §229.13(g).

6. Review hold notices. Determine if the notices meet the timing and content requirements for each type of exception hold. (Note: institutions are required to retain copies of "reasonable cause" hold notices.)

New Accounts [§229.13(a)]

1. Review financial institution policies for new accounts.

2. Determine how the financial institution defines a "new account" relationship. Determine if the financial institution's definition is in compliance with Regulation CC.

3. Review the specific availability policy disclosure to determine whether the institution has disclosed its availability policy regarding new accounts.

4. Review a new account report or listing of new account holders. Determine if any holds were placed on the accounts.

5. Sample deposit accounts and request the financial institution to provide documentation concerning the composition of the opening deposit or most recent deposit.

6. Review holds placed and determine if holds are within regulatory limits with respect to time and amount. See §229.13(a)(1) (Note: No regulatory time limits are set forth for funds availability for local and nonlocal check deposits into new accounts.)

Large Deposits [§229.13(b)]

1. Determine whether the financial institution has procedures and a special hold policy for "large deposits." If yes, determine whether the institution considers a large deposit, for purposes of the large deposit exception, to be a day's aggregate deposit of checks exceeding $5000.

2. Determine that the financial institution does not invoke the large deposit exception for cash or electronic payments.

3. Review at least one account deposit on which a large deposit hold was placed and ensure that the hold was placed only on the amount by which a day's deposits of checks exceeds $5000.

4. Determine if the financial institution provided the customer with a written exception notice which meets the requirements of §229.13(g)(1) or (g)(2).

5. Determine if the notice was provided within the prescribed time frames of §229.13(g)(1) or (g)(2).

Redeposited Checks [§229.13(c)]

1. Determine if the financial institution has procedures and a special hold policy for redeposited checks.

2. If yes, determine if the institution refrains from imposing this exception solely because of a missing endorsement or because the check was post dated.

3. Determine if the financial institution provided the customer with a written exception notice which meets the requirements of §229.13(g)(1) or (g)(2).

4. Determine if the notice was provided within the prescribed time frames of §229.13(g)(1) or (g)(2).

Repeated Overdrafts [§229.13(d)]

1. Determine whether the financial institution has procedures or a special hold policy for customers with repeated overdrafts.

2. If yes, review the financial institution's definition for accounts "repeatedly overdrawn" and

determine whether it meets the regulatory definition in §229.13(d).

3. Determine that the financial institution returns the account to the financial institution's normal account status when the account has not been repeatedly overdrawn for a six month period following the time the account was characterized as repeatedly overdrawn.

4. Review the financial institution's overdraft account holder list. (Note*:* this may or may not be the same overdraft list maintained in the ordinary course of business. The financial institution may maintain a list of recent overdrafts, as well as a list of customers repeatedly overdrawn.]

5. Review an account classified as repeatedly overdrawn. Determine if the financial institution properly classified the account and followed the regulatory procedures outlined in §229.13(d).

6. Determine the date the account was placed in "repeated overdraft" exception status. Review account statements six months prior to the date the account was identified as an overdraft exception.

7. Determine whether the financial institution provided the customer with an exception notice when an exception hold was placed on the account. If so, review the content of the notice and determine if it meets the requirements of §229.13(g)(1) or (g)(3).

8. Determine if notice was given within the required time frames. [§229.12(g)(1) or (g)(3)]

Reasonable Cause to Doubt Collectability [§229.13(e)]

1. Determine if the financial institution has procedures or a special policy for placing "reasonable cause" holds.

2. If yes, determine who initiates "reasonable cause" holds.

3. Obtain a listing of accounts or checks where this exception was applied. Review the exception notice given to the customer.

4. Determine if the reason for invoking the exception was "reasonable".

5. Review the content of the notice and determine if it meets the requirements of §229.13(g)(1).

6. Determine if notice was given within the required time frames. [§229.13(g)(1)]

7. If the institution imposes a "reasonable cause" exception hold and does not provide the notice at the time of deposit, determine whether it either discloses the availability of refunds of overdraft and returned check fees, or does not assess these fees, when the requirements of §229.13(e)(2) are met.

Emergency Conditions [§229.13(f)]

1. Determine if the financial institution has procedures or a special policy for placing "emergency condition" holds. If yes, review the institution's procedures for placing these holds.

2. Determine whether the institution invokes this exception only under the conditions specified in §229.13(f).

3. Determine whether the institution makes the funds available for withdrawal within a reasonable time period from either the termination of the emergency or the period in which the deposit would normally be available for withdrawal, whichever is later. (Note: a reasonable period for on-us checks is one business day. A reasonable time for local checks is five business days. For nonlocal checks, six days is usually considered reasonable.) [§229.13(h)(3), 229.13(h)(4)]

Miscellaneous Provisions

Special Deposit Slips [§229.10(c)(3)]

1. Determine if the financial institution requires a special deposit slip for state or local govern-

ment checks, cashier's, certified, or teller's checks in order to provide next business day availability on the deposits. [§229.10(c)(3)(i)]

2. If the financial institution requires a special deposit slip, determine that the financial institution: [§229.10(c)(3)(ii)]

   a. provides the deposit slip to its customers; or

   b. informs the customers how to obtain and prepare the slips; or

   c. makes the special deposit slips "reasonably available."

Additional Disclosure Requirements [§229.18]

1. Determine if the financial institution displays a notice of its availability policy in a conspicuous place at locations where employees receive consumer deposits. [§229.18(b)] (Note: Drive-up windows and night depositories do not require the notice. See commentary to §229.18(b))

2. Determine if the financial institution displays a notice at each of its proprietary ATMs stating that the funds deposited in the ATM may not be available for immediate withdrawal. [§229.18(c)(1)]

3. If the financial institution has off-premise ATMs from which funds are not collected more than twice a week, determine if the institution discloses on or at the ATM, the days upon which the deposits made at the ATM will be considered "received." [§229.18(c)(2)]

4. Determine if the institution includes a notice on all preprinted deposit slips that the deposited funds may not be available for immediate withdrawal. [§229.18(a)]

Payment of Interest [§229.14]

1. Determine whether the financial institution pays interest as of the date of the deposit, or as of the date provisional credit is granted.

2. If the financial institution pays interest as of the date provisional credit is granted, review the financial institution's schedule for provisional credit. (This schedule may be from a Federal Reserve Bank or may be based on the time credit is generally received from a correspondent bank.) Select a NOW account statement and ask the financial institution to detail interest rate calculation.

3. Review the financial institution's method for calculating interest on deposits reviewed. Select another NOW account and, using the financial institution's procedures for calculating interest, verify that the financial institution accrues interest as of the date provisional credit is received.

Calculated Availability ¾ Non-consumer Transaction Accounts [§229.19(d)]

1. Determine if the financial institution uses a formula for calculating funds availability for non-consumer transaction accounts.

2. Review a copy of the financial institution's formula.

3. Select a large corporate account subject to the formula. Ask the financial institution to demonstrate how funds are made available to the customer. Determine whether it appears that the formula accurately reflects the type of deposit mix reasonably expected for this type of account holder. (For example, a local grocery store may have 90% of its deposits made up of local check deposits. Therefore, a formula providing a deposit mix of at least 90% availability within two days may be reasonable. A mail order firm, on the other hand, may have a large percent of nonlocal checks in its check deposits. Therefore, its formula may allow for lengthier availability schedules.)

Record Retention [§229.21(g) and 229.13(g)(4)]

1. Determine that the financial institution retains for two years, the notices required when a "reasonable cause" exception is invoked.

Introduction

Background and Summary

The National Flood Insurance Program (NFIP) is administered primarily under two statutes: the National Flood Insurance Act of 1968 (1968 Act) and the Flood Disaster Protection Act of 1973 (FDPA).[1] The 1968 Act made Federally subsidized flood insurance available to owners of improved real estate or mobile homes located in special flood hazard areas (SFHA) if their community participates in the NFIP. The NFIP is administered by a department of the Federal Emergency Management Agency (FEMA), the Federal Insurance Administration (FIA). The FDPA requires federal financial regulatory agencies to adopt regulations prohibiting their regulated lending institutions from making, increasing, extending or renewing a loan secured by improved real estate or a mobile home located or to be located in a SFHA in a community participating in the NFIP unless the property securing the loan is covered by flood insurance.

Title V of the Riegle Community Development and Regulatory Improvement Act of 1994[2] which is called the National Flood Insurance Reform Act of 1994 (Reform Act), comprehensively revised the Federal flood insurance statutes. The purpose of the Reform Act is to increase compliance with flood insurance requirements and participation in the NFIP in order to provide additional income to the National Flood Insurance Fund and to decrease the financial burden of flooding on the Federal government, taxpayers, and flood victims.[3] The Reform Act required the federal financial regulatory agencies[4] to revise their current flood insurance regulations and brought the Farm Credit Administration (FCA) under coverage of the Act. These agencies issued a joint final rule (final rule) on August 29, 1996, (61 FR 45684). On July 23, 1997, the FFIEC issued the Interagency Questions and Answers regarding Flood Insurance which are located in Appendix A of this section.

*Approved—FFIEC

The Reform Act also applied flood insurance requirements directly to the loans purchased by the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) and to agencies that provide government insurance or guarantees such as the Small Business Administration, Federal Housing Administration and the Veteran's Administration.

Objectives of the FDPA:

- Provide flood insurance to owners of improved real estate located in SFHAs of communities participating in the NFIP.
- Require communities to enact measures designed to reduce or avoid future flood losses as a condition for making federally subsidized flood insurance available.
- Require federal financial regulatory agencies to adopt regulations prohibiting their regulated lending institutions from making, increasing, extending or renewing a loan secured by improved real estate or a mobile home located or to be located in an SFHA of a community participating in the NFIP, unless the property securing the loan is covered by flood insurance.
- Require federal agencies, such as the Federal Housing Administration (FHA), Small Business Administration (SBA) and the Depart-

[1] These statutes are codified at 42 USC 4001-4129. FEMA administers the NFIP; its regulations implementing the NFIP appear at 44 CFR parts 59-77.

[2] Pub. L. 103-325, tit. V, 108 Stat. 2160, 2255-87 (September 23, 1994).

[3] H.R. Conf. Rep. No. 652, 103d Cong., 2d Sess. 195 (1994) (Conference Report).

[4] The agencies are the OCC, FDIC, OTS, NCUA and Federal Reserve.

ment of Veteran's Affairs (VA) not to subsidize, insure or guarantee any loan if the property securing the loan is in an SFHA of a community not participating in the NFIP.

Responsibilities of FIA:

- Identifying communities with SFHAs.
- Issuing flood boundary and flood rate maps for flood-prone areas.
- Making flood insurance available through the NFIP "Write Your Own" Program (WYO) which enables the public to purchase NFIP coverage from private companies that have entered into agreements with FIA.
- Assisting communities in adopting flood plain management requirements.
- Administering the insurance program. Licensed property and casualty insurance agents and brokers provide the primary connection between the NFIP and the insured party. Licensed agents sell flood insurance, complete the insured party's application form, report claims and follow-up with the insured for renewals of the policies.

National Flood Insurance Program

The NFIP has two distinct phases, the Emergency Program and the Regular Program.

- The Emergency Program is for communities that first enter the NFIP. It is an interim program that provides lower levels of flood insurance on eligible structures at subsidized rates. FEMA issues flood hazard boundary maps with this program to determine whether properties are located in a flood plain area. A community that is in the Emergency Program will be admitted to the Regular Program upon completion of specific requirements.
- A community enters the Regular Program once a detailed study has been completed and a flood insurance rate map for the area has been issued by FEMA. The maps delineate communities by degrees of probable flood hazard and include more specific area identification than do the flood hazard boundary maps. They also indicate base flood elevations depicting depth or elevation of flooding. The Regular Program provides full insurance coverage for eligible structures and it requires additional flood-plain management responsibilities for the community.

Eligible Structures for Flood Insurance

The NFIP covers improved real property or mobile homes located or to be located in an area identified by FEMA as having special flood hazards. Generally each insurable structure requires a separate insurance policy, although FEMA does provide special consideration for some nonresidential buildings. The following types of structures are eligible for coverage:

- Residential, industrial, commercial and agricultural buildings that are walled and roofed structures that are principally above ground.
- Buildings under construction where a development loan is made to construct insurable improvements on the land. Insurance can be purchased to keep pace with the new construction.
- Mobile homes that are affixed to a permanent site, including mobile homes that are part of a dealer's inventory and affixed to permanent foundations.
- Condominiums.
- Co-operative buildings.
- Flood insurance coverage is also available for personal property and other insurable contents contained in real property or mobile homes located in SFHAs. The property must be insured in order for the contents to be eligible.

Structures not eligible for flood insurance under the NFIP

- Unimproved land, bridges, dams and roads.
- Mobile homes not affixed to a permanent site.
- Travel trailers and campers.

- Converted buses or vans.
- Buildings entirely in, on, or over water into which boats are floated.
- Buildings newly constructed or substantially improved on or after October 1, 1983, in an area designated as an undeveloped coastal barrier with the Coastal Barrier Resource System established by the Coastal Barrier Resources Act (Public Law 97-348).

Flood Insurance Requirements for Lending Institutions

Basic Requirement

Flood insurance is required for the term of the loan on buildings or mobile homes when all three of the following factors are present:

- The institution makes, increases, extends or renews any loan(s) (commercial or consumer) secured by improved real estate or a mobile home that is affixed to a permanent foundation ("security property")
- The property securing the loan is located or will be located in an SFHA as identified by FEMA; and
- The community participates in the NFIP.

In the case of mobile homes, the criteria for coverage turns on whether the mobile home is affixed to a permanent foundation. An institution does not have to obtain a security interest in the underlying real estate in order for the loan to be covered by the final rule.

Institutions are not prohibited from making, increasing, extending or renewing a conventional loan if the community in which the security property is located has been mapped by FEMA but does not participate in the NFIP. However, federal flood insurance is not available in these communities. In addition, it should be noted that government guaranteed or insured loans (secured or unsecured) cannot be made if the community has been mapped by FEMA and does not participate in the NFIP. Flood insurance requirements apply to loans where a security interest in improved real property is only taken "out of an abundance of caution." Section 102(b)(1) of the FDPA, as amended by the Reform Act,[5] provides that a regulated lending institution may not make, increase, extend or renew any loan secured by improved real property that is located in a special flood hazard area unless the improved real property is covered by the minimum amount of flood insurance required by statute.

Special Situation ¾ Table Funded Loans

In the typical table funding situation, the party providing the funding reviews and approves the credit standing of the borrower and issues a commitment to the broker or dealer to purchase the loan at the time the loan is originated. Frequently, all loan documentation and other statutorily mandated notices are supplied by the party providing the funding, rather than the broker or dealer. The funding party provides the original funding "at the table" when the broker or dealer and the borrower close the loan. Concurrent with the loan closing, the funding party acquires the loan from the broker or dealer. While the transaction is, in substance, a loan made by the funding party, it is structured as the purchase of a loan.

The final rule reflects the position that, for flood hazard determination purposes, the substance of the table funded transaction should control and that the typical table funded transaction should be considered a loan made, rather than purchased, by the entity that actually supplies the funds. Regulated institutions that provide table funding to close loans originated by a mortgage broker or mobile home dealer will be considered to be "making" a loan for purposes of the flood insurance requirements.

Treating table funded loans as loans made by the funding entity need not result in duplication of flood hazard determinations and borrower notices. The funding entity may delegate to the broker or dealer originating the transaction the responsibility for fulfilling the flood insurance requirements or may otherwise divide the responsibilities with the broker or dealer, as is currently done with respect

[5] See 42 USC 4012a(b)(1).

to the requirements under the Real Estate Settlement Procedures Act (RESPA).

Exemptions to the Purchase Requirement

The flood insurance purchase requirement does not apply to the following two loan situations:

- Loans on state-owned property covered under an adequate policy of self-insurance satisfactory to the Director of FEMA. The Director will periodically publish a list of state property falling within this exemption.
- Loans with an original principal balance of $5,000 or less, and having an original repayment term of one year or less.

Amount of Flood Insurance Required

The amount of flood insurance required must be at least equal to the outstanding principal balance of the loan, or the maximum amount available under the NFIP, whichever is less. Flood insurance coverage does not include the value of the land; rather, it only covers the amount of the insurable structure(s). Institutions may deduct the appraised value of the land from the total amount of the secured property to determine an estimated amount for insurance coverage. The amount of insurance coverage should not be less than the value of the improved structure(s).

Since March 1, 1995, the limits of coverage for flood policies are:

- $250,000 for residential property structures and $100,000 for personal contents
- $500,000 for non-residential structures and $500,000 for contents.

Waiting Period

Effective March 1, 1995, the Reform Act increased the waiting period for flood insurance coverage from five days to thirty days. FEMA through Policy Issuance 8-95, dated December 5, 1995, stated that increases in coverage amounts would be subject to the increased waiting period except in the following circumstances:

- When there is an existing policy and an additional amount of insurance is required in connection with the making, increasing, extension, or renewal of a loan, such as a second mortgage, home equity, or refinancing,
- When an additional amount of insurance is required as a result of a map revision
- When an additional amount of insurance is being obtained in connection with the renewal of an existing policy, and
- When flood insurance is required as a result of a lender determining that a loan which does not have flood insurance coverage should be protected by insurance (forced placement).

Special Situations ¾ Second Mortgages/Home Equity Loans

Both second mortgages and home equity loans are transactions that come within the purchase provisions of the FDPA. Since only one flood insurance policy can be issued for a building, an institution should not request that a new flood insurance policy if one already exists. Instead, the institution should have the borrower contact the insurance agent:

- To inform the agent of the intention to obtain a loan involving a subordinate lien
- To obtain verification of the existence of a flood insurance policy, and
- To check whether the amount of insurance covers all loan amounts.

After obtaining this information, the insurance agent should increase the amount of coverage if necessary and issue an endorsement that will reflect the institution as a lien holder.

For loans with approved lines of credit to be used in the future, it may be difficult to calculate the amount of insurance for the loan since the borrower will be drawing down differing amounts on the line at different times. In those instances where there is no policy on the collateral the borrower must, at a minimum, obtain a policy as a requirement for drawing on the line. As a matter of administrative convenience to ensure compliance with the requirements, an institution may take the following alternative approaches:

- Review its records periodically so that as draws are made against the line or repayments made to the account, the appropriate amount of insurance coverage can be maintained; or
- Upon origination, require the purchase of flood insurance for the total amount of the loan or the maximum amount of flood insurance coverage available, whichever is less.

Special Situations ¾ Condominium Policies

Effective October 1, 1994, FEMA issued a new condominium master policy called a Residential Condominium Building Association Policy (RCBAP). If the amount of the policy is 80% or more of the replacement value of the building, no co-insurance deductible is required by the policy. An institution can rely on a RCBAP as the required amount of flood insurance to support the loan if the policy meets the 80% requirement.

The amount of possible coverage available to a condominium association is $250,000 per unit multiplied by the total number of units. For instance, the maximum amount of coverage on a 50 unit condominium building would be $12,500,000 ($250,000 x 50). If the replacement value of the building was $10,000,000, the condominium association could purchase a policy of $8,000,000 (or more) and not be required to have a co-insurance payment in the event of a flood. This amount of insurance would meet the requirements of the final rule for any individual unit insurance requirement in the condominium.

Other Special Situations

- *Multiple Structures*. Multiple structures that secure a loan located in an SFHA generally must each be covered by flood insurance, even though the value of one structure may be sufficient to cover the loan amount. FEMA does permit borrowers to insure nonresidential buildings using one policy with a schedule separately listing each building. Loans secured by agricultural properties and improvements may be particularly assisted through this practice.
- *Other Real Estate Owned*. An institution with other real estate owned (OREO) in flood hazard areas should, as a prudent practice, purchase flood insurance policies on its OREO property, although it is not required to do so by the regulation.

Escrow Requirements

An institution must require the escrow of flood insurance premiums for loans secured by “residential improved real estate” if it requires the escrow of other funds to cover other charges associated with the loan, such as taxes, premiums for hazard or fire insurance, or any other fees. Depending on the type of loan, the escrow account for flood insurance premiums may be subject to section 10 of RESPA, 12 U.S.C. 2609,[6] which generally limits the amount that may be maintained in escrow accounts for consumer mortgage loans, and requires notices containing escrow account statements for those accounts. RESPA escrow requirements apply to “federally related mortgage loans,” a category of loans that is narrower in scope than the Reform Act's “residential improved real estate.” Therefore, escrow accounts established for federally related mortgage loans must comply with the requirements of section 10 of RESPA. However, an escrow account for “residential improved real estate” that is not also a “federally related mortgage loan” need not comply with section 10 of RESPA, even though the escrow requirements of the Reform Act apply.

The escrow provisions are designed to improve compliance with flood insurance requirements by ensuring that homeowners located in special flood hazard areas obtain and maintain flood insurance for the life of the loan. However, the Reform Act itself does not restrict the flood insurance escrow requirement to consumer mortgage loans. The de-

[6] The regulations of the Department of Housing and Urban Development (HUD) implementing section 10 appear at 24 CFR 3500.17 (1995); see also 60 FR 8812 (Feb. 15, 1995), 60 FR 24734 (May 9, 1995), 61 FR 13232 (Mar. 26, 1996) and 61 FR 29238 (June 7, 1996) (revising § 3500.17).

terminative factor in the coverage of the escrow requirement is not the purpose of the loan, but the purpose of the building-whether it is used primarily for residential purposes or for other purposes. Because the Reform Act defines "residential improved real estate" as "improved real estate for which the improvement is a residential building," the escrow provisions cover, for example, multifamily properties containing five or more residential units.

Special situation involving condominium units

In the case of a condominium unit where the association has purchased an RCBAP that meets the 80% requirement of FEMA, the payments made by the borrower to the condominium association for the policy will constitute compliance with the requirements of the final rule for the escrow provisions.

Types of escrow accounts covered

The escrow requirement does not apply if the institution does not require other escrows to be maintained. An escrow arrangement is generally considered voluntary if the policies of the institution do not require the establishment of an escrow account in connection with the particular type of loan, even if permitted by the loan documents. In determining whether an escrow account arrangement is voluntary, it is appropriate to look to the loan policies and practices of the institution and the contractual agreement underlying the loan. If the loan documentation permits the institution to require an escrow account, and its loan policies normally would require an escrow account for a loan with particular characteristics, an escrow account in connection with such a loan generally would not be considered to be voluntary.

In the preamble to their final rule, the agencies noted that HUD takes the position that voluntary payments for credit life insurance do not constitute escrows for purposes of RESPA.[7] Therefore, the agencies have also determined that payments for credit life insurance and similar types of contracts should not trigger the escrow of flood insurance premiums.

Standard Flood Hazard Determination Form

Note: FEMA has revised the Standard Flood Hazard Determination Form effective April 20, 1999. The updated form and instructions can be obtained by contacting FEMA at the address below or from FEMA's website at
http://www.fema-.gov/library/fform.html.

When an institution makes, increases, extends, or renews any loan secured by improved real estate or by a mobile home, it must use the standard flood hazard determination form (SFHDF) developed by FEMA[8] to determine whether the building or mobile home offered as security property is or will be located in an SFHA in which flood insurance is available under the Act.

An institution can use a printed, computerized or electronic form. It must retain a copy of the completed form, in either hard copy or electronic format, for the period of time it owns the loan. FEMA has stated that if an electronic format is used, the format and exact layout of the SFHDF is not required, but the fields and elements listed on the form are required. Any electronic format used by an institution must contain all mandatory fields indicated on the SFHDF.

Decisions as to the applicability of flood insurance may not be based on an institution's unilateral determination of elevations at which floods may occur. Official elevation determinations and, therefore, map revisions or amendments (LOMAs or LOMRs) may only be performed by FEMA.

Flood maps and Standard Flood Hazard Determination forms may be obtained from FEMA by writing to:

Federal Emergency Management Agency
Flood Map Distribution Center
6930 (A-F) San Tomas Road
Baltimore, MD 21227-6227

or calling:

1-800-358-9616 or 1-800-611-6125

[7] See 60 FR 24733 (May 9, 1995) (revising 24 CFR 3500.17).

Community status information is no longer published in the Federal Register. To obtain information on a community's participation status, telephone a FEMA representative at 1-800-358-9616 to request a community status book. Information on community status is also available on the World Wide Web at http://www.fema.gov/fema /finifp.html.

Reliance on prior determination

The Reform Act permits an institution to rely on a prior determination, whether or not the security property is located in an SFHA, and it is exempt from liability for errors in the previous determination if:

- The previous determination is not more than seven years old, and
- The basis for it was recorded on the SFHDF mandated by the Reform Act.

There are, however, two circumstances in which an institution may not rely on a previous determination:

- If FEMA's map revisions or updates show that the security property is now located in an SFHA, or
- If the lender contacts FEMA and discovers that map revisions or updates affecting the security property have been made after the date of the previous determination.

The Reform Act also states that an institution cannot rely on a previous determination set forth on an SFHDF when it makes a loan; only when it increases, extends, renews or purchases a loan. However, the preamble to the final rule indicates that the agencies will treat subsequent transactions by the same institution with respect to the same property, such as assumptions, refinancings and second lien loans, as renewals. A new determination would, therefore, not be required in those limited circumstances, assuming the other requirements are met.

Forced Placement Requirements

The Reform Act does not require an institution to monitor for map changes, and the final rule does not require that determinations be made at any time other than when a loan is made, increased, extended, or renewed. If, however, at any time during the life of the loan the institution or its servicer determines that required flood insurance is deficient, the final rule requires initiation of forced placement procedures.

The Reform Act imposed the requirement on an institution or a servicer acting on its behalf to purchase or “force place” flood insurance for the borrower if the institution or the servicer determines that coverage is lacking. The final rule, therefore, provides that an institution, or servicer acting on its behalf, upon discovering that security property is not covered by an adequate amount of flood insurance, must, after providing notice and an opportunity for the borrower to obtain the necessary amount of flood insurance, purchase flood insurance in the appropriate amount on the borrower's behalf.

An institution or its servicer continues to be responsible for ensuring that where flood insurance was required at origination, the borrower renews the flood insurance policy and continues to renew it for as long as flood insurance is required for the security property. If a borrower allows a policy to lapse when insurance is required the institution or its servicer is required to commence force placement procedures.[8]

Forced placement should not be necessary at the time an institution makes, increases, extends or renews a loan, when it is obligated to require that flood insurance be in place prior to closing. Rather, forced placement authority is designed to be used if, over the term of the loan, the institution or its servicer determines that flood insurance coverage on the security property is deficient; that is,

[8] The insurance carrier should notify the institution or its servicer, along with the borrower, when the insurance contract is due for renewal. The insurance carrier also notifies these parties if it has not received the policy renewal.

whenever the amount of coverage in place is not equal to the lesser of the outstanding principal balance of the loan or the maximum stipulated by statute for the particular category of structure securing the loan. The amount that must be force placed is equal to the difference between the present amount of coverage and the lesser of the outstanding principal balance or the maximum coverage limit.

There is no required specific form of notice to borrowers for use in connection with the forced placement procedures. An institution or its servicer may choose to send the notice directly or may use the insurance company that issues the forced placement policy to send the notice. FEMA has developed the Mortgage Portfolio Protection Program (MPPP) to assist lenders in connection with forced placement procedures. For information concerning the contents of the notification letters used under the MPPP, lenders and others should consult FEMA's MPPP Notice.[9]

Determination Fees

An institution or its servicer may charge a reasonable fee to the borrower for the costs of making a flood hazard determination under the following circumstances:

- The borrower initiates a transaction (making, increasing, extending or renewing a loan) that triggers a flood hazard determination;
- There is a revision or updating of floodplain areas or risk zones by FEMA;
- The determination is due to FEMA's publication of a notice that affects the area in which the loan is located; or
- The determination results in the purchase of flood insurance under the forced placement provision.

The preamble to the final rule indicates that the authority to charge a borrower a reasonable fee for a flood hazard determination extends to a fee for life-of-loan monitoring by either the institution, its servicer, or by a third party, such as a flood hazard determination company.

Truth in Lending Act Issues

The Official Staff Commentary to Regulation Z states that a fee for services that will be performed periodically during the loan term is a finance charge, regardless of whether the fee is imposed at closing, or when the service is performed. This would include the fee for life-of-loan coverage. The fee for the determinations of whether a security property is in a SFHA is excluded from the finance charge. The Commentary further indicates that any portion of a fee that does not relate to the initial decision to grant credit must be included in the finance charge.[10] If creditors are uncertain about what portion of a fee is related to the initial decision to grant credit, the entire fee may be treated as a finance charge.

Notice Requirements

The final rule requires that when the security property is or will be located in a SFHA, the institution must provide a written notice to the borrower and the servicer. This notice must be provided regardless of whether the security property is located in a participating or non-participating community. The written notice must contain the following information:

- A warning that the building or mobile home is or will be located in a SFHA.
- A description of the flood purchase requirements contained in §102(b) of the FDPA, as amended.
- A statement whether flood insurance coverage is available under the NFIP and may also be available from private insurers.
- A statement whether Federal disaster relief assistance may be available in the event of damage to the building or mobile home, caused by flooding in a Federally declared disaster.

[9] Notice by FEMA, 60 FR 44881 (August 29, 1995).

[10] See 12 CFR part 226, supplement 1 comment 4(c)(7)-3.

The final rule permits an institution to use the sample form to comply with the notice requirements. The sample form is an example of an acceptable form that notice may take and it does contain additional information not required under the regulation. Lenders may also personalize, change the format of, and add information to the sample form if they wish to do so. However, to ensure compliance with the notice requirements, a lender-revised notice form must provide the borrower, at a minimum, with the information required by the regulation.

The final rule permits an alternate notice provision by which an institution may rely on assurances from a seller or lessor that the seller or lessor has provided the requisite notice to the purchaser or lessee. This alternate form of notice might arise in a situation where the lender is providing financing through a developer for the purchase of condominium units by multiple borrowers. The lender may not deal directly with the individual condominium unit purchaser and need not provide notice to each purchaser but may instead rely on the developer/seller's assurances that the developer/seller has given the required notice. The same may be true for a cooperative conversion, where the sponsor of the conversion may be providing the required notice to the purchasers of the cooperative shares. A purchaser of shares in a cooperative may be considered to be a "lessee" rather than a purchaser with respect to the underlying real property. The final rule provides that delivery of notice must take place within a "reasonable time" before the completion of the transaction. What constitutes "reasonable" notice will necessarily vary according to the circumstances of particular transactions. An institution should bear in mind, however, that a borrower should receive notice timely enough to ensure that:

- The borrower has the opportunity to become aware of the borrower's responsibilities under the NFIP; and
- Where applicable, the borrower can purchase flood insurance before completion of the loan transaction.

The preamble to the final rule states that the agencies generally continue to regard ten days as a "reasonable" time interval.

Notice to Servicer

The Reform Act added loan servicers to the entities that must be notified of special flood hazards. In many cases the servicer's identity will not be known until well after the closing; consequently, notification to the servicer in advance of the closing would not be possible or would serve no purpose. In recognition that the servicer is often not identified prior to closing, the preamble to the final rule requires notice to the servicer as promptly as practicable after the institution provides notice to the borrower, and provides that notice to the servicer must be given no later than at the time the lender transmits to the servicer other loan data concerning hazard insurance and taxes. The final rule explicitly states that delivery of a copy of the borrower's notice to the servicer suffices as notice to the servicer.

Notice to Director of FEMA

An institution must notify the Director of FEMA, or the Director's designee, of the identity of the loan servicer and of any change in the servicer. FEMA has designated the insurance carrier as its designee to receive notice of the servicer's identity and of any change therein, and at FEMA's request this designation is stated in the final regulation. Notice of the identity of the servicer will enable FEMA's designee to provide notice to the servicer of a loan 45 days before the expiration of a flood insurance contract. The final rule requires the notice to be sent within 60 days of the effective date of the transfer of servicing. No standard form of notice is required to be used, however, in the preamble to the final rule, the agencies stated that the information should be sufficient for the Director, or the Director's designee, to identify the security property and the loan, as well as the new servicer and its address.

Record-keeping Requirements

The record-keeping requirements of the final rule include retention of:

- Copies of completed SFHD forms, in either hard copy or electronic form, for as long as the institution owns the loan; and
- Records of the receipt of the notice to the borrower and the servicer for as long as the institution owns the loan.

The final rule does not prescribe a particular form for the record of receipt, however, it should contain a statement from the borrower indicating that the borrower has received the notification. Examples of records of receipt may include:

- A borrower's signed acknowledgment on a copy of the notice,
- A borrower-initialed list of documents and disclosures that the lender provided the borrower, or
- A scanned electronic image of a receipt or other document signed by the borrower.

An institution may keep the record of receipt provided by the borrower and the servicer in the form that best suits the institution's business. Institutions who retain these records electronically must be able to retrieve them within a reasonable time.

Penalties and Liabilities

The Reform Act revised the FDPA to provide penalties for violations of:

- Escrow requirements;
- Notice requirements; and
- Forced placement requirements.

If an institution is found to have a pattern or practice of committing violations, the agencies shall assess civil penalties in an amount not to exceed $350 per violation with a total amount against any one regulated institution not to exceed $100,000 in any calendar year. Any penalty assessed will be paid into the National Flood Mitigation Fund. Liability for violations cannot be transferred to a subsequent purchaser of a loan. Liability for penalties expires four years from the time of the occurrence of the violation.

Federal Emergency Management Agency (FEMA) and
National Flood Insurance Program (NFIP) Regional Offices

FEMA administers the National Flood Insurance Program through the Federal Insurance Administration located at:

Federal Emergency Management Agency
Federal Insurance Administration
500 C Street, S.W.
Washington, DC 20472

Federal Emergency Management Regional Offices:

Region I
(CT, MA, ME, NH, RI, VT)
442 J.W. McCormack Post Office
and Court House Building, Room 462
Boston, Massachusetts 02109-4595
(617) 223-9540

Region II
(NJ, NY)
26 Federal Plaza,
Room 1338
New York, New York 10278-0002
(212) 225-7209

Caribbean Area Office
(Puerto Rico, Virgin Islands)
P.O. Box 70105
San Juan, PR 00936
(809) 729-7624

Region III
(DC, DE, MD, PA, VA, WV)
Liberty Square Building
Second Floor
105 South Seventh Street
Philadelphia, Pennsylvania 19106-3316
(215) 931-5500

Region IV
(AL, FL, GA, KY, MS, NC, SC, TN)
1371 Peachtree Street, N.E.
Suite 700
Atlanta, Georgia 30309-3108
(404) 853-4200

Region V
(IL, IN, MI, MN, OH, WI)
175 West Jackson Boulevard, Fourth Floor
Chicago, Illinois 60604-2698

Region VI
(AR, LA, NM, OK, TX)
Federal Regional Center
800 North Loop 288, Room 206
Denton, Texas 76201-3698
(817) 898-5104

Region VII
(IA, KS, MO, NE)
911 Walnut Street, Room 200
Kansas City, Missouri 64106-2085
(816) 283-7061

Region VIII
(CO, MT, ND, SD, UT, WY)
Denver Federal Center, Building 710 A
P.O. Box 25267
Denver, Colorado 80225-0267
(303) 235-4800

Region IX
(AZ, CA, Guam, HI, NV)
Presidio of San Francisco
Building 105
San Francisco, California 94129-1250
(415) 923-7100

Region X
(AK, ID, OR, WA)
Federal Regional Center
130 228th Street, S.W.
Bothell, Washington 98021-9796
(206) 481-8800

NFIP offices are field offices of the Federal Insurance Administration's servicing contractor for the National Flood Insurance Program. Although they do not coincide with the areas served by FEMA regional offices, NFIP offices supplement the work of the regional offices.

National Flood Insurance Program Bureau and Statistical Agent Regional Offices

Region I
(CT, MA, ME, NH, RI, VT)
140 Wood Road
Suite 200
Braintree, Massachusetts 02184
(617) 848-1908

Region II
(NJ, NY)
33 Wood Avenue, South
Suite 600
Iselin, NJ 08830
(908) 603-3875

Caribbean Area Office
(Puerto Rico, and the Virgin Islands)
1407 J.T. Pinero
Capporra Terrace, PR 00921
(809) 782-2733

Region III
(DC, DE, MD, PA, VA, WV)
1930 East Marlton Pike
Suite T-3
Cherry Hill, NJ 08003
(609) 489-4003

Region IV
(AL, FL, GA, KY, MS, NC, SC, TN)
1532 Dunwoody Village Parkway
Suite 200, Offices B & C
Dunwoody, Georgia 30338
(404) 396-9117

Region V
(IL, IN, MI, MN, OH, WI)
2443 Warrenville Road
Suite 600, Offices 612 & 613
Lisle, IL 60532
(708) 955-4550

Region VI
(AR, LA, NM, OK, TX)
11931 Wickchester Road
Suite 304
Houston, Texas 77043
(713) 531-5990

Region VII
(IA, KS, MO, NE)
The Courtyards
601 N. Mur-Len
Suite 13-B
Olathe, KS 66062
(913) 780-4238

Region VIII
(CO, MT, ND, SD, UT, WY)
One Monaco Park
6795 E. Tennessee Avenue
Suite 165
Denver, CO 80224
(303) 393-1698

Region IX
(AZ, CA, Guam, HI, NV)
100 Smith Ranch Road
Suite 301
San Rafael, CA 94903
(415) 492-2815

Region X
(AK, ID, OR, WA)
1611 116th Avenue
Suite 116
Bellevue, WA 98004
(206) 646-4908

Examination Objectives

To determine whether an institution performs required flood determinations for loans secured by improved real estate or a mobile home affixed to a permanent foundation in accordance with the final rule.

To determine if the institution requires flood insurance in the correct amount when it makes, increases, extends, or renews a loan secured by improved real estate or a mobile home located or to be located in a SFHA.

To determine if the institution provides the required notices to the borrower, servicer and to the Director of FEMA whenever flood insurance is required as a condition of the loan.

To determine if the institution requires flood insurance premiums to be escrowed when flood insurance is required on a residential building and other items are required to be escrowed.

To determine if the institution complies with the forced placement provisions if at any time during the term of a loan it determines that flood insurance on the loan is not sufficient to meet the requirements of the regulation.

To initiate corrective action when policies or internal controls are deficient, or when violations of law or regulation are identified.

Examination Procedures

The following procedures should be performed, as appropriate:

- by reviewing previous examinations and supervisory correspondence;
- by obtaining and reviewing the institution's policies, procedures and other pertinent information;
- by reviewing the institution's system of internal controls;
- through discussions with management; and
- by reviewing a sample of loan files.

Coverage and Internal Control

1. Determine the method(s) used by the institution to ascertain whether improved real estate or mobile homes are or will be located in a special flood hazard area.
2. Verify that the process used accurately identifies special flood hazard areas.
3. For those special flood hazard areas identified, determine if the communities in which they are located participate in the National Flood Insurance Program (NFIP).
4. If the institution provides “affordable funding” to close loans originated by mortgage brokers or dealers, verify that it complies with regulatory requirements.
5. If the institution purchases servicing rights, review the contractual obligations placed on the institution as servicer by the owner of the loans to ascertain if flood insurance requirements are identified and compliance responsibilities are adequately addressed.
6. If the institution utilizes a third party to service loans, review the contractual obligations between the parties to ascertain that flood insurance requirements are identified and compliance responsibilities are adequately addressed.

Property Determination Requirements

1. Verify that flood zone determinations are accurately prepared on the Standard Flood Hazard Determination Form (SFHDF).

2. Verify that the institution only relies on a previous determination if it is not more than seven years old, is recorded on the SFHDF and that it is not in a community that has been remapped.

3. If the institution utilizes a third party to prepare flood zone determinations, review the contractual obligations between the parties to ascertain that flood insurance requirements are identified and compliance responsibilities are adequately covered, including the extent of the third party's guarantee of work and the procedures in place to resolve disputes relating to determinations.

4. Verify that the institution retains a copy of the completed SFHDF, in either hard copy or electronic form, for as long as it owns the loan.

Purchase Requirements

1. For loans that require flood insurance, determine that sufficient insurance was obtained prior to loan closing and is maintained for the life of the loan.

2. If the institution makes loans insured or guaranteed by a government agency (SBA, VA or FHA) determine how it complies with the requirement not to make these loans if the security property is in a SFHA within a nonparticipating community.

Determination Fee Requirements

1. Determine that any fees charged to the borrower by the institution for flood zone determinations (absent some other authority such as contract language) are charged only when a loan :

   - is made, increased, renewed or extended;
   - is made in response to a remapping by FEMA; or
   - results in the purchase of flood insurance under the forced placement provisions.

2. If other authority permits the institution to charge fees for determinations in situations other than the ones listed above, determine if the institution is consistent in this practice.

3. Determine the reasonableness of any fees charged to a borrower for flood determinations by evaluating the method used by the institution to determine the amount of the charge. Consider, for example, the relationship of the fees charged to the cost of services provided.

Notice Requirements

1. Ascertain that written notice is mailed or delivered to the borrower within a reasonable time prior to loan closing.

2. Verify that the notice contains:

   - a warning that the property securing the loan is or will be located in a SFHA;
   - a description of the flood insurance purchase requirements;
   - a statement, where applicable, that flood insurance coverage is available under the NFIP and may also be available from private insurers, if applicable; and
   - a statement whether Federal disaster relief assistance may be available in the event of damage to the property caused by flooding in a Federally declared disaster, if applicable.

3. If the seller or lessor provided the notice to the purchaser or lessee, verify that the institution obtained satisfactory written assurance that the notice was provided within a reasonable time before the completion of the sale or lease transaction.

4. Verify that the institution retains a record of receipt of the notice provided to the borrower for as long as it owns the loan.

5. If applicable, verify that the institution provided written notice to the servicer of the loan within the prescribed time frames and that the institution retains a record of receipt of the notice for as long as it owns the loan.

6. If the institution transfers servicing of loans to another servicer, ascertain whether it provides notice of the new servicer's identity to the flood insurance carrier (Director of FEMA's designee) within prescribed time frames.

Escrow Requirements

1. If the institution's policies or loan documents require the escrow of funds to cover charges such as taxes, premiums for hazard insurance or other fees, verify that the institution requires the escrow of funds for loans secured by residential improved real estate to cover premiums and other charges associated with flood insurance.

2. For loans closed after October 1, 1996, where flood insurance is required and where the loan is subject to RESPA, verify that the institution's escrow procedures comply with Section 10 of RESPA.

Forced Placement Requirements

1. If the institution determines that flood insurance coverage is less than the amount required by the FDPA, ascertain that is has appropriate policies and procedures in place to exercise its forced placement authority.

2. If the institution is required to force place insurance, verify:

   - That it provides written notice to the borrower that flood insurance is required, and
   - That if the required insurance is not purchased by the borrower within 45 days from the time that the institution provides the written notice, that the institution purchases the required insurance on the borrower's behalf.

Notice to Director of FEMA

1. Does the institution provide the appropriate notice to the carrier of the insurance policy (the Director of FEMA's designee) regarding the identity of the servicer of a designated loan?

2. If the institution sells or transfers the servicing of designated loans to another party, does it have procedures in place to provide the appropriate notice to the Director's designee within 60 days of the effective date of the transfer of the servicing?

Interagency Questions and Answers Regarding Flood Insurance - July 23, 1997

Background

The National Flood Insurance Reform Act of 1994 (the Reform Act) (Title V of the Riegle Community Development and Regulatory Improvement Act of 1994) comprehensively revised the two federal flood insurance statutes, the National Flood Insurance Act of 1968 and the Flood Disaster Protection Act of 1973. The Reform Act required the OCC, Board, FDIC, OTS, and NCUA to revise their current flood insurance regulations and required the FCA to promulgate flood insurance regulations for the first time. The agencies fulfilled these requirements by issuing a joint final rule in the summer of 1996. See 61 FR 45684 (August 29, 1996).

Purpose

The purpose of these Interagency Questions and Answers is to consolidate, to the extent possible, useful flood insurance information into a comprehensive document. These Interagency Questions and Answers supplement other documents that the agencies are not superseding, including, for example, interagency staff flood insurance interpretive letters.

Interagency Questions and Answers Regarding Flood Insurance

Table of Contents

I. Definitions.

Designated Loan - A loan secured by a building or mobile home that is located or to be located in a special flood hazard area (SFHA) in which flood insurance is available under the Act.

1. Is an interim loan to construct a commercial building included in this definition?

   Answer: Yes. If the purpose of the loan is to construct a building (assuming the loan is secured by that building), the Regulation applies. If the community in which the property is located participates in the National Flood Insurance Program (NFIP), then NFIP policies, subject to certain conditions and restrictions, can be purchased to provide coverage during the construction period for a building that will be located in an SFHA.

2. Are loans secured by raw land that will be developed into buildable lots subject to the Regulation?

Answer: No. Acquisition and development loans would not be subject to the Regulation because they do not meet the definition of a "designated loan." However, when the final construction phase of an ADC (acquisition, development, construction) project commences, the Regulation becomes applicable. This will require lenders to determine whether the property is located in an SFHA. If the building securing the loan is located or to be located in an SFHA, the other requirements of the Regulation will also apply. As noted above, the NFIP permits policies (subject to certain conditions and restrictions) to be purchased prior to the actual construction of a building.

3. Is a home equity loan considered a "designated loan?"

Answer: Yes, a home equity (or other) loan can be a designated loan, regardless of the lien priority, if: the loan is secured by a building or a mobile home; the collateral is located in an SFHA; and, the community where the property is located participates in the NFIP.

4. Are draws against approved lines of credit a "triggering event" requiring a flood determination under the Regulation or is it only the original application for the line of credit that triggers a determination?

Answer: Assuming that the line of credit is secured by a building and is thereby a "designated loan," a determination is required when application is made for the loan. Draws against an approved line would not require further determinations. However, a request for an increase in the line of approved credit is a triggering event and might require a new determination, depending upon whether a previous determination was done. (See the response to Question 4 in Section V, Required use of Standard Flood Hazard Determination Form)

5. If the loan request is to finance inventory stored in a building located within an SFHA but the building is not security for the loan, is flood insurance required?

Answer: No. The Act looks to the collateral securing the loan. In this example, the collateral does not meet the definition of a "designated loan" because it is not a building or mobile home.

6. If the building and contents both secure the loan, and the building is located in an SFHA, in a community that participates in the NFIP, what are the requirements for flood insurance? What if the contents securing the loan are located in buildings other than the building securing the loan?

Answer: Flood insurance is required for the building located in the SFHA and any contents stored in that building. If collateral securing the loan is stored in buildings that do not secure the loan and these buildings are not located in an SFHA, then flood insurance is not required on those contents.

7. Does the Regulation apply where the lender is taking a security interest only as an "abundance of caution?"

Answer: Yes. The Act looks to the collateral securing the loan, not to the purpose of the loan. If the lender takes a security interest in improved real estate, the Regulation applies without regard to the purpose of the loan.

8. If a borrower offers a note on a single family dwelling as collateral for a personal loan but the lender does not take a security interest in the dwelling itself, is this a "designated loan?"

Answer: No. A designated loan is a loan secured by a building or mobile home. In this example, the lender did not take a security interest in the building, therefore, the loan is not a "designated loan."

9. Does the Regulation apply to loans that are being restructured because of the borrower's default on the original loan?

Answer: Yes, assuming that the loan otherwise meets the definition of a "designated loan" and if the lender increases the amount of the loan, or extends or renews the terms of the original loan.

10. A lender makes a loan (not secured by real estate) on the condition that a third party personally guarantees the loan and permits the lender to take a security interest in improved real estate owned by the third party. Is this a "designated loan" to which the Regulation applies if the guarantor's property is located in an SFHA in a community that participates in the NFIP?

Answer: Yes. The making of a loan on condition of a personal guarantee by a third party and further secured by improved real estate owned by that third party is so closely tied to the making of the loan that it is considered a "designated loan" under the Regulation.

II. Requirement to purchase flood insurance where available.

1. If flood insurance is not available because the community in which the property securing the loan is located is a non-participating community in the NFIP, does the Regulation apply?

Answer: Yes. The Regulation still applies, although it does not require the borrower to obtain flood insurance. The lender must make a determination on the Special Flood Hazard Determination Form (SFHDF) to determine if the property is located in an SFHA and notify the borrower. The lender may make a conventional loan in an SFHA in a non-participating community if it chooses to do so. Government-guaranteed or insured loans (e.g., SBA, VA, FHA), however, are not permitted to be made in non-participating communities (see 42 USC §4106(a)).

Nevertheless, institutions should exercise good risk management practices to ensure that making loans on properties that are in an SFHA where no flood insurance is available does not create unacceptable risks in an institution's loan portfolio.

2. Does the Regulation apply loans purchased from others?

Answer: No. The Regulation lists certain events that trigger its requirements: making, increasing, extending or renewing a designated loan. The purchase of a loan is not an event that requires a purchaser to make a new determination at the time of purchase. However, if the lender becomes aware at some point during the life of the loan that flood insurance is required, then the lender must comply with the Regulation. Similarly, if the lender extends, increases or renews the loan, the Regulation applies.

3. What about table funding programs? Are they treated as originations or as loans purchased from others?

Answer: Loans made through a table funding process will be treated as though the party providing the funds has originated the loan. The funding party must comply with the Regulation. The table funding lender can meet the administrative requirements of the Regulation by requiring the party processing and underwriting the application to perform those functions on its behalf.

4. How are loans that are now under-insured because of previous insurance limitations to be handled?

Answer: In accordance with the Act, the Federal Insurance Administration has increased the amount of insurance available under the NFIP. Consequently, loans that previously had principal balances in excess of the program limits may now be underinsured. The new insurance limitations went into effect on March 1, 1995. Lenders and servicers must adjust coverage limits at the first renewal date or the first anniversary date following March 1, 1995, if the policy is a multi-year policy. Loans made after March 1, 1995, are subject to the new limits.

5. If the insurable value of the building securing the loan is less than the outstanding balance of the loan, can a lender require the borrower to obtain flood insurance up to the balance of the loan?

Answer: No. The insurable value of the improvements to the real estate that secures the loan governs the amount of insurance that is required. The amount of required insurance coverage is the lesser of the principal balance of the loan(s) or the maximum coverage available under the NFIP. An NFIP policy will not provide insurance coverage for losses in excess of the value of the improvements. Since the NFIP policy does not cover land value, lenders should determine the amount of insurance necessary based on the value of the improvements.

6. How do the flood insurance requirements apply in situations involving loan servicing?

Scenario 1- Loan is originated by a regulated lender and secured by a building on property located in an SFHA in a community in which flood insurance is available under the Act. Borrower is provided appropriate notice and insurance is obtained. Lender services the loan. Loan is subsequently sold to a non-regulated party and servicing is transferred to that party. What responsibilities are imposed on the regulated lender? What if the regulated lender only transfers or sells the servicing rights?

Answer: The lender must comply with all requirements of the Regulation, including making the initial determination, providing appropriate notice to the borrower, and ensuring that the proper amount of insurance is obtained. When the loan is sold and servicing is transferred to the new servicer, the lender must provide notice of the identity of the new servicer to FEMA or its designee.

If the lender retains ownership of the loan and only transfers or sells servicing rights to a non-regulated party, the lender must notify FEMA or its designee of the identity of the new servicer. The servicing contract should require the servicer to comply with all the requirements that are imposed on the lender as owner of the loan, including escrow of insurance premiums and forced placement (if necessary).

More generally, the Regulation does not impose obligations on a loan servicer independent from the obligations it imposes on the owner of a loan. Loan servicers are covered by the escrow, forced placement and flood hazard determination fee provisions of the Act and Regulation primarily to ensure that they may perform the administrative tasks for the lender, without fear of liability to the borrower for the imposition of unauthorized charges. In addition, the preamble to the Regulation emphasizes that the obligation of a loan servicer to fulfill administrative duties with respect to the flood insurance requirements arises from the contractual relationship between the loan servicer and the lender or from other commonly accepted standards for performance of servicing obligations. The lender remains ultimately liable for fulfillment of those responsibilities, and must take adequate steps to ensure that the loan servicer will maintain compliance with the flood insurance requirements.

Scenario 2 - Loan is originated by a non-regulated lender. Property is located in an SFHA but the lender did not make an initial determination or notify borrower of the need to obtain insurance. Loan is purchased by regulated lender who also services the loan. What are the responsibilities of the regulated lender? What if the regulated lender only purchases the servicing rights?

Answer: If the loan is purchased by the regulated lender, no determination is necessary at that point nor is any notice to FEMA required. If, at some time in the future, the lender becomes aware that the property is located in an SFHA in a community in which flood insurance is available under the Act, it must notify the borrower of that fact and require the borrower to purchase flood insurance. If the borrower does not voluntarily comply, the lender must force place the insurance. If servicing is subsequently sold or transferred, the lender must also notify FEMA or its designee of the identity of the new servicer.

If the regulated lender purchases only the servicing rights to the loan, the lender is only obligated to follow the terms of its servicing contract with the owner of the loan.

7. A loan is secured by multiple agricultural buildings located throughout a large geographic area. Some of the properties are located in an SFHA and others are not. In addition, the buildings are located in several jurisdictions or counties where some of the communities participate in the NFIP, and others do not. What are the flood insurance requirements for security properties in this scenario?

Answer: Flood insurance would be required only on those buildings located in an SFHA in which the community participates in the NFIP. A notice of special flood hazards is required for those buildings located in an SFHA whether or not the community participates in the NFIP. The amount of insurance required will depend upon the principal amount of the loan, the value of the buildings located in participating communities and the amount of insurance available under the NFIP.

For example, a loan in the principal amount of $150,000 is secured by 5 buildings, 3 of which are located in SFHAs within participating communities. The properties are non-residential in nature, therefore the maximum amount of insurance available under the NFIP is $500,000 per building. Each of the three buildings located in an SFHA must be covered by flood insurance. The total required amount of insurance for the three buildings would be the lesser of $150,000 or the value of the three buildings with each building insured separately from the other. The amount of required flood insurance could be allocated among the three buildings in varying amounts, so long as each is covered by flood insurance.

8. What is the appropriate amount of coverage under federal flood insurance legislation with respect to condominiums, in particular, multi-story condominium complexes?

Answer: Effective October 1, 1994, the Federal Insurance Administration issued a new form of Master Policy for condominiums - the Residential Condominium Building Association Policy (RCBAP). To meet federal flood insurance requirements, an RCBAP should be purchased in the amount of at least 80% of the replacement value of the building or the maximum amount available under the NFIP (currently $250,000 multiplied by the number of units), whichever is less. For instance, the maximum amount of coverage on a 50 unit condominium building could be up to $12,500,000 ($250,000 x 50). However, if the replacement value of the building was only $10,000,000, the condominium association could purchase a policy of $8,000,000 and not be required to have a co-insurance payment in the event of a flood. The $8,000,000 of coverage would meet the requirements of the Regulation for all the units within the condominium. A lender should make a similar analysis to determine the amount of coverage for other condominium complexes where flood insurance is required.

When making a loan on a condominium unit located in an SFHA, lenders should determine whether a master policy or similar product, provides adequate flood insurance coverage and is in place at the time the loan is made. Lenders should further ensure that a mechanism is in place (possibly a covenant on the part of the condominium association) that provides for adequate flood insurance coverage for the term of the loan.

9. A lender has a loan secured by a condominium unit in a multi-unit complex whose condominium association allows its existing flood insurance policy to lapse. As a result, there is no flood insurance coverage for the condominium unit. What recourse does the lender have?

   Answer: The NFIP does make an individual condominium unit policy available (the Dwelling Form), in addition to association master policies. In this instance, the lender after receiving notice that the association policy has lapsed, must notify the unit owner according to the forced placement procedures to obtain a policy (within 45 days) for the amount of the loan or the maximum amount of coverage available, whichever is less.

III. Exemptions.

1. What are the exemptions from coverage?

   Answer: There are only two exemptions from the purchase requirements: The first applies to State-owned property covered under a policy of self-insurance satisfactory to the Director of FEMA. The second applies if the original principal balance of the loan is $5,000 or less, and the original repayment term is one year or less. Both of these conditions must be present for the second exemption to apply.

IV. Escrow requirements.

1. The effective date of the escrow requirement was October 1, 1996. Does the escrow requirement apply to applications received before October 1, 1996?

   Answer: No. The escrow requirement applies only to loans closed on or after October 1, 1996.

2. Are multi-family buildings or mixed-use properties included in the definition of “residential improved real estate?” Are escrows required?

Answer: The Regulation states that if the collateral securing the loan meets the definition of "residential improved real estate" and the lender requires escrows for other items (e.g., hazard insurance or taxes), then the lender is required to also escrow flood insurance premiums.

Multi-family buildings. Neither the Act nor the Regulation distinguishes whether residential improved real estate is single or multi-family, or whether it is owner or renter-occupied. The preamble to the Regulation indicates that single family dwellings (including mobile homes), two to four family dwellings, and multi-family properties containing five or more residential units are covered under the Act's escrow provisions. If the building securing the loan meets the Regulation's definition of residential improved real estate, and the lender requires the escrow of other items, such as taxes or hazard insurance premiums, the lender is required to also escrow premiums and fees for flood insurance.

Mixed-use properties. The lender should look to the primary use of a building to determine if it meets the definition of "residential improved real estate." For example, a building having a retail store on the ground level with a small upstairs apartment used by the store's owner is generally considered a commercial enterprise and consequently would not constitute a residential building under the definition. Even though the Regulation does not require escrows for flood insurance, the lender may impose such a requirement through contract.

On the other hand, if the primary use of a mixed-use property is for residential purposes, the Regulation's escrow requirements apply.

3. When must escrow accounts established for flood insurance purposes be administered in accordance with the escrow rules under Section 10 of RESPA?

Answer: Lenders should look to the definition of "federally related mortgage loan" contained in RESPA to see if a particular loan is subject to Section 10. Generally, only loans on one to four family dwellings will be subject to the escrow requirements of RESPA. Consequently, only those escrow accounts established for loans subject to RESPA are required to conform with Section 10 of RESPA. Loans on multi-family dwellings with five or more units are not covered by RESPA requirements.

Pursuant to the Regulation, however, lenders must escrow premiums and fees for any required flood insurance if the lender requires escrows for other purposes such as hazard insurance or taxes. This requirement pertains to any loan, including those subject to RESPA. The preceding paragraph addresses the requirement for administering loans covered by RESPA. The preamble to the Regulation contains a more detailed discussion of the escrow requirements.

4. Do voluntary escrow accounts established at the request of the borrower, trigger a requirement for the lender to escrow premiums for required flood insurance?

Answer: No. If escrow accounts for other purposes are established at the voluntary request of the borrower, the lender is not required to establish escrow accounts for flood insurance premiums. Examiners should review the loan policies of the lender and the underlying legal obligation between the parties to the loan to determine whether the accounts are in fact voluntary. For example, if the loan policies of the lending institution require borrowers to establish escrow accounts for other purposes and the contractual obligation permits the lender to establish escrow accounts for those other purposes, the lender will have the burden of demonstrating that an existing escrow was made pursuant to a voluntary request.

5. Will premiums paid for credit life insurance, disability insurance, or similar insurance programs be viewed as escrow accounts requiring the escrow of flood insurance premiums?

Answer: No. Premiums paid for these types of insurance policies will not trigger the escrow requirement for flood insurance premiums.

6. Will escrow-type accounts for multi-family building commercial loans trigger the escrow requirement for flood insurance premiums?

Answer: Various types of accounts are established in connection with commercial purpose real estate loans. These loans typically involve multi-family properties and are substantially different in purpose and type from escrow accounts on single family residences. These involve accounts such as "interest reserve accounts," "compensating balance accounts," "marketing accounts," and similar accounts that may be established by contract between the purchaser and seller of the building (although administered by the lender in some cases). Accounts established in connection with the underlying agreement between the buyer and seller, or that relate to the commercial venture itself are not the type of accounts that constitute escrow accounts for the purpose of the Regulation. Escrow accounts for the protection of the property, such as escrows for hazard insurance premiums or local real estate taxes, are the types of escrows that trigger the requirement to escrow flood insurance premiums.

7. What requirements for escrow accounts apply to properties covered by Residential Condominium Building Association Policies?

Answer: RCBAPs are policies purchased by the condominium association on behalf of the individual unit owners in the condominium. The premiums on the policy are paid by a portion of the periodic dues paid to the association by the condominium owners. When a lender makes a loan on the purchase of a condominium over which a RCBAP is in place and the premiums are paid by dues to the condominium association, the escrow requirement is satisfied. Lenders should exercise due diligence with respect to continuing compliance with the insurance requirements on the part of the condominium association.

V. Required use of Standard Flood Hazard Determination Form (SFHDF).

1. Does the SFHDF replace the borrower notification form?

Answer: No. The notification form is used to notify the borrower(s) that they are purchasing improved property located in an SFHA. The financial regulatory agencies, in consultation with FEMA, included a revised version of the sample borrower notification form in Appendix A to the Regulation. The SFHDF is used by the lender to determine whether the property securing the loan is located in an SFHA.

2. Must the SFHDF be provided to the borrower? If so, must the borrower sign the form acknowledging receipt?

Answer: While it may be a common practice in some areas for lenders to provide a copy of the SFHDF to the borrower to give to the insurance agent, lenders are neither required to, nor prohibited from, providing the borrower with a copy of the form. Signature of the borrower is not required on the SFHDF.

3. May the SFHDF be used in electronic format?

Answer: Yes. FEMA, in the final rule adopting the SFHDF stated: If an electronic format is used, the format and exact layout of the Standard Flood Hazard Determination Form is not required, but the fields and elements listed on the form are required. Any electronic format used by lenders must contain all mandatory fields indicated on the form. It should be noted, however, that the lender must be able to reproduce the form upon receiving a document request by its Federal supervisory agency.

4. Section 528 of the Act permits a lender to rely on a previous determination using the SFHDF when it is increasing, extending, renewing or purchasing a loan secured by a building or a mobile home. The Act omits the "making" of a loan as a permissible event to rely on a previous determination. May a lender rely on a previous determination for a refinancing or assumption of a loan?

Answer: It depends. If a subsequent loan involving a refinancing or assumption is made on the same property by the same lender who obtained the original determination, and the other requirements contained in Section 528 are met, the lender may rely on the previous determination. Section 528 of the Act requires that a lender may rely on a previous determination only if the original determination was recorded on the SFHDF within the previous seven years and there were no map revisions or updates affecting the security property since the original determination was made. However, a loan refinancing or assumption made by a lender other than the lender who obtained the original determination would constitute "making" a new loan, thereby requiring a new determination.

5. If a borrower requesting a home equity loan secured by a junior lien provides evidence that flood insurance coverage is in place, does the lender have to make a new determination? Does the lender have to adjust the insurance coverage?

Answer: It depends. Assuming the requirements in Section 528 are met and the lender made the first mortgage, then a new determination would not be necessary. If, however, a lender other than the one that made the first mortgage loan is making the home equity loan, a new determination would be required because this lender would be deemed to be "making" a new loan. In any event, the institution will need to determine if the amount of insurance in force is sufficient to cover either the principal balance of all loans (including the home equity loan) or the maximum amount of coverage available on the improved real estate, whichever is less.

VI. Forced placement of flood insurance.

1. Is forced placement allowed? What are the procedures?

Answer: The Act and Regulation require a lender to force place flood insurance if all of the following circumstances occur:

- The lender determines at any time during the life of the loan that the property securing the loan is located in an SFHA;
- The community in which the property is located participates in the NFIP;

- Flood insurance coverage is inadequate or does not exist; and
- The borrower fails to purchase the appropriate amount of coverage.

In order to force place, a lender must notify the borrower of the required amount of flood insurance that must be obtained within 45 days after notification. The notice must also state that if the borrower does not obtain the insurance within the 45 day period, the lender will purchase the insurance on behalf of the borrower and may charge the borrower the cost of premiums and fees to obtain the coverage. Standard FNMA/FHLMC documents permit the servicer or lender to add those charges to the principal amount of the loan.

FEMA developed the Mortgage Portfolio Protection Program (MPPP) to assist lenders in connection with forced placement procedures. FEMA published these procedures in the Federal Register on August 29, 1995 (60 FR 44881). Appendix A of the FEMA publication contains examples of notification letters to be used in connection with the MPPP.

2. Can a servicer force place on behalf of a lender?

Answer: Yes. Assuming the statutory prerequisites for forced placement are met, and subject to the servicing contract between the lender and the servicer, the Act clearly authorizes servicers to force place flood insurance on behalf of the lender, following the procedures set forth in the Regulation.

3. When forced placement occurs, what is the amount of insurance required to be placed?

Answer: The amount of flood insurance coverage required is the same regardless of how the insurance is placed. (See Section II. Requirement to purchase flood insurance where available.)

VII. Determination fees.

1. When can lenders or servicers charge the borrower a fee for making a determination?

Answer: There are four instances under the Act and Regulation when the borrower can be charged a specific fee for a flood determination:

- When the determination is made in connection with the making, increasing, extending, or renewing of a loan that is initiated by the borrower;
- When the determination is prompted by a revision or updating by FEMA of floodplain areas or flood-risk zones;
- When the determination is prompted by FEMA's publication of a notice or compendia that affects the area in which the security property is located; or
- When the determination results in forced placement of insurance.
- Loan or other contractual documents between the parties may also permit the imposition of fees.

2. May charges made for life of loan reviews by flood determination firms be passed along to the borrower?

Answer: Yes. Many flood determination firms provide a service to the lender for conducting a periodic review of the loan during the time it is outstanding to ascertain whether the original determination remains valid. This service is sometimes coupled with the making of the original determination and the fee charged is a composite one for conducting both the original and subsequent reviews. Charging a fee for the original determination is clearly within the permissible purpose envisioned by the Act. The agencies agree that a determination fee may include, among other things, reasonable fees for a lender, servicer, or third party to monitor the flood hazard status of property securing a loan in order to make determinations on an ongoing basis.

Consequently, the agencies also believe that a fee for a life of loan service may be passed along to the borrower. However, because the life of loan fee is based on the ability to charge a determination fee, the monitoring fee may be charged only if the events specified in the answer to question VII.1 occur.

VIII. Notice of special flood hazards and availability of Federal disaster relief.

1. Does the notice have to be provided to each borrower for a real estate related loan?

Answer: The notice must be provided to a borrower only when the lender determines that the property securing the loan is or will be located in an SFHA. In a transaction involving multiple borrowers, the agencies believe it is only necessary to provide the notice to any one of the borrowers in the transaction. Lenders may provide multiple notices if they choose. The lender and borrower(s) typically designate the borrower to whom the notice will be provided.

2. Lenders making loans on mobile homes may not always know where the home is to be located until just prior to, or sometimes after, the time of loan closing. How is the notice requirement applied in these situations?

Answer: The notice requirement can be met by lenders in mobile home loan transactions if notice is provided to the borrower as soon as practicable after determination that the mobile home will be located in an SFHA and, if possible, before completion of the loan transaction. In circumstances where time constraints can be anticipated, regulated lenders should use their best efforts to provide adequate notice of flood hazards to borrowers at the earliest possible time.

In the case of loan transactions secured by mobile homes not located on a permanent foundation, the agencies note that such "home only" transactions are excluded from the definition of mobile home and the notice requirements would not apply to these transactions. However, as indicated in the preamble to the Regulation, the agencies encourage a lender to advise the borrower that if the mobile home is later located on a permanent foundation in an SFHA, flood insurance will be required. If the lender, when notified of the location of the mobile home subsequent to the loan closing, determines that it has been placed on a permanent foundation and is located in an SFHA in which flood insurance is available under the Act, flood insurance coverage becomes mandatory and appropriate notice must be given to the borrower under those provisions. If the borrower fails to purchase flood insurance coverage within 45 days after notification, the lender must force place the insurance.

3. When is the lender required to provide notice to the servicer of a loan that flood insurance is required?

Answer: Because the servicer of a loan is often not identified prior to the closing of a loan, the Regulation requires that notice be provided no later than the time the lender transmits other loan data, such as information concerning hazard insurance and taxes, to the servicer.

4. What will constitute appropriate form of notice to the servicer?

Answer: Delivery to the servicer of a copy of the notice given to the borrower is appropriate notice. The Regulation also provides that the notice can be made either electronically or by a written copy.

5. In the case of a servicer affiliated with the lender, is it necessary to provide the notice?

Answer: Yes. The Act requires the lender to notify the servicer of special flood hazards and the Regulation reflects this requirement. Neither contains an exception for affiliates.

6. How long does the lender have to maintain the record of receipt by the borrower of the notice?

Answer: The record of receipt provided by the borrower must be maintained for the time that the lender owns the loan. Lenders may keep the record in the form that best suits the lender's business practices. Lenders may retain the record electronically, but they must be able to retrieve the record within a reasonable time pursuant to a document request from their Federal supervisory agency.

IX. Notice of servicer's identity.

1. When a lender makes a designated loan and it will be servicing that loan, what are the requirements for notifying the Director of FEMA or the Director's designee?

Answer: FEMA stated in a June 4, 1996 letter, that the Director's designee is the insurance company issuing the flood insurance policy. The borrower's purchase of a policy (or the lender's forced placement of a policy), will constitute notice to FEMA when the lender is servicing that loan. In the event the servicing is subsequently transferred to a new servicer, the lender must provide notice to the insurance company of the identity of the new servicer.

2. Would a RESPA Notice of Transfer sent to the Director of FEMA (or the Director's designee) satisfy the regulatory provisions of the Act?

Answer: The delivery of a copy of the Notice of Transfer or any other form of notice is sufficient if the sender includes, on or with the notice, the following information that FEMA has indicated is needed by its designee:

- Borrower's Full Name
- Flood Insurance Policy Number
- Property Address (including city and state)
- Name of bank or servicer making notification
- Name and address of new servicer
- Name and telephone number of contact person at new servicer

3. Can delivery of the notice be made electronically, including batch transmissions?

Answer: Yes. The Regulation specifically permits transmission by electronic means and a timely batch transmission of the notice would also be permissible, if it is acceptable to the Director's designee.

4. If the loan and its servicing rights are sold by the lender, is the lender required to provide notice to the Director or the Director's designee?

Answer: Yes. Failure to provide such notice would defeat the purpose of the notice requirement because FEMA would have no record of the identity of either the owner or servicer of the loan.

5. Is the lender required to provide notice when a servicer other than the lender sells or transfers the servicing rights to another servicer?

Answer: No. The obligation of the lender to notify the Director or the Director's designee of the identity of the servicer transfers to the new servicer. The duty to notify the Director or the Director's designee of any subsequent sale or transfer of the servicing rights and responsibilities belongs to that servicer. For example, First Financial Institution makes and services the loan. It then sells the loan in the secondary market and also sells the servicing rights to First Financial Mortgage Company. First Financial Institution notifies the Director's designee of the identity of the new servicer and the other information requested by FEMA so that FEMA can track the loan. If First Financial Mortgage Company later sells the servicing rights to another firm, First Financial Mortgage Company is responsible for notifying the Director's designee of the identity of the new servicer, not First Financial Institution.

6. In the event of a merger of one lending institution with another, what are the responsibilities of the parties for notifying the Director's designee?

Answer: If an institution is acquired by or merges with another institution, the duty to provide notice for the loans being serviced by the acquired institution will fall to the successor institution in the event that notification is not provided by the acquired institution prior to the effective date of the acquisition or merger.

X. Appendix A to the Regulation - Sample Form of Notice of Special Flood Hazards and Availability of Federal Disaster Relief Assistance.

1. Is use of the sample form of notice mandatory? Can it be revised to accommodate a lender's needs?

Answer: Although lenders are required to provide a notice to a borrower who is purchasing property secured by an improved structure located in an SFHA, use of the sample form of notice provided in Appendix A is not mandatory. It should be noted that the sample form includes other information in addition to what is required by the Act and the Regulation. Lenders may personalize, change the format of, and add information to the sample form if they choose. However, a lender-revised form must provide the borrower with at least the minimum information required by the Regulation. Therefore, lenders should consult the Regulation to determine the information needed.

Introduction

The Right to Financial Privacy Act (RTFPA) of 1978 became effective on March 10, 1979 (12 U.S.C. 3401). It was enacted because financial institution customers have a right to expect that their financial activities have a reasonable amount of privacy from federal government scrutiny. The Act establishes specific procedures for government authorities which seek information from a financial institution about a customer's financial records and imposes limitations and duties on financial institutions prior to the release of information sought by government agencies.

Prior to the Act, customers could not challenge government access to their financial records. Nor did the customer have any way of knowing that personal records were being turned over to a government authority. In *United States v. Miller*, 425 U.S. 435(1976), the Supreme Court held that financial records, because they are kept by the institution, are the property of the institution rather than the customer. As such, the customer had no protectable legal interest in records kept by the financial institution, nor could he or she limit government access to those accounts. It was principally in response to this decision that the RTFPA was adopted.

General Requirements

The RTFPA generally requires that the customer must receive:

- A written notice of the agency's intent to obtain financial records,
- An explanation of the purpose for which the records are sought, and
- A statement describing procedures to use if the customer does not wish such records or information to be made available.

Approved-FFIEC

Certain exceptions apply which allow for delayed notice or no notice to be given to the customer.

Definitions

As defined by the Act, a customer is any person or representative of that person who utilized or is utilizing any service of a financial institution. It also includes any person for whom the financial institution is acting or has acted as a fiduciary. However, a customer does not include a corporation or a partnership of six or more individuals.

Requirements

In order to obtain access to the financial records of the customer, the Act requires, with certain exceptions, that the government authority first obtain one of the following:

1. An authorization, signed and dated by the customer, which identifies the records being sought, the reasons the records are being requested and the customer's rights under the Act;
2. An administrative subpoena or summons;
3. A search warrant;
4. A judicial subpoena; or
5. A formal written request by a government agency (to be used only if no administrative summons or subpoena authority is available).

If a financial institution receives a request for information, it may not release the financial records of a customer until the government authority seeking such records certifies in writing that it has complied with the applicable provision of the Act (§1103(b)).

The financial institution is required to maintain a record of all instances in which a customer's record is disclosed to a government authority pursuant to customer authorization. The record should include the date, the name of the government authority and an identification of the records disclosed. Generally, the customer has a right to inspect that record (§1104(c)).

Although there are no specific record retention requirements in the Act, financial institutions should retain copies of all administrative and judicial subpoenas, search warrants and formal written requests given to them by federal government agencies or departments along with the written certification required (§1103(b)).

Under the Act, a financial institution is required to begin assembling the required information upon receipt of the agency's summons or subpoena or a judicial subpoena and must be prepared to deliver the records upon receipt of the written certificate of compliance (§1111).

Cost Reimbursements

One section of the Act, effective October 1, 1979, allows, with certain exceptions, the financial institution to receive payment from a government authority requesting information pursuant to the Act. This may include costs for assembling or providing records, reproduction and transportation costs or any other costs reasonably necessary or incurred in gathering and delivering requested information. The Federal Reserve Board's Regulation S establishes the rates and conditions under which these payments may be made.

Exceptions to Notice and Certification Requirements

The Act specifically allows for a financial institution to notify law enforcement officials if it has information relevant to a violation of the law (§1103(c)).

A financial institution may submit copies of financial records to any court or agency when perfecting a security interest, proving a claim in bankruptcy, or collecting a debt for itself or a fiduciary (§1103(d)(1)).

A financial institution may also release records that are not individually identifiable with a particular customer (§1113(a)).

The Act does not apply to records that are sought by a supervisory agency in connection with its supervisory, regulatory or monetary functions. This includes regular examinations and any investigations relating to consumer complaints (§1113(b)).

The Act does not apply where records are sought in accordance with procedures authorized by the Internal Revenue Code (for example, records which are intended to be accessed by procedures authorized by the Tax Reform Act of 1976) (§1113(c)).

A financial institution may provide records that are required to be reported in accordance with any federal statute or rule promulgated thereunder (e.g., the Bank Secrecy Act) (§1113(d)).

If the agency and the customer are parties to a suit, records are obtainable under the Federal Rules of Civil and Criminal Procedure (§1113(e)).

The Act does not apply, with the exception of cost reimbursement and the restricted use of Grand Jury information, to a subpoena issued in conjunction with proceedings before a Grand Jury (§1113(i)).

The Act does not apply to records sought by the General Accounting Office for an authorized proceeding or audit directed at a federal agency (§1113(j)).

Exception to Notice Requirements But Where Certification Is Required

The Act does not apply where a financial institution, rather than a customer, is being investigated; however, the federal agency seeking access to customer records must provide the financial institution with the certification of compliance required (§ 1113(h)(1)(A)).

Records may also be provided incidental to processing a government loan, loan guaranty, loan insurance agreement or default upon a government-guaranteed or insured loan. Again, the federal agency seeking access must provide the financial institution with the written certification of compliance. The federal agency must also give to the loan applicant a notice of its access rights when the customer initially applies for the loan. The financial institution is then required to keep a record of all disclosures made to government authorities and the customer is entitled to inspect this record (§§1113(h)(1)(B) and 1103(d)(2)).

No notice is required and the customer does not have the right to challenge any access where the government is engaging in authorized foreign intelligence activities or where the Secret Service is conducting its protective functions. A certificate of compliance must be furnished to the institution (§1114(a)).

The Securities and Exchange Commission is covered by the Act although the Commission can obtain customer records from an institution without prior notice to the customer by obtaining an order from a United States district court. The agency must however provide the certificate of compliance to the institution along with the court order prohibiting the disclosure of the fact that the documents have been obtained. The court order will set a delay of notification date after which the customer will be notified by the institution that the SEC has obtained the customer's records (§§1122 and 1109).

Delayed Notice Requirements

Delayed notice to customers that government authorities have obtained their financial records may be given by a court under certain circumstances. Customer notice can be delayed for periods up to 90 days if the government can convince the court that notice would result in endangering the life or physical safety of any person; flight from prosecution; destruction of or tampering with evidence; intimidation of potential witnesses; or otherwise seriously jeopardizing or unduly delaying an investigation, trial or official proceeding. Delayed notice of no later than 90 days is also allowed for search warrants.

Civil Liability

Any government agency that obtains, or any financial institution or employee of the institution who discloses information in violation of the Act is liable for: (1) actual damages; (2) $100, regardless of the volume of records involved; (3) court costs and reasonable attorney's fees; (4) and such punitive damages as the court may allow for willful or intentional violations. A financial institution that relies in good faith upon a federal agency's certification cannot be held liable to a customer for the disclosure of financial records. An action can be brought up to 3 years after the date of violation or the date of its discovery.

Examination Objectives

To determine that the financial institution has established procedures to ensure that it is in compliance with the RTFPA.

To determine that the financial institution is in compliance with the provisions of the RTFPA.

Examination Procedures

1. Determine if the financial institution has received any requests covered by the Act for consumers' financial records since March 10, 1979. If no requests have been made the examiner should determine if the institution is aware of its responsibilities under the Act. If requests have been made the examiner should complete the remaining procedures.

2. Determine if the financial institution has established procedures and internal controls for fulfilling requests by government authorities for a consumer financial records which are adequate to ensure that all requests are handled in compliance with the Act.

3. Determine if the financial institution provides customers' financial records to government authorities only after receiving the proper written certification required by the Act.

4. Determine if the internal procedures of the financial institution require that the institution refrain from requiring a customer's authorization for disclosure of financial records as a condition of doing business.

5. Determine if the financial institution keeps appropriate records of those instances in which a customer's financial records are disclosed to the government authority, upon authorization by the customer including a copy of the request and the identity of the government authority. Determine if the institution provides customers a copy of the records upon request (unless a court order has been obtained blocking access).

6. Determine if the financial institution maintains appropriate records of all disclosures of a customer's records made to a government authority in connection with a government loan, guaranty or insurance program. Determine if the institution allows customers to examine these records upon request.

References

Laws

12 U.S.C. 3401 Financial Institutions

et seq. Regulatory and Interest Rate Control Act, Title XI Short Title: Right to Financial Privacy Act

5 U.S.C. 552a Privacy Act of 1974

Regulations

12 C.F.R. Part 219 Federal Reserve Board Regulation S

Introduction

The Fair Debt Collection Practices Act (FDCPA), which became effective March 20, 1978, was designed to eliminate abusive, deceptive and unfair debt collection practices. In addition, the federal law (15 USC 1692 et seq.) protects reputable debt collectors from unfair competition and encourages consistent state action to protect consumers from abuses in debt collection.

Debt That is Covered

The FDCPA applies only to the collection of debt incurred by a consumer primarily for personal, family or household purposes. It does not apply to the collection of corporate debt or to debt owed for business or agricultural purposes.

Debt Collectors That Are Covered

Under FDCPA, a "debt collector" is defined as any person who regularly collects, or attempts to collect, consumer debts for another person or institution or uses some name other than its own when collecting its own consumer debts. That definition would include, for example, an institution that regularly collects debts for an unrelated institution. This includes reciprocal service arrangements where one institution solicits the help of another in collecting a defaulted debt from a customer who has moved.

Debt Collectors That Are Not Covered

An institution is not a debt collector under the FDCPA when it collects:

- another's debts in isolated instances.
- its own debts under its own name.
- debts it originated and then sold but continues to service (for example, mortgage and student loans).
- debts that were not in default when they were obtained.
- debts that were obtained as security for a commercial credit transaction (for example, accounts receivable financing).
- debts incidental to a bona fide fiduciary relationship or escrow arrangement (for example, a debt held in the institution's trust department or mortgage loan escrow for taxes and insurance).
- debts regularly for other institutions to which it is related by common ownership or corporate control.

Debt collectors that are not covered also include:

- officers or employees of an institution who collect debts owed to the institution in the institution's name.
- legal process servers.

Communications Connected with Debt Collection

For communications with a consumer or third party with the collection of a debt, the term "consumer" is defined to include the borrower's spouse, parent (if the borrower is a minor), guardian, executor, or administrator.

When, Where, and With Whom Communication is Permitted

Communicating with the Consumer

A debt collector may not communicate with a consumer at any unusual time (generally before 8 a.m. or after 9 p.m. in the consumer's time zone) or at any place that is inconvenient to the consumer, unless the consumer or a court of competent jurisdiction has already given permission for such contacts. A debt collector may not contact the consumer at his or her place of employment if the collector has reason to believe the employer prohibits such communications.

Approved-FFIEC

If the debt collector knows the consumer has retained an attorney to handle the debt, and can easily ascertain the attorney's name and address, all contacts must be with that attorney, unless the attorney is unresponsive or agrees to allow direct communication with the consumer.

Ceasing Communication With the Consumer

When a consumer refuses, in writing, to pay a debt or requests that the debt collector cease further communication, the collector must cease all further communication, except to advise the consumer that:

- the collection effort is being stopped.
- certain specified remedies ordinarily invoked may be pursued or, if appropriate, that a specific remedy will be pursued.

Mailed notices from the consumer are official when they are received by the debt collector.

Communicating With Third Parties

The only third parties that a debt collector may contact when trying to collect a debt are:

- the consumer.
- the consumer's attorney.
- a consumer reporting agency (if permitted by local law).
- the creditor.
- the creditor's attorney.
- the debt collector's attorney.

The consumer or a court of competent jurisdiction may, however, give the debt collector specific permission to contact other third parties. In addition, a debt collector who is unable to locate a consumer may ask a third party for the consumer's home address, telephone number and place of employment (location information). The debt collector must give his or her name and state that he or she is confirming or correcting location information about the consumer. Unless specifically asked, the debt collector may not name the collection firm or agency or reveal that the consumer owes any debt.

No third party may be contacted more than once unless the collector believes that the information from the first contact was wrong or incomplete and that the third party has since received better information, or unless the third party specifically requests additional contact.

Contact with any third party by postcard, letter or telegram is allowed only if the envelope or content of the communication does not indicate the nature of the collector's business.

Validation of Debts

The debt collector must provide the consumer with certain basic information. If that information was not in the initial communication and if the consumer has not paid the debt five days after the initial communication, the following information must be sent to the consumer in written form:

- the amount of the debt;
- the name of the creditor to whom the debt is owed;
- notice that the consumer has 30 days to dispute the debt before it is assumed to be valid;
- notice that upon such written dispute, the debt collector will send the consumer a verification of the debt or a copy of any judgment; and
- notice that if, within the 30-day period, the consumer makes a written request for the name and address of the original creditor, if it is different from the current creditor, the debt collector will provide that information.

If, within the 30-day period, the consumer disputes in writing any portion of the debt or requests the name and address of the original creditor, the collector must stop all collection efforts until he or she mails the consumer a copy of a judgment or verification of the debt, or the name and address of the original creditor, as applicable.

PROHIBITED PRACTICES: Harassing or Abusive Practices

A debt collector in collecting a debt, may not harass, oppress, or abuse any person. Specifically, a debt collector may not:

- use or threaten to use violence or other criminal means to harm the physical person, reputation, or property of any person.
- use obscene, profane, or other language which abuses the hearer or reader.
- publish a list of consumers who allegedly refuse to pay debts, except to a consumer reporting agency or to persons meeting the requirements of section 603(f) or 604(3) of the Act.
- advertise a debt for sale to coerce payment.
- annoy, abuse, or harass persons by calling repeatedly their telephone number or allowing their telephones to ring continually.
- make telephone calls without properly identifying oneself, except as allowed to obtain location information.

False or Misleading Representations

A debt collector, in collecting a debt, may not use any false, deceptive, or misleading representation. Specifically, a debt collector may not:

- falsely represent or imply that he or she is vouched for, bonded by, or affiliated with the United States or any state, including the use of any badge, uniform, or similar identification.
- falsely represent the character, amount, or legal status of the debt, or of any services rendered, or compensation he or she may receive for collecting the debt.
- falsely represent or imply that he or she is an attorney or that communications are from an attorney.
- threaten to take any action which is not legal or intended.
- falsely represent or imply that nonpayment of any debt will result in the arrest or imprisonment of any person or the seizure, garnishment, attachment or sale of any property or wages of any person, unless such action is lawful and intended by the debt collector or creditor.
- falsely represent or imply that the sale, referral, or other transfer of the debt will cause the consumer to lose a claim or a defense to payment, or become subject to any practice prohibited by the FDCPA.
- falsely represent or imply that the consumer committed a crime or other conduct to disgrace the consumer.
- communicate, or threaten to communicate, false credit information or information which should be known to be false, including not identifying disputed debts as such.
- use or distribute written communications made to look like or falsely represented to be documents authorized, issued, or approved by any court, official, or agency of the United States or any state if it would give a false impression of its source, authorization, or approval.
- use any false representation or deceptive means to collect or attempt to collect a debt or to obtain information about a consumer.
- fail to disclose in the initial written communication with the consumer, and the initial oral communication if it precedes the initial written communication, that the debt collector is attempting to collect a debt and that any information obtained will be used for that purpose. In addition, the debt collector must disclose in subsequent communications that the communication is from a debt collector. (These disclosures do not apply to a formal pleading made in connection with a legal action.)
- falsely represent or imply that accounts have been sold to innocent purchasers.
- falsely represent or imply that documents are legal process.

- use any name other than the true name of the debt collector's business, company, or organization.
- falsely represent or imply that documents are not legal process or do not require action by the consumer.
- falsely represent or imply that he or she operates or is employed by a consumer reporting agency.

Unfair Practices

A debt collector may not use unfair or unconscionable means to collect or attempt to collect a debt. Specifically, a debt collector may not:

- collect any interest, fee, charge or expense incidental to the principal obligation unless it was authorized by the original debt agreement or is otherwise permitted by law.
- accept a check or other instrument postdated by more than five days, unless he or she notifies the consumer, in writing, of any intention to deposit the check or instrument. That notice must be made not more than ten or less than three business days before the date of deposit.
- solicit a postdated check or other postdated payment instrument to use as a threat or to institute criminal prosecution.
- deposit or threaten to deposit a postdated check or other postdated payment instrument before the date on the check or instrument.
- cause communication charges, such as those for collect telephone calls and telegrams, to be made to any person by concealing the true purpose of the communication.
- take or threaten to repossess or disable property when the creditor has no enforceable right to the property or does not intend to do so, or if, under law, the property cannot be taken, repossessed or disabled.
- use a postcard to contact a consumer about a debt.

Multiple Debts

If a consumer owes several debts that are being collected by the same debt collector, payments must be applied according to the consumer's instructions. No payment may be applied to a disputed debt.

Legal Actions by Debt Collectors

A debt collector may file a lawsuit to enforce a security interest in real property only in the judicial district in which the real property is located. Other legal actions may be brought only in the judicial district in which the consumer lives or in which the original contract creating the debt was signed.

Furnishing Certain Deceptive Forms

No one may design, compile and/or furnish any form which creates the false impression that someone other than the creditor (for example, a debt collector) is participating in the collection of a debt.

Civil Liability

A debt collector who fails to comply with any provision of the FDCPA is liable for:

- any actual damages sustained as a result of that failure;
- punitive damages as allowed by the court-
  - in an individual action, up to $1,000; or
  - in a class action, up to $1,000 for each named plaintiff and an award to be divided among all members of the class of an amount up to $500,000 or 1 percent of the debt collector's net worth, whichever is less;
- costs and a reasonable attorney's fee in any such action.

In determining punitive damages, the court must consider the nature, frequency and persistency of the violations and the extent to which they were intentional. In a class action, the court must also consider the resources of the debt collector and the number of persons adversely affected.

Defenses

A debt collector is not liable for a violation if a preponderance of the evidence shows it was not intentional and was the result of a bona fide error that arose despite procedures reasonably designed to avoid any such error. The collector is also not liable if he or she, in good faith, relied in an advisory opinion of the Federal Trade Commission even if the ruling is later amended, rescinded, or determined to be invalid for any reason.

Jurisdiction and Statute of Limitations

Action against debt collectors for violations of the FDCPA may be brought in any appropriate U.S. district court or other court of competent jurisdiction. The consumer has one year from the date on which the violation occurred to start such as action.

Administrative Enforcement

The Federal Trade Commission (FTC) is the primary enforcement agency for the FDCPA. The various financial regulatory agencies enforce the FDCPA for the institutions they supervise.

Neither the FTC nor any other agency may issue regulations governing the collection of consumer debts by debt collectors. The FTC may, however, issue advisory opinions under the Federal Trade Commission Act on the meaning and application of the FDCPA.

Relation to State Law

The FDCPA preempts state law only to the extent that a state law is inconsistent with the FDCPA. A state law that is more protective of the consumer is not considered inconsistent with the FDCPA.

Exemption for State Regulation

The FTC may exempt certain classes of debt collection practices from the requirements of the FDCPA if the FTC has determined that state laws impose substantially similar requirements and that there is adequate provision for enforcement.

Examination Objectives

To determine the adequacy of the institution's internal procedures and controls to assure consistent compliance with FDCPA.

To determine if the institution complies with the requirements of the FDCPA in collecting or attempting to collect third-party consumer debts.

Examination Procedures

The following procedures are to be completed through interviews with personnel knowledgeable about and directly engaged in the institution's collection activities and through reviews of any written collection procedures, reciprocal collection agreements, collection letters, dunning notices, envelopes, scripts used by collection personnel, validation notices, individual collection files, complaint files, and other relevant records.

1. Determine if the institution is a debt collector under the FDCPA.

2. Determine if the institution has established internal procedures and controls to assure compliance with the FDCPA.

3. If the institution has acted or is acting as a debt collector under the FDCPA, determine if the institution has:

   - Communicated with the consumer or third parties in any prohibited manner;
   - Furnished the written validation notice within the required time period and other wise complied with applicable validation requirements;
   - Used any harassing, abusive, unfair or deceptive collection practice prohibited by the FDCPA;

- Collected any amount not expressly authorized by the agreement creating the debt or by state law;
- Applied all payments received as instructed and, where no instruction was given, applied payments only to undisputed debts; and
- Filed suit in an authorized forum if the institution sued to collect the debt.

Introduction

A Credit Practices Rule was adopted by the OTS and the Federal Reserve Board under Section 18(f)(1) of the Federal Trade Commission Act (15 USC 45) in response to a similar rule adopted by the Federal Trade Commission. The Rule is contained in 12 CFR 535 for savings associations, and Subpart B of Regulation AA (12 CFR Part 227) for banks. The Rule became effective on January 1, 1986.

The Rule prohibits financial institutions from using: (1) certain provisions in their consumer credit contracts; (2) a certain late charge accounting practice; and (3) deceptive cosigner practices. The Rule also requires that a disclosure notice be given to a cosigner prior to becoming obligated. Finally, the Rule prohibits financial institutions from enforcing in purchased contracts the same provisions that institutions are prohibited from including in their own consumer credit contracts.

Scope

The Rule applies to the consumer credit contracts of all financial institutions and their subsidiaries other than those contracts that are for the purchase of real estate. Dwellings such as mobile homes and houseboats are not considered real estate if they are considered personal property under state law. A consumer is a natural person who seeks or acquires goods, services, or money for personal, family, or household purposes. There is no monetary limitation on the coverage of the Rule.

Prohibited Contract Provisions

Confession of Judgment

A confession of judgment is a provision (which may also be known as a cognovit, or warrant of attorney) in which the borrower waives the right to notice and the opportunity to be heard in the event of a suit to enforce an obligation. [§535.2 (a)(1)]

The following are not prohibited:

- confessions executed after default or the filing of a suit on the debt
- powers of attorney contained in a mortgage or deed of trust for foreclosure purposes or given to expedite the repossession or transfer of collateral
- confessions in Louisiana for the purpose of executory process

Waiver of Exemption

A waiver of exemption is a provision in which the consumer relinquishes the statutory right to protect his or her home (known as the homestead exemption), possessions, or wages from seizure to satisfy a judgment unless the waiver is given with respect to property that will serve as security for an obligation. [§535.2(a)(2)]

Any other types of waivers (for example, waiver of demand, presentment, protest, notice of dishonor, and notice of protest and dishonor) are not prohibited.

Assignment of Wages

An assignment of wages is a provision which gives the institution the right to receive the consumer's wages or earnings directly from the consumer's employer. [§535.2(a)(3)]

The following are not prohibited:

- an assignment that by its terms is revocable at will by the consumer
- a payroll deduction or preauthorized payment plan (whether or not revocable by the consumer), commencing at consummation of the loan, for the purpose of making each payment
- an assignment of wages that have been earned at the time of the assignment

Approved-FFIEC

- garnishment

Earnings are defined as compensation paid or payable for personal services rendered or to be rendered by the consumer, whether denominated as wages, salary, commission, or bonus, including periodic payments pursuant to a pension, retirement, or disability program. [§535.1(f)]

Household Goods Security Interests

A nonpossessory security interest in household goods is prohibited unless such goods are purchased with credit extended by the financial institution. [§535.2(a)(4)]

The following are not prohibited:

- security interests in household goods not purchased with credit extended by the financial institution if the goods are placed in the financial institution's possession.
- security interests in all other real and personal property of the consumer other than household goods as defined in the rule.

The term "household goods" is defined as meaning only the clothing, furniture, appliances, linens, china, crockery, kitchenware, and personal effects of the consumer and consumer's dependents. [§535.1(g)]

The following are not household goods:

- works of art
- electronic equipment (other than one television and one radio)
- items acquired as antiques (they must be over one-hundred years of age in order to be considered antiques), including such items that have been repaired or renovated without changing their original form or character
- jewelry (other than wedding rings)
- fixtures, automobiles, boats, snowmobiles, cameras and camera equipment (including darkroom), pianos, home workshops, and the like.

Prohibited Practices

Pyramiding of Late Charges

"Pyramiding" of late charges is a prohibited practice. Pyramiding is an accounting method which results in the assessment of multiple delinquency charges due to a single delinquent payment. For example, when a borrower is late on a payment, the lender applies a late charge to the payment, when it is received, which then results in a short or insufficient payment. A subsequent payment is received on time, but since the previous payment is considered short a late charge is again applied. This is perpetuated until the borrower either pays the late charge separately or until the loan matures. The examiner should not confuse this with a situation in which a payment is missed and never made up, triggering late charges each month until the entire payment is made and the account is brought entirely up to date or paid in full. [§535.4(a)]

Cosigner Deception

The institution may not misrepresent the nature and extent of a cosigner's liability to any person. [§535.3(a)(1)]

Cosigner Disclosure (§535.3(b)(1))

The financial institution must provide, either in a separate document or in the credit obligation, a clear and conspicuous notice that is substantially similar to the following statement:

<u>Notice of Cosignor</u>

You are being asked to guarantee this debt. Think carefully before you do. If the borrower doesn't pay the debt, you will have to. Be sure you can afford to pay the debt if you have to, and that you want to accept this responsibility.

You may have to pay up to the full amount of the debt if the borrower does not pay. You may also have to pay late fees or collection costs, which increase this amount.

The bank can collect this debt from you without first trying the collect from the *borrower. The bank can use the same collection methods against you that can be used against the borrower, such as suing you, garnishing your wages, etc. If this debt is ever in default, that fact may become a part of your credit record.*

This notice is not the contract that makes you liable for the debt.

This notice must be given to the cosigner prior to the time he or she becomes obligated. In the case of open-end credit plans, the notice must be given prior to the time the cosigner becomes obligated for fees or transactions on the account.

A Cosigner is defined as (§535.1(c)):

- Any person who assumes personal liability, in any capacity, for the obligation of another consumer without receiving goods, services, or money in return for the obligation. This includes any person whose signature is requested to allow a consumer to obtain credit or to prevent collection of a consumer's obligation that is in default.
- A person who meets the above definition is a cosigner whether or not designated as such in the contract.
- For open-end credit, a cosigner is a person who signs the debt instrument but does not have the contractual right to obtain credit under the account.

A Cosigner is not:

- A spouse whose signature is required on a credit obligation to perfect a security interest pursuant to state law.
- A person who does not assume personal liability, but who rather only provides collateral for the obligation of another person.
- A person who has the contractual right to obtain credit under an open-end account, whether exercised or not.

Civil Liability

There is no express provision for civil liability either in the Federal Trade Commission Act or Regulation AA, or the OTS Regulations.

Administrative Enforcement

The regulation is to be enforced for banks through Section 8 of the Federal Deposit Insurance Act (12 USC 1818), and for savings associations through Section 5 of the Home Owners' Loan Act (15 USC 1464), Section 407 of the National Housing Act (15 USC 1730), and Section 5 (1) and 17 of the Federal Home Loan Bank Act (15 USC 1457). In addition, a supervisory agency may enforce compliance through any other authority conferred on it by law. [15 USC 57a(f) (4)]

Examples of Prohibited Contract Provisions

<u>Confession of Judgment</u>

1. If you fail to carry out the terms of this notice, you appoint _________________ or ________________________ as your attorney in-fact for the purpose of confessing judgment against you and you authorize either of them to confess judgment against you in favor of us in the Clerk's Office of the City/ County of <u>POWATAN</u>, Virginia or in any other court of proper jurisdiction for the unpaid balance of this Note plus costs, expenses and attorney's fees as provided on the reverse side of this Note.

2. You and any Co-Maker, jointly and severally, authorize the Prothonotary, Clerk or any attorney of any court of record to appear for you and any Co-Maker and confess judgment in our favor or in favor of any other holder of this Note. Judgment of confession may be entered either prior to or after an event of default, as often as necessary, for such sums as are or any become due on this Note, with costs of suit and 20% added as actual and reasonable attorney's fees. You and any Co-Maker agree to waive, to the extent permitted by law, all rights of appeal, appraisement, stay of execution and exemption now or later in force. If a copy of this Note is led in connection with the entry of

judgment, it shall not be necessary to le the original Note as a Warrant of Attorney, if the copy is verified by affidavit.

3. You and any Co-Maker, jointly and severally, authorize the Prothonotary, Clerk and any attorney of any court of record to appear for you and any Co-Maker and confess judgment in our favor or in favor of any other holder of this Note. Judgment by confession may be entered either prior to or after an event of default, as often as necessary, for such sums as are or may become due on this Note, with costs of suit and 20% added as actual and reasonable attorney's fees. You and Co-Maker agree to the extent permitted by law, all rights of appeal, appraisement, stay of execution and exemption now or later enforce. If a copy of this Note is filed in connection with the entry of judgment, it shall not be necessary to file the original Note as a Warrant of Attorney, if the copy if verified by affidavit.

Waiver of Exemption

1. I waive my homestead exemption.

2. In consideration of the credit extended, Mortgagor waives and relinquished, with respect to the Property and all other property now or hereafter owned by Mortgagor, the benefit of any and all stay and extension laws, and further expressly waives notice and delay accorded by Louisiana Code of Civil Procedure Articles 2331, 2639, 2639 and 2722 and La. R. S. 12:4363-4366 including, but not limited to, any and all homestead and other claims to exemption from seizure which under existing or future laws, might be asserted against enforcement of payment of the indebtedness secured hereby, and consents to the immediate seizure, advertisement and sale of said property in the event of institution of executory or other legal proceedings.

3. Debtor hereby acknowledges express intent to hereby waive and abandon all personal property exemptions granted by law upon the goods which are the subject of this Agreement. NOTICE: By signing this Agreement, Debtor waives all rights provided by law to claim such goods exempt from process.

4. I waive (to the extent permitted by law) certain rights I might otherwise have. All exemptions in and to any of the property are hereby waived.

Examination Objectives

To determine if the institution has established an effective system to ensure that it:

- does not originate, acquire, or enforce contracts which contain prohibited provisions
- does not "pyramid" late charges
- does not engage in deceptive cosigner practices
- provides the required disclosure to cosigners prior to becoming obligated.

To determine whether the institution's contracts contain prohibited provisions in their originated or purchased credit contacts.

To determine whether the institution used impermissible late charge accounting practices.

To determine if the institution advised cosigners prior to becoming contractually liable of the nature and extent of their liability.

To determine if the institution provides the required notices to cosigners prior to becoming obligated, or in case of open-end credit plans, prior to the time the cosigner becomes obligated for fees or transactions on the account.

To determine if the institution has attempted to enforce prohibited provisions in contracts it has originated or acquired.

Examination Procedures

1. Obtain and review blank notes (contracts) and disclosures (including those furnished to dealers) used by the institution in extending con-

sumer credit for the following prohibited contract provisions:

a. Confessions to Judgment - which is a waiver of the right to notice and the opportunity to be heard in the event of a suit on the obligation. [§535.2(a)(1)]

b. Waiver of Statutory Property Exemption - which is a provision that waives the consumer's statutory right to protect his or her home (known as the homestead exemption), possessions, or wages unless given solely on property that will serve as security for the obligation. [§535.2(a)(2)]

c. Assignment of Wages - which is a provision that gives the institution the right to receive the consumer's wages or earnings directly from the consumer's employer. [§535.2(a)(3)] However, such an assignment is permitted if:

- It is revocable, at will, by the consumer.
- It is a payroll deduction plan or preauthorized payment plan (whether or not revocable by the consumer), commencing at consummation, for the purpose of making loan payments.
- It applies only to wages or earnings already earned at the time of the assignment.

d. Blanket Security Interest in Household Goods - which is a provision which allows the institution to hold as collateral the clothing, furniture, appliances, and the personal effects of the consumer's dependents. [§535.2(a)(4)]

2. Determine through discussions with management and staff if the institution attempts to enforce confessions of judgment, assignments of wages, security interests in household goods, or waivers of exemption in originated or acquired contracts.

3. Review the institution's collection policies, procedures, and practices to ensure that staff members are not using an assignment of wages except where permissible. [§ 535.2(a) (3)]

4. Judgmentally sample an adequate number of loan files to ensure that prohibited contract provisions are not included in contracts (or related documents) originated, or enforced in contracts acquired, by the institution.

5. Judgmentally sample an adequate number of overdue loans to determine if the institution collects or attempts to collect overdue payments through assignments of wages. [§535.2(a)(3)]

6. Judgmentally sample an adequate number of overdue loans to determine if the institution collects or attempts to collect a late charge on a timely payment because of the consumer's failure to pay a late charge attributable to a prior delinquent payment. [§535.4(a)]

7. Determine through a review of procedures, policies, and practices whether the institution takes steps to prevent its staff from engaging in prohibited cosigner practices in loans it originated or acquired. [§535.3(a)]

8. Determine through discussions with management and staff if there is evidence that the institution engages in prohibited cosigner practices (i.e., misrepresentation of a cosigner's liability and contractually obligating cosigners prior to informing them of their liability).

9. Determine through discussions with management and staff of the institution, whether the nature and extent of a cosigner's liability is properly represented to cosigners prior to the time signatures are obtained. [§535.3(b)]

10. Judgmentally sample the documents evidencing the credit obligation for the required notice to cosigners. [§535.3(b)(1)]

- If the notice to cosigners is contained in the note or disclosure, it must be clear, conspicuous, and substantially similar to that provided in the regulation and must be provided before the cosigner becomes obligated.

- If the notice to cosigners is contained in a separate document also:
  - Interview applicable employees to determine if they are aware that the notice must be provided prior to the cosigners becoming obligated.
  - Review the institution's polices, procedures, and practices to ensure that staff members are aware that cosigners must be provided with the notice prior to becoming obligated.

References

Laws

15 U.S.C. 41 et seq.	Federal Trade Commission Act

Regulations

<u>OTS Regulations:</u>

12 C.F.R. Part 535	Prohibited Consumer Credit Practices

Introduction

Section 106 (c)(5) of the Housing and Urban Development Act of 1968 (the Act) (12 USC 1701x(c)(5)) provides for homeownership counseling notification by creditors to eligible homeowners. The Act has been amended at various times,[1] with the most recent amendment on November 26, 2001, when the Departments of Veterans Affairs and Housing and Urban Development, and Independent Agencies Appropriations Act of 2002 (Pub. L. 107-73) was enacted. Section 205 of that Act repealed the previous sunset provision.

Applicability

All creditors that service loans secured by a mortgage or lien on a one-family residence (home loans) are subject to the homeownership counseling notification requirements. Home loans include conventional mortgage loans and loans insured by the Department of Housing and Urban Development (HUD).

Approved – FFIEC

[1] Section 577 of the National Affordable Housing Act of 1990 (Pub. L. 101-625) extended the homeownership counseling provisions to September 30, 1992; Section 162 of the Housing and Community Development Act of 1992 (Pub. L. 102-550) extended the provisions to September 30, 1994; and Section 594 of the Departments of Veterans Affairs and Housing and Urban Development, and Independent Agencies Appropriation Act of 1999 (Pub. L. 105-276) extended the provisions to September 30, 2000.

Requirements

Notice Requirements[2]

A creditor or proposed creditor must provide notification of the availability of homeownership counseling to a homeowner, eligible for counseling, who fails to pay any amount by the due date under the terms of the home loan.

Eligibility

A homeowner must be given homeownership counseling notification if:

- The home loan is secured by the homeowner's principal residence;
- The home loan is not assisted by the Farmers Home Administration; and
- The homeowner is, or is expected to be, unable to make payments, correct a home loan delinquency within a reasonable time, or resume full home loan payments due to a reduction in the homeowner's income because of:
  - — An involuntary loss of, or reduction in, the homeowner's employment, the homeowner's self-employment, or income from the pursuit of the homeowner's occupation; or
  - — Any similar loss or reduction experienced by any person who contributes to the homeowner's income.

[2] The FFIEC Consumer Compliance Task Force has requested clarification from HUD on HUD's current position regarding notice requirements to first-time homebuyers. These interagency examination procedures are currently limited to determining compliance with the Act's notice provisions related to delinquent borrowers. However, should a response from HUD to the Task Force indicate that notices to first-time homebuyers should be provided under the Act, the agencies will expand these examination procedures to cover notices to first-time homebuyers.

Contents of Notice

The notice must:

1. notify the homeowner of the availability of any homeownership counseling offered by the creditor; and
2. provide either a list of HUD-approved nonprofit homeownership counseling organizations or the toll-free number[3] HUD has established through which a list of such organizations may be obtained.

Timing of Notice

The notice must be given to a delinquent homeowner borrower no later than 45 days after the date on which the homeowner becomes delinquent. If, within the 45-day period, the borrower brings the loan current again, no notification is required.

Definitions

For purposes of these requirements, the following definitions apply:

"Creditor" means a person or entity that is servicing a home loan on behalf of itself or another person or entity.

"Home loan" means a loan secured by a mortgage or lien on residential property.

"Homeowner" means a person who is obligated under a home loan.

"Residential property" means a 1-family residence, including a 1-family unit in a condominium project, a membership interest and occupancy agreement in a cooperative housing project, and a manufactured home and the lot on which the home is situated.

Examination Objective

To determine whether the financial institution has established procedures regarding homeownership counseling notification requirements to ensure that it is in compliance with the provisions of Section 106(c)(5) of the Housing and Urban Development Act of 1968.

Examination Procedures

Determine if the financial institution is informing eligible homeowners, within 45-days of an initial loan default, of: (1) the availability of any homeownership counseling offered by the creditor; and (2) the availability of any homeownership counseling by nonprofit organizations approved by HUD, or the toll-free telephone number through which the homeowner can obtain a list of such organizations.

Examination Checklist

1. Does the financial institution notify eligible homeowners, within 45-days of initial loan default, of any homeownership counseling the institution (creditor) provides?
2. Does the financial institution provide eligible homeowners with the names of nonprofit organizations approved by HUD or the toll-free telephone number to obtain a list of such organizations?

[3] The number is 1-800-569-4287.

Introduction

The Truth in Savings Act (TISA) (12 U.S.C. 4301 et seq.) was enacted on December 19, 1991, as Subtitle F of the Federal Deposit Insurance Corporation Improvement Act of 1991. Amendments to TISA were enacted on October 28, 1992, in Titles IX and XVI of the Housing and Community Development Act of 1992 (Pub. L. 102-550, 106 Stat. 3672). Regulation DD, which implements the TISA, became effective on June 21, 1993.

In general, Regulation DD covers accounts held by consumers at depository institutions. Consumer accounts include deposits such as checking, savings, and time accounts held by an individual primarily for a personal, family or household purpose. A depository institution is an institution that is either federally insured or is eligible to apply for such insurance.

The purpose behind Regulation DD is to enable consumers to make better informed decisions about accounts at depository institutions through the use of uniform disclosures. The disclosures aid comparison shopping by informing consumers about the fees, annual percentage yield, interest rate and other terms for deposit accounts. Consumers are entitled to receive disclosures about accounts upon request, when an account is opened, when terms are changed, before the maturity of most time accounts, and if a periodic statement is sent. Also, an institution must pay interest on the full balance in consumer accounts each day, and must choose between two methods of calculating the balance for paying interest.

Payment of Interest

The "interest rate" is the annual rate of interest paid on an account which does not reflect compounding. In general, an institution pays "interest" through the application of a periodic rate to an account balance. Interest does not include the absorption of expenses, forbearance in charging fees, or the payment of bonuses. Regulation DD does not require an institution to pay consumers interest for the use of funds in an account. However, if an institution does pay interest on an account, the following rules apply:

- Interest must be paid on the full principal balance in the account each day. A daily rate of at least 1/365 (or 1/366 in a leap year) of the interest rate must be applied to the balance. An institution may apply a daily periodic rate that is greater than 1/365 of the interest rate (for example, a daily periodic rate of 1/360) as long as it is applied 365 days a year.

- Either the daily balance method or the average daily balance method must be used to calculate the balance on which interest is paid. The "daily balance method" applies a daily periodic rate to the entire principal balance every day. The "average daily balance method" applies a daily periodic rate to the average principal balance. The average principal balance is the sum of the entire principal balance for each day of the period, divided by the number of days in the period.

- Consumers may be required to maintain a minimum balance to earn interest. An institution using the daily balance method may choose not to pay interest for those days balances drop below the required daily minimum balance. An institution using the average daily balance method may choose not to pay interest if the average balance for the period falls below the minimum. If an institution imposes a minimum balance, it must use the same method to calculate whether the minimum balance is met as it uses to calculate interest. If it would benefit consumers unequivocally, an additional method can be used to determine if the minimum balance requirement is met.

- An institution may choose how often it will credit interest to interest-bearing accounts. It may also choose whether to compound interest, and if so, how often the compounding will occur. If a consumer closes an account between

Approved-FFIEC

crediting dates, an institution may choose not to pay accrued but uncredited interest

- Interest must begin to accrue no later than when the institution must begin accruing interest for interest-bearing accounts under section 606 of the Expedited Funds Availability Act (12 U.S.C. 4005 et seq.) and Regulation CC (12 CFR 229.14). In addition, once interest starts to accrue, it must continue to accrue until funds are withdrawn. However, an institution need not pay interest during a grace period for automatically renewable time accounts if the consumer decides during the grace period not to renew the account or after a nonautomatically renewable time account matures.

Annual Percentage Yields

There are two terms used to describe the rate paid to consumers. First, for account disclosures and advertising, the term "annual percentage yield" represents an annualized rate measuring the total amount of interest paid on an account based on the interest rate and the frequency of compounding. Second, the term "annual percentage yield earned" represents an annualized rate that is tied directly to the amount of interest earned and the account balance for the period reflected on a periodic statement. It reflects the relationship between the amount of interest actually earned and the average balance in the account for the statement period, or in limited cases, for the interest accrual period.

General Disclosure Requirements

The account disclosures must be in writing and reflect the legal obligation between the parties and be in a form the consumer can retain. The information must be presented clearly and conspicuously, so that consumers may readily understand the terms of their account. An institution may have a separate disclosure for each account or may combine Regulation DD disclosures for several accounts in a single document such as a brochure for all NOW accounts.

Regulation DD requires specific terminology for three figures. First, the "annual percentage yield" must be labeled as such in account disclosures and advertisements. Second, when the "interest rate" is used in account disclosures and advertisements, it must be so labeled. Finally, the "annual percentage yield earned" must be labeled as such on the periodic statement.

The annual percentage yield and annual percentage yield earned must be shown to two decimal places and rounded to the nearest one-hundredth of one percent (.01%). (For example, an annual percentage yield of 5.644% would be shown as 5.64%; 5.645% would be disclosed as 5.65%.) The same rule applies to interest rates; however, an institution may show the contract interest rate at more than two decimals in account disclosures.

The annual percentage yield or annual percentage yield earned disclosed is considered accurate if it is not more than 1/20 of one percentage point (.05%) above or below the actual annual percentage yield as determined in accordance with Appendix A. An institution may not purposefully incorporate the tolerance as part of its calculations. There is no corresponding tolerance for the accuracy of the interest rate.

Providing Account Disclosures

An institution must provide account disclosures to consumers before an account is opened or a service is provided, whichever is earlier. If consumers are not present when accounts are opened, the account disclosures must be mailed or delivered within 10 business days of the time the accounts are opened. An institution must also provide disclosures to consumers for each account for which the consumer requests information.

Disclosures must be accurate when provided to the consumer. For disclosures given upon request, the annual percentage yield and maturity of time accounts are accurate if an institution provides an annual percentage yield and interest rate that are current within the most recent seven calendar days, along with a statement that the rates are accurate as of a given date and a telephone number to call for rates currently available.

Content of Account Disclosures

The following information must be disclosed, as applicable.

- Rate information
- Annual percentage yields and interest rates - An institution must disclose the "annual percentage yield," using that term and the "interest rate," using that term (The corresponding periodic rate is the only other rate permitted to be disclosed.)
- The period of time the interest rate will be in effect after a fixed-rate account is opened
- All annual percentage yields and interest rates for stepped-rate and tiered-rate accounts
  - — A "stepped-rate account" has two or more interest rates that take effect in succeeding periods and are known when the account is opened.
  - — A "tiered-rate account" is two or more interest rates that are applicable to specified balance levels.
- Variable rate information — A "variable-rate account" is one in which the interest rate may change after the account is opened, unless the institution contracts to give at least 30 calendar days advance written notice of rate decreases. A variable-rate account includes those where the rate change is determined by reference to an index, by use of a formula, or merely at the discretion of the institution. If an institution offers variable-rate accounts, it must disclose the following:
  - — that the interest rate and annual percentage yield may change.
  - — how the interest rate is determined. If an institution reserves the right to change rates and does not tie changes to an index, the institution must disclose the fact that rate changes are solely within the institution's discretion.
  - — the frequency with which the interest rate may change. An institution that reserves the right to change rates at any time must state that fact.
  - — any limits on the amount the interest rate will change at any one time or for any period.
- Compounding and crediting interest — If an institution compounds or credits interest, it must disclose the frequency, such as "daily," "monthly," or "quarterly."
- Effect of closing an account — An institution must disclose if the deposit contract provides that interest that has accrued but not been credited will not be paid if the consumer closes his or her account before interest is credited.
- Balance information
  - — Minimum balance requirements. An institution must disclose any minimum balance required to open the account, to avoid the imposition of fees, or to obtain the annual percentage yield. An institution must also describe how it determines any minimum balance.
  - — Balance computation method. An institution must describe the balance computation method it uses to calculate interest on the account.
- When interest begins to accrue — An institution must state when interest begins to accrue.
- Fees — An institution must disclose the amount of all fees that may be assessed in connection with the account, including maintenance fees, fees related to deposits or withdrawals, whether by check or electronic transfer, fees for special account services and fees to open or to close accounts.
- Transaction limitations — An institution must state any limitations on the number or dollar amount of deposits to, withdrawals from, or checks written on an account for any time period. If an institution does not allow any withdrawals or deposits on time accounts, that fact must be disclosed.
- Features of time accounts — An institution must make the following disclosures for time accounts:
  - — Time requirements. Except for responses to requests for disclosures, an institution must state the maturity date.

- Early withdrawal penalties. An institution must disclose the conditions under which an early withdrawal penalty will be assessed.
- Withdrawal of interest prior to maturity. If, on a time account that compounds interest during the term, a consumer elects to withdraw accrued interest, the institution must disclose that the annual percentage yield assumes that interest remains on deposit until maturity and that a withdrawal reduces the earnings on the account.
- Renewal policies. An institution must state whether or not a time account will automatically renew at maturity. If the account will renew automatically, the institution must disclose if a grace period will be provided, and if so, its length. For nonautomatically renewable time accounts, an institution must tell consumers whether interest will be paid after maturity of the account.

- Bonuses — If bonuses are offered on accounts, an institution must state the amount and type of bonus, when the bonus will be paid, and any minimum balance or time requirements consumers must meet in order to obtain the bonus.

Change in term notices

If an institution changes the term for an account required to be disclosed, and the change might reduce the annual percentage yield or adversely affect consumers, an institution must send a written notice 30 calendar days before the effective date of the change. An institution is not required to send notices if the rate changes on a variable rate account, if the terms change for time accounts with maturities of 31 days or less, or if the fees for check printing increase.

Notices for Maturing Time Accounts

Regulation DD requires an institution to provide disclosures for certain maturing time accounts. If the annual percentage yield and interest rate for a renewing time account is not known when the maturity notice must be sent, an institution may explain that this information is not available and provide the date when the yield and rate will become known and a telephone number consumers may call to learn about the new yield and rate.

- If an automatically renewable time account has a maturity of longer than one year (366 days), an institution must provide the maturity date for the existing account, and all disclosures required for a new account. These disclosures must be sent either 30 calendar days before the scheduled maturity date, or 20 calendar days before the end of a grace period following maturity, as long as the grace period is at least five days.
- If an automatically renewable time account has a maturity of more than one month (31 days) but one year or less, an institution must provide either the disclosures required for automatically renewable time accounts with maturities longer than one year, or the maturity date for the new account and the maturing account, and any difference in terms of the new account as compared to those required to be disclosed for the existing account. The time frames within which these disclosures must be sent is the same as those for automatically renewable time accounts with a maturity of longer than one year.
- If an automatically renewable time account has a maturity of one month (31 days) or less, an institution must send disclosures within a reasonable time after maturity and must include any term (other than the annual percentage yield and rate) that has changed for the new account as compared to those disclosed for the existing account.
- If a nonautomatically renewable time account has a term longer than one year, an institution must send a notice 10 calendar days before maturity that states the maturity date of the existing account and whether interest will be paid after maturity.

Periodic Statement Disclosures

Regulation DD does not require an institution to send periodic statements to consumers, but if a statement is provided, it must include certain information. An institution provides "periodic statements" to consumers if the statements set forth account information and are provided to consumers on a regular basis four or more times a year. Statements providing information to consumers about time accounts or passbook savings accounts are not covered.

An institution that provides periodic statements must disclose the following information for the statement period, as applicable:

- Annual percentage yield earned — An institution must disclose the "annual percentage yield earned" (computed in accordance with Appendix A, Part II), using that term.
- Amount of interest — An institution must show interest earned during the statement period.
- Fees — An institution must disclose fees (required to be disclosed under §230.4(b)(4)) that have actually been debited from the account during the period.
- Length of period — An institution must disclose the total number of days in the statement period. Alternatively, an institution may state the beginning and ending dates of the statement period, as long as it is clear whether or not both of these days are included in the period.

Prematurity Disclosures for Time Accounts

	Automatically Renewable ("Rollover") Time Accounts	**Nonautomatically Renewable ("Nonrollover") Time Accounts**
Less than or equal to 1 month	No *advance* notice required. Notice must be sent within a "reasonable time" *after* renewal if any change made to disclosed term (other than interest rate and annual percentage yield).	No notice required.
More than 1 month but less than or equal to 1 year	**Timing** (a) 30 (calendar) days before maturity; or (b) 20 (calendar) days before end of grace period, if a grace period of at least 5 (calendar) days is provided. **Content** Interest rate and APY for new account (or fact that rates have not been determined, when they will be, and telephone number for consumer to call for rates), and *either*: (a) date of maturity of existing and new account, and change in terms; *or* (b) full disclosures for account (section 4(b)) and date of maturity for existing account.	No notice required.
More than 1 year	**Timing** Same as for accounts greater than one month and not more than one year. **Content** Full disclosures for account (section 4(b)) and date of maturity for existing account.	**Timing** 10 (calendar) days before maturity. **Content** Maturity date, and whether or not interest will be paid after maturity.

- For institutions that use the average daily balance method and that calculate interest for a period other than the statement period, the annual percentage yield earned and interest earned shall be based on that other period.

Advertising

An "advertisement" is any commercial message appearing in any medium (for example, newspaper, television, lobby boards and telephone response machines) if it directly or indirectly promotes the availability of an account. Regulation DD permits abbreviated disclosure requirements for advertisements made through broadcast or electronic media, such as radio and television; outdoor media, such as billboards; and telephone response machines. Limited disclosure rules apply to indoor signs. If an indoor sign states a rate of return it shall state the rate as an annual percentage yield, using that term or the term "APY". Indoor signs must also contain a statement advising consumers to contact an employee for further information about applicable fees and terms.

An institution cannot make any misleading or inaccurate statements in its advertisements. Using the term "profit," for example, which implies a return on an investment, is a misleading advertisement. Using the term "free" or "no-cost" (or a similar term) to describe an account is misleading if any maintenance or activity fee might be imposed on the account.

If any rate or yield is advertised, an institution must express it using the term "annual percentage yield." The "interest rate," using that term, that corresponds to the advertised annual percentage yield may be displayed. An institution may abbreviate the annual percentage yield as "APY" if the term is printed or stated in full in an advertisement.

For advertisements not exempt under 230.8(e), an institution triggers additional disclosure requirements if advertisements display either a bonus or an annual percentage yield. In such case, advertisements must disclose the following, as applicable:

- Variable rates — If accounts are variable-rate, advertisements must display the fact that rates may vary.

- Time period the annual percentage yield is offered — An institution must state how long advertised annual percentage yields are offered, such as "from March 7 through March 13" or "annual percentage yield effective as of March 7."

- Minimum balances — If a minimum balance is required to obtain the advertised annual percentage yield, the minimum balance must be stated.

- Minimum opening deposit — An institution must state any minimum opening deposit requirement.

- Statement concerning fees — An institution must state that fees could reduce earnings on the account.

- Time account features — The term of the time account ("three months," for example) must be stated. An institution must also state if a penalty will (or may) be imposed for early withdrawals.

- Bonus information — If a bonus is advertised, an institution must disclose any time requirement to obtain the bonus, when the bonus will be provided, any required minimum balance to obtain the bonus, and the annual percentage yield (which triggers additional disclosures).

Effect on State Laws

Regulation DD preempts state law requirements that are inconsistent with the requirements of the TISA or Regulation DD. A state law is inconsistent if it requires an institution to make a disclosure or take action that is prohibited by federal law.

Record Retention

An institution must retain records regarding compliance with Regulation DD for a minimum of two years after disclosures are required to be made or actions are required to be taken. It must keep evidence that disclosures were provided, but are not required to keep a copy of each disclosure provided to every consumer. Instead, an institution will establish compliance by providing evidence that it has established procedures for providing disclosures, has followed them, and has retained sample disclosures. An institution must keep sufficient rate and balance information to enable examiners to verify the interest paid on an account.

Records may be stored by use of microfiche, micro lm, magnetic tape, or other methods capable of accurately retaining and reproducing Information (for example, from a computer file). An institution need not retain disclosures in hard copy, as long as enough information is retained to reconstruct the required disclosures or other records.

Consequences of Noncompliance

Section 271 of the TISA provides that an institution failing to comply with the TISA requirements may be liable to consumer account holders for the sum of actual damages, attorney fees and court costs, and statutory penalties.

Examination Objectives

1. To verify that the institution has procedures in place to assure compliance with all provisions of the regulation.

2. To verify that the institution provides all required deposit account disclosures to consumers on a timely basis; and that the account disclosures are accurate and reflect the terms of the legal obligation between the consumer and the institution.

3. To verify that the institution complies with the subsequent disclosure requirements of the regulation, including change in terms and maturity notices.

4. To verify, if the institution provides periodic statements for deposit accounts, that such statements accurately disclose all required information.

5. To verify that the method used by the institution to pay interest is permissible, and to verify the accuracy of other calculations (e.g., the method used by the institution to calculate daily balances, average daily balances, and minimum balances).

6. To determine that the institution's advertisements are not misleading or inaccurate and that they include all required information.

Examination Procedures

Management and/or Policy-related Procedures

1. Determine the extent and adequacy of the institution's policies, procedures and practices for ensuring compliance with the regulation. This should include a determination as to whether the institution has an adequate mechanism in place to monitor the effectiveness of its compliance with the regulation.

2. Determine the extent and adequacy of the training received by the various individuals in the institution with responsibilities related to compliance with the regulation. This should include a review of any training materials pertaining to the regulation.

3. Determine the procedures or policies used by the institution to ensure that account disclosure information is provided to new or potential deposit account customers within the appropriate time frames.

4. Determine if the institution's procedures ensure subsequent disclosure of any change in terms required to be disclosed under 230.4(b) and that exceptions to notice requirements are limited to those set forth in §230.5(a)(2).

5. Determine if the institution's method of paying interest is permissible. This should include a review of when interest begins to accrue for deposits to the account as required by the Expedited Funds Availability Act.

6. Determine if the institution's advertising policies are consistent with the requirements of the regulation.

Transaction-Related Procedures

The procedures in this section of the examination procedures call for testing of the institution's procedures, policies and practices with respect to the regulation. In this regard, the examiner should review a sample of the various deposit account disclosures and notices required by the regulation, in addition to a sample of the institution's advertisements. The examiner must use judgment in deciding how large the sample should be. The samples of each required action, deposit account disclosure and advertisement reviewed should be expanded until the examiner is con dent that all aspects of the institution's activities and policies that are subject to the regulation are reviewed.

Account Disclosures

7. Determine the types of deposit accounts offered by the institution to consumers (including accounts usually offered to commercial customers that may occasionally be offered to consumers) as well as the characteristics for each type of deposit account (e.g., bonuses offered, minimum balances, balance computation method, frequency of interest crediting, fixed or variable rates, fees imposed, frequency of periodic statements, etc.).

8. Review each deposit account disclosure to determine whether the contents are accurate and include all information required by the regulation and that the disclosures reflect the legal obligation between the consumer and the institution.

9. Determine whether the institution provides the required deposit account disclosures on a timely basis in connection with the opening of an account or upon request.

Notice of Change in Terms and Notice Before Maturity

10. Determine whether the institution sends out change in terms notices to consumers at least 30 calendar days in advance of the effective date of any change in a term that may reduce the APY or that adversely affects the consumer. Review a sample of these notices to ensure that they include all required information and that they are sent on a timely basis.

11. Determine whether the institution sends out notices before maturity for time accounts. Review a sample of these notices to ensure that they contain all required information and that they are sent on a timely basis.

Periodic Statement Disclosures

An institution is not required to send a periodic statement; however, if it does, it must comply with the provisions of the regulation concerning periodic statements.

12. Determine the accounts for which the institution sends a periodic statement and the frequency with which they are sent.

13. Review a sample of periodic statements from each of the different types of deposit accounts. The examiner should obtain samples of periodic statements for each deposit account that illustrates the various types of transactions and activities permitted on the account. Determine if the periodic statement includes all required disclosures and that they are accurate.

Payment of Interest

14. Review a sample of each of the different types of deposit accounts to determine whether the institution's method of paying interest is one of the methods permitted by the regulation.

15. Determine if interest begins to accrue not later than the business day specified for interest bearing accounts in Section 606 of the Expedited Funds Availability Act (Regulation CC) and that interest accrues until the day funds are withdrawn.

16. Determine that accrued interest is not forfeited when a consumer closes their account prior to crediting of the interest unless this practice is included in the initial account disclosures.

Advertising Requirements

17. Determine the types of advertisements placed by the institution, including but not limited to, radio ads, newspaper, brochures, television, statement stuffers, etc.

18. Review a sample of each type of advertisement to determine if the advertisements are misleading, inaccurate, or misrepresent the deposit contract. In addition, verify that the advertisements include all required disclosures.

Record Retention Requirements

19. Review a sample of the institution's records to determine whether the institution has maintained evidence of compliance for a minimum of 2 years after disclosures are required to be made or action is required to be taken, including rate information, advertising, etc.

Introduction

Savings associations, along with other types of financial institutions, are developing and employing new electronic technologies for delivering financial products to improve customer service and lower costs. The new technologies being offered include on-line financial services, stored value card systems, and electronic cash. Services and products can be accessed through personal computers connecting to participating institutions via proprietary software, commercial on-line services, and the Internet, or through other access devices including, for example, video kiosks and interactive television. The most significant growth involves the establishment of Internet web sites by institutions that are used to advertise products and services, accept electronic mail, and provide consumers with the capability to conduct transactions through an on-line system.

The regulatory environment continues to evolve in response to the introduction and implementation of new electronic banking technologies. However, it is important to keep in mind that the new technologies merely offer an alternative means for delivering traditional products and services; they do not represent new or different banking products standing alone. Existing consumer laws and regulations generally apply to transactions, advertisements and other services conducted electronically. This section is intended to describe how existing compliance rules are applied to the emerging electronic banking technologies and to highlight new developments in the compliance area intended to address some of the unique aspects of the new services. References to applicable consumer affairs, compliance, and fair lending laws and regulations are made in the various policy statements, guidance, proposed rule changes, and reports discussed or included herein.

Regulatory Guidance

Some recent guidance has been issued to address consumer compliance concerns arising from use of the new technologies:

Interagency Guidance on Electronic Financial Services and Consumer Compliance, issued by the FFIEC in July 1998

Policy Statement on Privacy and Accuracy of Personal Customer and *Interagency Pretext Phone Calling Memorandum,* both issued by OTS in November 1998

The interagency guidance is intended to assess the implications of some of the emerging electronic technologies for the consumer regulatory environment, to provide institutions with an overview of pertinent regulatory issues, and to offer suggestions on how to apply existing consumer laws and regulations to new electronic financial services. It also seeks to promote compliance with relevant laws and regulations. The guidance contains two sections, one on the compliance regulatory environment and the other on the role of consumer compliance in developing and implementing electronic services. The text of the document is included in full within this section.

The policy statement and pretext phone calling memorandum are intended to enhance awareness of customer privacy. They reflect the OTS' understanding of certain "best practices" that may help to adequately protect personal information. These documents are also included in this section following the interagency guidance.

Federal Reserve Board Interim and Proposed Rule Changes

The FRB issued an Interim Rule on Regulation E and Proposed Rules on Regulations B, M, Z, and DD in April 1998. The Interim Rule on Regulation E became effective March 25, 1998 and allows institutions to deliver by electronic communication certain disclosures and other information generally required by the regulation to be provided in writing, as long as the customer agrees to such delivery. The term "electronic communication" is defined as a message transmitted electronically that can be displayed as visual text on equipment such as a modem-equipped computer. The disclosures must be delivered in a form that can be printed or downloaded by consumers. Institutions are not required to monitor a customer's ability to print or download disclosures unless they control the equipment used, such as terminals in lobbies or kiosks located in shopping centers. Moreover, the "clear and conspicuous" standard continues to apply in the electronic environment as do any applicable timing requirements.

The Proposed Rules on Regulations B, M, Z, and DD are not effective until the FRB issues final rules. Under the Proposed Rules, institutions would be permitted to deliver all disclosures electronically rather than requiring paper copies, similar to the Interim Rule on Regulation E. Most of the same requirements previously described for electronic delivery of disclosures provided under Regulation E apply equally to proposed changes to Regulations B, M, Z, and DD. However, since these rule changes are not effective (as of December 31, 1998), institutions should provide paper copies of the disclosures during the interim period.

The Interim Rule on Regulation E and the Proposed Rule on Regulations B, M, Z, and DD can be found at the FRB's web site at www.bog.frb.fed.us.

Consumer Electronic Payments Task Force

The Consumer Electronic Payments Task Force was comprised of the four bank regulatory agencies together with the Financial Management Service, the Federal Reserve Bank of Atlanta, and the Federal Trade Commission. The Task Force, with the participation of the industry and the public, attempted to: (1) identify the primary consumer issues arising from electronic money products, (2) evaluate the extent to which the issues are addressed by state and federal laws and regulations and voluntary industry guidelines, and (3) identify nonregulatory responses to address the remaining issues. The final report is divided into four areas of consumer concern: Access, Privacy, Financial Condition of Issuers, and Consumer Disclosures and Protections.

The Task Force report did not recommend any governmental regulatory responses at time of its issuance (April 1998), but did recommend that the industry develop effective self-regulatory techniques to address consumer concerns. The final report did include recommendations on the role of government in providing consumer financial education, monitor industry developments, and encourage appropriate industry action. It also contains specific recommended actions on each of the four areas that should be taken by the industry.

The final report and other related information can be found at the web site of the Office of the Comptroller of the Currency located at www.occ.treas.gov.

Examination Procedures

No examination procedures specific to electronic banking are included in this section. Over time, the agencies intend to insert pertinent revisions into existing examination procedures that take into account use of the new electronic technologies by financial institutions. Rather than developing a single set of examination procedures relating to all aspects of electronic banking, the agencies intend to make changes to existing examination procedures for consumer affairs and compliance laws and regulations as they are identified.

Interagency Guidance on Electronic Financial Services and Consumer Compliance

See Appendix A.

Policy Statement on Privacy and Accuracy of Personal Customer

See Appendix B.

Interagency Pretext Phone Calling Memorandum

See Appendix C.

FEDERAL FINANCIAL INSTITUTIONS EXAMINATION COUNCIL

INTERAGENCY GUIDANCE ON ELECTRONIC FINANCIAL SERVICES AND CONSUMER COMPLIANCE[1]

INTRODUCTION

Federally insured depository institutions are developing or employing new electronic technologies for delivering financial products to improve customer service and enhance competitive positions. Some of those institutions have asked regulators questions regarding the application of existing consumer protection laws and regulations to electronic product delivery methods. It is clear from these questions that these institutions are uncertain about the appropriate manner to address electronic services under the existing regulatory framework. Accordingly, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the National Credit Union Administration, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision (collectively, the "Agencies") are providing federally insured depository institutions with some basic information and suggested guidance pertaining to federal consumer protection laws and regulations and their application to electronic financial service operations.

This issuance is intended to assess the implications of some of the emerging electronic technologies for the consumer regulatory environment, to provide institutions with an overview of pertinent regulatory issues, and to offer suggestions on how to apply existing consumer laws and regulations to new electronic financial services.

The term "electronic financial service" as used in this guidance includes, but is not limited to, on-line financial services, electronic fund transfers, and other electronic payment systems. On-line financial services, stored value card systems, and electronic cash are among the new electronic products being introduced in the market. Financial institutions are establishing Internet web sites that advertise products and services, accept electronic mail, and provide consumers with the capability to conduct transactions through an on-line system. Services and products can be accessed through personal computers connecting to the institution via proprietary software, commercial on-line services, and the Internet, or through other access devices including, for example, video kiosks and interactive television. Financial institutions should be advised that many of the general principles, requirements, and controls that apply to paper transactions may also apply to electronic financial services. This guidance letter contains two sections: 1) The Compliance Regulatory Environment, and 2) The Role of Consumer Compliance in Developing and Implementing Electronic Services. Examples relating to compliance issues are used for illustrative purposes; institutions are encouraged to use the concepts underlying these examples when implementing an electronic services technology plan. It should be understood that existing consumer laws and regulations generally apply to applicable transactions, advertisements and other services conducted electronically. It should also be understood, however, that not all of the consumer protection issues that have arisen in

[1] This document does not serve as an Official Staff Commentary or shield institutions that comply with this guidance from civil liability for violations under the various statutes addressed.

connection with new technologies are specifically addressed in this guidance. Additional communiqués may be issued in the future to address other aspects of consumer laws and regulations as the financial service environment evolves.

COMPLIANCE REGULATORY ENVIRONMENT

This section summarizes and highlights the most recent changes in the relevant sections of federal consumer protection laws and regulations that address electronic financial services, and notes other relevant provisions of law. This information is not intended to be a complete checklist for consumer compliance in the electronic medium. It does not address a number of open issues surrounding the application of consumer rules to new electronic financial services that are currently being considered by the appropriate agencies. It is critical that institutions providing electronic delivery mechanisms develop and maintain an in-depth knowledge of the relevant statutes and regulations. Moreover, it should be kept in mind that additional changes to relevant laws and regulations arising in response to the new electronic service technologies may occur. The rapid development of technology and new products will require updating of this information.

Generally, the regulatory requirement that disclosures be in writing and in a form the customer can keep has been met by providing paper disclosures to the customer. For example, a bank would supplement electronic disclosures with paper disclosures until the regulations have been reviewed and changed, if necessary, to specifically allow electronic delivery of disclosures. Some of the consumer regulations were reviewed and changed to reflect electronic disclosures. These changes are summarized in this section. Also, attached to this guidance is a matrix entitled "Compliance Issues Involving Electronic Services" that highlights some of the principal compliance issues that should be considered by financial institutions when developing and implementing electronic systems.

DEPOSIT SERVICES

Electronic Fund Transfer Act (Regulation E)

Generally, when on-line banking systems include electronic fund transfers that debit or credit a consumer's account, the requirements of the Electronic Fund Transfer Act and Regulation E apply. A transaction involving stored value products is covered by Regulation E when the transaction accesses a consumer's account (such as when value is "loaded" onto thecard from the consumer's deposit account at an electronic terminal or personal computer).

In accordance with §205.4, financial institutions must provide disclosures that are clear and readily understandable, in writing, and in a form the consumer may keep. An Interim rule was issued on March 20, 1998 that allows depository institutions to satisfy the requirement to deliver by electronic communication any of these disclosures and other information required by the act and regulations, as long as the consumer agrees to such method of delivery. According to the Federal Reserve Board Official Staff Commentary (OK) §205.7(a)-4, financial institutions must ensure that consumers who sign-up for a new banking service are provided with disclosures for the new service if the service is subject to terms and conditions different from those described in the initial disclosures required under §205.7. Although not specifically mentioned in the commentary, this applies to all new banking services including electronic financial services.

The OSC also clarifies that terminal receipts are unnecessary for transfers initiated on-line. Specifically, OSC 4205.2(h)-1 provides that, because the term “electronic terminal” excludes a telephone operated by a consumer, financial institutions need not provide a terminal receipt when a consumer initiates a transfer by a means analogous in function to a telephone, such as by a personal computer or a facsimile machine.

Additionally, OSC §205.10(b)-5 clarifies that a written authorization for preauthorized transfers from a consumer’s account includes an electronic authorization that is not signed, but similarly authenticated by the consumer, such as through the use of a security code. According to the OSC, an example of a consumer’s authorization that is not in the form of a signed writing but is, instead, “similarly authenticated” is a consumer’s authorization via a home banking system. To satisfy the regulatory requirements, the institution must have some means to identify the consumer (such as a security code) and make a paper copy of the authorization available (automatically or upon request). The text of the electronic authorization must be displayed on a computer screen or other visual display that enables the consumer to read the communication from the institution. Only the consumer may authorize the transfer and not, for example, a third-party merchant on behalf of the consumer.

Pursuant to §205.6, timing in reporting an unauthorized transaction, loss, or theft of an access device determines a consumer’s liability. A financial institution may receive correspondence through an electronic medium concerning an unauthorized transaction, loss, or theft of an access device. Therefore, the institution should ensure that controls are in place to review these notifications and also to ensure that an investigation is initiated as required.

Truth in Savings Act (Regulation DD)

Financial institutions that advertise deposit products and services on-line must verify that advertising disclosures are made in accordance with all provisions of §230.8. Institutions should note that the disclosure exemption for electronic media under §230.8(e) does not specifically address commercial messages made through an institution’s web site or other on-line banking system. Accordingly, adherence to all of the advertising disclosure requirements of §230.8 is required.

Advertisements should be monitored for recency, accuracy, and compliance. Financial institutions should also refer to OSC §230.2(b)-2(i) if the institution’s deposit rates appear on third party web sites or as part of a rate sheet summary. These types of messages are not considered advertisements unless the depository institution, or a deposit broker offering accounts at the institution, pays a fee for or otherwise controls the publication.

Pursuant to §230.3(a), disclosures generally are required to be in writing and in a form that the consumer can keep. Until the regulation has been reviewed and changed, if necessary, to allow electronic delivery of disclosures, an institution that wishes to deliver disclosures electronically to consumers, would supplement electronic disclosures with paper disclosures.

Expedited Funds Availability Act (Regulation CC)

Generally, the rules pertaining to the duty of an institution to make deposited funds available for withdrawal apply in the electronic financial services environment. This includes rules on fund availability schedules, disclosure of policy, and payment of interest. Recently, the FRB published a commentary that clarifies requirements for providing certain written notices or disclosures to customers via electronic means. Specifically, the commentary to §229.13(g)-la states that a financial institution satisfies the written exception hold notice requirement, and the commentary to §229.15(a)-1 states that a financial institution satisfies the general disclosure requirement by sending an electronic version that displays the text and is in a form that the customer may keep. However, the customer must agree to such means of delivery of notices and disclosures. Information is considered to be in a form that the customer may keep if, for example, it can be downloaded or printed by the customer. To reduce compliance risk, financial institutions should test their programs' ability to provide disclosures in a form that can be downloaded or printed.

Reserve Requirements of Depository institutions (Regulation D)

Pursuant to the withdrawal and transfer restrictions imposed on savings deposits §204.2(d)(2) electronic transfers, electronic withdrawals (paid electronically) or payments to third parties initiated by a depositor from a personal computer are included as a type of transfer subject to the six transaction limit imposed on passbook savings and MMDA accounts.

Institutions also should note that, to the extent stored value or other electronic money represents a demand deposit or transaction account, the provisions of Regulation D would apply to such obligations.

LOAN/LEASING SERVICES

Truth in Lending Act (Regulation Z)

The commentary to regulation Z was amended recently to clarify that periodic statements for open-end credit accounts may be provided electronically, for example, via remote access devices. OSC §226S(b)(2)(ii)-3 states that financial institutions may permit customers to call for their periodic statements, but may not require them to do so. If the customer wishes to pick up the statement and the plan has a grace period for payment without imposition of finance charges, the statement, including a statement provided by electronic means, must be made available in accordance with the "14-day rule," requiring mailing or delivery of the statement not later than 14 days before the end of the grace period.

Provisions pertaining to advertising of credit products should be carefully applied to an on-line system to ensure compliance with the regulation. Financial institutions advertising open-end or closed-end credit products on-line have options. Financial institutions should ensure that on-line advertising complies with §226.16 and §226.24.. For on-line advertisements that may be deemed to contain more than a single page, financial institutions should comply with §226.16(c) and §226.24(d), which describe the requirements for multiple-page advertisements.

Consumer Leasing Act (Regulation M)

OSC §213.2(b)-1 provides examples of advertisements that clarity the definition of an advertisement under Regulation M. The term advertisement includes messages inviting, offering, or otherwise generally announcing to prospective customers the availability of consumer leases, whether in visual, oral, print, or electronic media. Included in the examples are on-line messages, such as those on the Internet. Therefore, such messages are subject to the general advertising requirements under §213.7.

Equal Credit Opportunity Act (Regulation B)

OSC §2025(e)-3 clarifies the rules concerning the taking of credit applications by specifying that application information entered directly into and retained by a computerized system qualifies as a written application under this section. If an institution makes credit application forms available through its on-line system, it must ensure that the forms satisfy the requirements of §202.5.

OSC §202.13(b)-4 also clarifies the regulatory requirements that apply when an institution takes loan applications through electronic media. If an applicant applies through an electronic medium (for example, the Internet or a facsimile) without video capability that allows employees of the institution to see the applicant, the institution may treat the application as if it were received by mail.

FAIR HOUSING ACT

A financial institution that advertises on-line credit products that are subject to the Fair Housing Act must display the Equal Housing Lender logotype and legend or other permissible disclosure of its nondiscrimination policy if required by rules of the institution's regulator (OTS §528.4, FDIC 9338.3, NCUA §701.31, FRB Fair Housing Advertising and Poster Requirements, 54 Fed. Reg. 11,567 (1989)).

HOME MORTGAGE DISCLOSURE ACT (REGULATION C)

OSC §203.4(a)(7)-5 clarifies that applications accepted through electronic media with a video component (the financial institution has the ability to see the applicant) must be treated as "in person" applications. Accordingly, information about these applicants' race or national origin and sex must be collected. An institution that accepts applications through electronic media without a video component, for example, the Internet or facsimile, may treat the applications as received by mail.

FAIR CREDIT REPORTING ACT

The Economic Growth and Regulatory Paperwork Reduction Act of 1996 (Public Law 104-208, §2408, 110 Stat. 3009 (1996)) amended Section 610 of the Fair Credit Reporting Act (15 U.S.C. 5 168 1 h), to allow consumer reporting agencies to make the disclosures to consumers required under Section 609 by electronic means if authorized by the consumer. Consumers must specify that they wish to receive the disclosures in an electronic form, and such form of delivery must be available from the credit reporting agency.

Any participant in an electronic service system who regularly gathers or evaluates consumer credit information or other information about consumers for the purpose of furnishing consumer reports to third parties (for monetary fees, dues, or on a cooperative nonprofit basis) is considered a consumer reporting agency. In such cases, the participant must comply with the applicable provisions of the FCRA.

MISCELLANEOUS

ADVERTISEMENT OF MEMBERSHIP (FDIC 12CFR 5328) (NCUA RR 740)

The FDIC and NCUA consider every insured depository institution's on-line system top level page, or "home page", to be an advertisement. Therefore, according to these agencies' interpretation of their rules, financial institutions subject to §328.3 (NCUA RR 9740.4) should display the official advertising statement on their home pages unless subject to one of the exceptions described under 5328.3(c) (NCUA RR9740.4(c)). Furthermore, each subsidiary page of an on-line system that contains an advertisement should display the official advertising statement unless subject to one of the exceptions described under §328.3(c) (NCUA RR4740.4(c)). Additional information about the FDIC's interpretation can be found in the Federal Register, Volume 62, page 6145, dated February 11, 1997.

The official bank sign (FDIC §328.2), official savings association sign (FDIC §328.4), and NCUA official sign (NCUA RR 740.3) are currently not required to be displayed on an institution's on-line system.

FAIR DEBT COLLECTION PRACTICES ACT

According to Section 803(2) of the Fair Debt Collection Practices Act (15 U.S.C. 9 1692a(2)), "communication" means conveying information regarding a debt directly or indirectly to any person through any medium. Financial institutions acting as debt collectors for third parties are permitted to communicate via electronic means, such as the Internet, to collect a debt or to obtain information about a consumer. In such instances, financial institutions must ensure that their communications and practices are in keeping with the requirements of the Act.

FLOOD DISASTER PROTECTION ACT

The regulation implementing the National Flood Insurance Program requires a financial institution to notify a prospective borrower and the servicer that the structure securing the loan is located or to be located in a special flood hazard area. The regulation also requires a notice of the servicer's identity be delivered to the insurance provider. While the regulation addresses electronic delivery to the servicer and to the insurance provider, it does not address electronic delivery of the notice to the borrower.

COMPLIANCE POLICY GUIDANCE

The following discussion provides specific interim compliance policy guidance regarding advertising, disclosures/notices, applications, stored value cards, and record keeping. This guidance is intended to discuss the regulations' requirements as presently written in the context of the electronic financial services environment and, to the extent possible, to provide practical examples for application of this guidance. This guidance may have to be reconsidered and revised at such time as applicable regulations are amended or clarified. Institutions may however, find it useful to apply the concepts underlying the examples in this guidance to their own electronic financial service operations. The electronic financial services environment is dynamic thus, the guidance outlined in this letter could also evolve based on developments in technology and the continuation of deliberations regarding appropriate policies.

ADVERTISEMENTS

Generally, Internet web sites are considered advertising by the regulatory agencies. In some cases, the regulations contain special rules for multiple-page advertisements. It is not yet clear what would constitute a single "page" in the context of the Internet or on-line text. Thus, institutions should carefully review their on-line advertisements in an effort to minimize compliance risk.

In addition, Internet or other systems in which a credit application can be made on-line may be considered "places of business" under HUD's rules prescribing lobby notices. Thus, institutions may want to consider including the "lobby notice," particularly in the case of interactive systems that accept applications.

DISCLOSURES/NOTICES

Several consumer regulations provide for disclosures and/or notices to consumers. The compliance officer should check the specific regulations to determine whether the disclosures/notices can be delivered via electronic means. The delivery of disclosures via electronic means has raised many issues with respect to the format of the disclosures, the manner of delivery, and the ability to ensure receipt by the appropriate person(s). The following highlights some of those issues and offers guidance and examples that may be of use to institutions in developing their electronic services.

Disclosures are generally required to be "clear and conspicuous." Therefore, compliance officers should review the web site to determine whether the disclosures have been designed to meet this standard. Institutions may find that the format(s) previously used for providing paper disclosures may need to be redesigned for an electronic medium. Institutions may find it helpful to use "pointers[1]" and "hotlink[2]" that will automatically present the disclosures to customers when selected. A financial institution's use solely of asterisks or other symbols as pointers or hotlinks would not be as clear as descriptive references that specifically indicate the content of the linked material.

Several regulations also require disclosures and notices to be given at specified times during a financial transaction. For example, some regulations require that disclosures be given at the time an application form is provided to the consumer. In this situation, institutions will want to ensure that disclosures are given to the consumer along with any application form. Institutions may accomplish this through various means, one of which may be through the automatic presentation of disclosures with the application form.

Regulations that allow disclosures/notices to be delivered electronically and require institutions to deliver disclosures in a form the customer can keep have been the subject of questions regarding how institutions can ensure that the consumer can "keep" the disclosure. A consumer using certain electronic devices, such as Web TV, may not be able to print or download the disclosure. If feasible, a financial institution may wish to include in its on-line program the ability for consumers to give the financial institution a non-electronic address to which the disclosures can be mailed.

In those instances where an electronic form of communication is permissible by regulation, to reduce compliance risk institutions should ensure that the consumer has agreed to receive disclosures and notices through electronic means. Additionally, institutions may want to provide information to consumers about the ability to discontinue receiving disclosures through electronic means, and to implement procedures to carry out consumer requests to change the method of delivery.

Furthermore, financial institutions advertising or selling non-deposit investment products through on-line systems, like the Internet, should ensure that consumers are informed of the risks associated with nondeposit investment products as discussed in the "Interagency Statement on

[1] A "pointer" is a declarative statement that refers to the location within the system at which additional important information begins.

[2] A "hotlink" is an electronic connection between two or more electronic documents that are not in sequential order.

Retail Sales of Non Deposit Investment Products." On-line systems should comply with this Interagency Statement, minimizing the possibility of customer confusion and preventing any inaccurate or misleading impression about the nature of the nondeposit investment product or its lack of FDIC insurance.

ELECTRONIC STORED VALUE PRODUCTS

Electronic stored value products are retail payment products in which value is recorded on a personal electronic device or on a magnetic strip or computer chip in exchange for a predetermined balance of funds. Electronic stored value products may include stored value cards, smart cards, and electronic cash recorded on a personal electronic device, such as a personal computer. Electronic stored value cards can be either disposable or reloadable. Disposable cards are purchased with a specific electronic value embedded on the card that can be used for transactions until the electronic value is depleted. A reloadable card permits a user to increase, as necessary, the value on the card at an electronic terminal or device that accepts currency or that allows the user to transfer funds from an account to the card.

The Federal Reserve Board of Governors, in its Report to the Congress on the Application of the Electronic Fund Transfer Act to Electronic Stored-Value Products, for purposes of the study, describes electronic stored value products as retail payment products intended primarily for consumer payments that generally have some or all of the following characteristics:

- A card or other device that electronically stores or provides access to a specified amount of funds selected by the holder of the device and available for making payments to others.
- The device is the only means of routine access to the funds.
- The issuer does not record the funds associated with the device as an account in thename of (or credited to) the holder.

The application of certain consumer protection laws and regulations to these products has not been determined. However, financial institutions that issue electronic stored value products may wish to provide information to consumers about the operation of these products to enable consumers to meaningfully distinguish among different payment products, such as stored value cards, debit cards and credit cards. Additionally, consumers likely would find it beneficial to receive information about the terms and conditions associated with the use of electronic stored value products, to ensure their informed use of these products. Some financial institutions that issue stored value products have provided consumers with a variety of disclosures including:

- federally insured or non-insured status of the product,
- all fees and charges associated with the purchase, use or redemption of the product,
- a any liability for lost or stolen electronic stored value,
- any expiration dates, or limits on redemption of the electronic stored value, and
- toll-free telephone number for customer service, malfunction and error resolution.

FDIC General Counsel Opinion No. 8, dated July 16, 1996, states that insured depository institutions are expected to disclose in a clear and conspicuous manner to consumers the insured or non-insured status of the stored value products they offer to the public, as appropriate. Some financial institutions have also printed some of this information, such as expiration date and telephone number, directly on the card.

Financial institutions should also consider establishing procedures to resolve disputes arising from the use of the electronic stored value products.

Record Retention

Record retention provisions apply to electronic delivery of disclosures to the same extent required for non-electronic delivery of information. For example, if the web site contains an advertisement, the same record retention provisions that apply to paper-based or other types of advertisements apply. Copies of such advertisements should be retained for the time period set out in the relevant regulation. Retention of electronic copies is acceptable.

THE ROLE OF CONSUMER COMPLIANCE IN DEVELOPING AND IMPLEMENTING ELECTRONIC SERVICES

When violations of the consumer protection laws regarding a financial institution's electronic services have been cited, generally the compliance officer has not been involved in the development and implementation of the electronic services. Therefore, it is suggested that management and system designers consult with the compliance officer during the development and implementation stages in order to minimize compliance risk. The compliance officer should ensure that the proper controls are incorporated into the system so that all relevant compliance issues are fully addressed. This level of involvement will help decrease an institution's compliance risk and may prevent the need to delay deployment or redesign programs that do not meet regulatory requirements.

The compliance officer should develop a compliance risk profile as a component of the institution's online banking business and/or technology plan. This profile will establish a framework from which the compliance officer and technology staff can discuss specific technical elements that should be incorporated into the system to ensure that the online system meets regulatory requirements. For example, the compliance officer may communicate with the technology staff about whether compliance disclosures/notices on a web site should be indicated or delivered by the use of "pointers" or "hotlinks" to ensure that required disclosures are presented to the consumer. The compliance officer can also be an ongoing resource to test the system for regulatory compliance.

Compliance officers will need to review their existing compliance policies and procedures and make appropriate modifications based upon the types of products, services, and operating features of the institution's online system. The compliance program may not need to be revamped, but merely extended to address the new level of technology employed by the institution. Staff should be trained and a monitoring system implemented to review continually the content and operation of the online programs to prevent inadvertent or unauthorized changes that may affect compliance with the regulations.

Management should review and revise the institution's electronic financial services as the regulatory environment changes and electronic delivery mechanisms evolve. This will help to ensure that the institution maintains an effective compliance program.

CONCLUSION

This guidance provides information for institutions to consider during the design, development, implementation and monitoring of electronic banking operations. Financial institutions are responsible for ensuring that their electronic banking operations are in compliance with applicable laws, regulations, and policies, including both federal and state provisions.

Financial institutions need to adapt to a changing technological environment so that compliance with consumer protections laws are maintained, while allowing the financial institution industry to continue to make effective use of new technology. Due to the continuing evolution of the technological environment and the associated regulatory environment, proposed changes to federal laws and regulations will undoubtedly affect the content of this letter in the future. The regulatory agencies are interested and willing to discuss these issues with financial institutions during the design and development of their electronic banking programs. Additionally, regulatory agency Internet sites may also contain information helpful to financial institutions.

Interagency Guidance on Electronic Financial Services and Consumer Compliance

ON-LINE SERVICES: INTERNET, PERSONAL COMPUTER, INTERACTIVE TELEVISION OR VIDEO KIOSKS, ETC.

Advertising and Information Only Systems

Includes advertising of loans, leases. deposit services - Truth in Lending Act, Equal Credit Opportunity Act, Consumer Leasing Act, Truth in Savings Act and Fair Housing Act apply.

- Unfair or Deceptive Advertising -- Consider state laws that may apply
- FDIC official advertising statement and Equal Housing Lending logo
- Information displayed as a on-line “lobby board” or scrolling message may constitute an advertisement

On-line Depository Services

Electronic Fund Transfer Act, Expedited Funds Availability Act, Truth in Savings Act, and Regulation D (Reserve Requirements Depository Institutions) apply.

- Major areas for consideration: delivery of disclosures; notices; periodic statements; error resolution procedures
- Ensure appropriate account authorization, including signature issues
- Determine appropriate manner of delivering written notices and/or other information to and from the customer with an on-line account
- Ensure disclosures are delivered in a timely manner and are “clear and conspicuous” / “clear and readily understandable” as required
- Ensure that correspondence and requests for information received from consumers via on-line or electronic communication are responded to in accordance with the regulations
- Consider BSA “Know your customer implications

Lending and Leasing Services

Equal Credit Opportunity Act, Home Mortgage Disclosure Act, Consumer Leasing Act, Truth in Lending Act, Unfair and Deceptive Practices Act, Community Reinvestment Act, Fair Credit Reporting Act, and the Fair Housing Act apply.

- Major areas for consideration: delivery of disclosures; notices; periodic statements; error resolution procedures
- Determine appropriate manner of delivering “written” notices and/or other information to and from the customer with an on-line account
- Ensure disclosures are delivered in a timely manner and are “clear and conspicuous” standard as required
- Ensure timely delivery of Adverse Action Notices in an appropriate manner
- Ensure that on-line products are offered and evaluated on a nondiscriminatory basis and that no illegal discouragement exists
- Determine that monitoring information and/or data collection requirements of Regulation B, C, and BB are handled appropriately
- Ensure that applications taken on-line receive the information required by the regulation
- Ensure that correspondence received from consumers via electronic communication are responded to in accordance with the regulations

Non-Deposit Investment Products

Includes securities, mutual funds, and annuities
See Interagency Statement on Retail Sales of Non-deposit Investment Products.

- Ensure appropriate notices are provided or posted indicating the services are not FDIC-insured, not guaranteed by the bank, and subject to loss of principal
- Consider whether non-deposit investment sales are appropriately segregated from where retail deposits are solicited in an on-line environment

Office of Thrift Supervision

Policy Statement on Privacy and Accuracy of Personal Customer Information
November 1998

INTRODUCTION

Savings associations regulated by the Office of Thrift Supervision ("OTS") have an obligation to protect and maintain confidential and accurate customer information. Institutions have already established internal controls to protect paper-based personal information. Institutions are now, however, faced with new challenges presented by the electronic storage and retrieval of information. As financial institutions increasingly use new technology to access, compile, and relay information to the customer, other institution staff, and third parties, new concerns arise about the privacy, security, and accuracy of such data. New technology also increases the potential for misuse or alteration of information.

This policy statement recommends that savings associations ("you") notify customers how you will use certain customer information and permit them to limit your use of it. It also reminds you to establish adequate controls to protect and maintain the confidentiality and accuracy of all customer information. Your written procedures should:

- Inform customers how you will use certain customer information and permit customers to limit the use of such information; and
- Safeguard the security and accuracy of all information about customers.

RECOMMENDED PRACTICES TO INFORM CUSTOMERS AND OBTAIN CONSENT FOR THE USE OF PERSONAL INFORMATION[1]

Before you collect any information from a customer, you should describe to that customer how you will use his or her personal information. For example, you may initially need specific information to open an account or authorize a loan for the customer. However, you may also want to share that personal information with your affiliates to cross-market other products or services to the customer.

There are many ways for you to provide adequate notice to your customers about use of their personal information. For example, when you open an account with a customer, you should consider providing the customer a notice that explains:

[1] The term "personal information," as used in this policy statement, does not include "information solely as to transactions or experiences between the customer and the [institution]" as provided in the Fair Credit Reporting Act, 15 U.S.C. § 1681a(d)(2)(A)(i).

- all intended uses of the personal information you are collecting;
- whether you intend to give or sell the personal information to an affiliated or non-affiliated party;
- what happens if the customer declines to provide the required information;
- a general description of the methods you use to assure the confidentiality and accuracy of information; and
- a phone number, e-mail address, or other point of contact at your institution that the customer can use to:
  - ⇒ review information that you have about the customer;
  - ⇒ correct inaccurate or outdated information; or
  - ⇒ notify you of possible unauthorized access to, or use of, his or her account information.

Existing customers and the general public may also want to read your customer notice. You may want to make this notice available upon request.

Before sharing personal information with affiliates, the Fair Credit Reporting Act requires that you disclose to the customer that you may share the information with affiliates and give the customer the opportunity to "opt out" of having this information shared with affiliates. We also recommend you offer your customers the choice to opt out of having this information shared with non-affiliated parties. Furthermore, certain federal and state privacy laws prohibit the release of a customer's financial records without the customer's permission.[2] If the customer has chosen to limit your sharing of their personal information, you may not exchange or sell personal information about the customer to third parties, unless you:

- receive a customer request or permission to release the information; or
- are required or allowed by law (e.g., subpoena or investigation of fraud) to disclose the information.

If you provide personal customer information to a service provider or other reporting agency under an outsourcing arrangement you should assure that they continue to protect the security and accuracy of such information.

[2] The federal Right to Financial Privacy Act ("RFPA"),, prohibits the release of the financial records of any custmer to any "Government authority" except in accordance with the requirements of the RFPA. 12 U.S.C. § 3403. For a listing of other privacy laws, *see* Federal Trade Commission, Privacy Online: A Report to Congress 40, n.160 (June 1988) and "The Report of the Consumer Electronic Payments Task Force" 24-29 (April 1998).

SAFETY AND SOUNDNESS STANDARD TO KEEP INFORMATION SECURE AND ACCURATE

Institutions already have internal controls in place that address the security of paper-based information. Specifically, you should have procedures for access, storage, and disposal of documents that contain confidential customer information.

In addition to handling paper documents within traditional brick and mortar facilities, financial institutions may use delivery channels (e.g., public telephone networks and the Internet) that are partially or totally outside the control of the institution. Operational risks increase with the reach of systems and the number of uncontrolled access points to the information.[3] Access to your electronic records through a local network, telephone or the Internet could potentially open your computer system to unauthorized users.[4] Therefore, adequate security of your institution's systems and customer information is paramount. Your internal controls must be updated to reflect the use of developing technologies and continue to adequately safeguard customer information. You should ensure that all employees are aware of their responsibilities to safeguard customer information. A comprehensive security program:

- Establishes controls to guard against unauthorized access to your networks, systems, and databases;
- Provides for employee training;
- Protects customers during transmissions over public networks to ensure the intended person receives accurate information and to prevent eavesdropping by others;
- Creates proof that both the sender and the receiver participated in a transaction: it is important that you ensure neither party in a transaction can deny his or her obligation;[5]
- Ensures the integrity and accuracy of your customer account information;
- Provides for correcting or updating information that you still use in account data files; and,
- Permits customers to review and correct any erroneous or outdated information.

If you collect, process, or maintain customer financial information, you should perform certain

[3] Operational risks arise from the potential that breaches of internal controls, operating problems, fraud, inadequate information systems, or unforeseen events may result in unexpected losses.

[4] For instance, "information brokers," operating generally over the telephone and the Internet, can obtain detailed information about a customer's financial history from financial institutions. You need to ensure that confidential customer account information is not inappropriately provided to information brokers. (For additional guidance on "information brokers," you can refer to the "Interagency Pretext Phone Calling Memorandum.") Also, outside hackers, disgruntled employees, unauthorized internal users and others may create havoc with your customer information if you fail to establish adequate operating controls.

[5] The *OTS Thrift Activities Handbook*, Section 341, Information Technology offers specific guidance on the type of controls that management should implement to ensure adequate security of information and authentication of users.

functions (e.g., account balance reconciling, funds transfer, or bill payments) under dual control. You should segregate the input of information from the review of processed information. These controls should also require the reviewer to reconcile the processed information. Your operating policies and procedures should describe the appropriate controls in detail.

SUMMARY

You should have written policies and procedures, approved by your board of directors, that describe how you will ensure that information is properly protected, confidential, and used as agreed with the customer. This policy statement and applicable laws and regulations will be considered by OTS examiners as they evaluate the adequacy of your internal controls.

OTHER SOURCES OF INFORMATION

Other federal agencies and bank industry trade groups also have issued privacy guidance that you may find useful. This includes:

- *"Privacy Online: A Report to Congress,"* Federal Trade Commission June 1998. (A description of core principles of fair information practices.) This report can be found on the Federal Trade Commission's web site at www.ftc.gov.

- *"Online Privacy of Consumer Personal Information,"* Federal Deposit Insurance Corporation August 1998. (A financial institutions letter that addresses online privacy to raise awareness among financial institutions.) This report can be found on the Federal Deposit Insurance Corporation's web site at www.fdic.gov.

- *"Emerging Privacy Issues in Electronic Banking,"* America's Community Bankers August 1998. (A description of specific operating privacy principles for community banks.) This report can be found on the trade association's web site at www.acbankers.org.

- *Banking Industry Privacy Principles," American* Bankers Association, Consumer Bankers Association, and the Bankers Roundtable. (Joint industry privacy principles for the benefit of bankers and consumers.) This report can be found on several trade associations' web sites such as www.aba.com or www.cbanet.org.

Office of Thrift Supervision

Interagency Pretext Phone Calling Memorandum
November 1998

PURPOSE

This memorandum alerts insured financial institutions to the practice of “pretext phone calling,” which is a means of gaining access to customers’ confidential account information by organizations and individuals who call themselves “account information brokers.” It is intended to enhance institutions’ awareness regarding the confidentiality and sensitivity of customer information generally, and identify some appropriate measures for the safeguarding of such information.

This guidance was jointly prepared by the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision, the Federal Reserve Board, the FBI, the Secret Service, the Internal Revenue Service, and the Postal Inspection Service.

BACKGROUND

There is a tremendous demand for information about individuals’ and businesses’ bank accounts. In recent years, this rising demand for account information has led to an increase in the number of organizations known as “account information brokers.” These “brokers” gather confidential financial information, including specific account numbers and balances, from various public and nonpublic sources. The brokers then sell this information to anyone who is willing to pay for it. Their clients include lawyers, debt collection services, and private investigators, who may use account information in civil lawsuits and other court proceedings, or identity thieves who may use account information to engage in check and credit card fraud, and other criminal acts.

Unscrupulous account information brokers are obtaining customers’ account information from insured financial institutions through a practice known as “pretext phone calling” or “social engineering.” Brokers who engage in this practice call institutions and use surreptitious or fraudulent means to try to induce employees into providing a customer’s account information. For example, a broker may pose as a customer who has misplaced his or her account number, and may repeatedly call the institution until the broker finds an employee who is willing to divulge confidential account information. The broker may use information about the customer, such as the customer’s social security number, that has been obtained from other sources, to convince the employee that the caller is legitimate. While there are no reliable estimates as to the extent of this practice, there is concern among the federal banking and law enforcement agencies that it is becoming increasingly prevalent.

The use of surreptitious or fraudulent means to obtain a customer's account information may violate state and federal laws prohibiting unfair and/or deceptive practices. It also may violate federal wire fraud laws. In addition, institutions that disclose customers' account information may be violating state privacy laws, such as those that prohibit the release of a customer's financial records without having first obtained the customer's permission.

RECOMMENDED ACTIONS

Institutions have an obligation to their customers to ensure that their customers' account information is not improperly disclosed. Authorizing employees to use their own discretion to determine whether to disclose confidential information over the telephone can result in inconsistent practice and expose the institution and its customers to the risk of an inappropriate or unauthorized release of information. To avoid this risk, institutions are encouraged to develop policies and procedures for addressing customers' financial privacy, and should, at a minimum, establish clear guidelines for dissemination of customer account information. These guidelines should set forth precisely the types of information and the circumstances under which an employee is allowed to disseminate such information over the telephone. Employee training should ensure that all employees are aware of their responsibility to safeguard customer financial information, and also should educate employees of the tactics used by information brokers to surreptitiously or fraudulently obtain confidential customer information.

Institutions should have strong controls in place to ensure against the unauthorized disclosure of customer information. For example, they should consider adopting a policy that prohibits the release of information over the telephone unless the proper authorization code is provided. The authorization code should be used in the same manner as a personal identification number (PIN) for transacting business by automatic teller machines, or credit, debit, or stored-value cards. The authorization code should not be associated with other commonly used numbers or identifiers, such as social security numbers, savings, checking, loan or other financial account numbers, PINS, or the customer's mother's maiden name. In addition, the authorization code should be unique to, and readily changed by, the authorized account holder. Finally, to increase effectiveness, the authorization code should be used in conjunction with other customer and account identifiers.

Another means of preventing unauthorized disclosures is to use a caller identification service or require employees who receive calls requesting account information to ask the caller for the number from which he or she is calling. If the number differs from that in the customer's account records, it may be an indication that the request is not a legitimate one, and the employee should not disclose the requested account information without taking further steps to verify that the customer made the request.

Interagency Pretext Phone Calling Memorandum Page 2 of 3

The institution’s security or internal audit department should consider conducting (or using third parties to conduct) unscheduled pretext phone calls to various departments to evaluate the institution’s susceptibility to unauthorized disclosures of customer information. Any weaknesses detected should be addressed through the adoption of enhanced training, procedures, and controls.

While this memorandum primarily concerns the unauthorized access to customer account information through pretext phone calling, unauthorized access to sensitive account information may occur through other means as well, including burglary, illegal or unauthorized access to the institution’s computer systems, and bribing employees with access to personal account information. Institutions should have effective procedures and controls in place to limit access to confidential information on a need to know basis, and to prevent unauthorized access to customer information through these and other means, including ensuring that all sensitive documents are properly disposed of and that the institution’s physical premises and computer systems are secure. Institutions also must properly train employees to understand the importance of protecting personal account information against improper disclosure. The federal banking agencies will continue to monitor institutions’ efforts to safeguard sensitive account information.

Institutions that suspect an illicit attempt to obtain a customer’s confidential information should immediately report the matter to the proper authorities. In such circumstances, institutions are encouraged to file a Suspicious Activity Report, and to contact their primary federal banking regulator, the Federal Trade Commission, and the appropriate state agencies charged with enforcing laws against unfair or deceptive practices. In addition, institutions should directly contact appropriate law enforcement agencies if a fraud requiring immediate attention is suspected.

Interagency Pretext Phone Calling Memorandum Page 3 of 3

Children's Online Privacy Protection Act

Background and Summary

The Children's Online Privacy Protection Act of 1998 (COPPA) (15 USC 6501 et seq.) addresses the collection, use, or disclosure of personal information about children that is collected from children through websites or other online services. On November 3, 1999, the Federal Trade Commission (FTC) issued a regulation (16 CFR 312), which implements COPPA. The regulation became effective on April 21, 2000.

Financial institutions are subject to COPPA if they operate a website(s) or online service(s) (or portion thereof) directed to children, or have actual knowledge that they are collecting or maintaining personal information from a child online. COPPA grants each of the federal financial regulatory agencies enforcement authority over the institutions they supervise under 12 USC 1818.

Definitions

The terms "child" or "children" mean individuals under the age of 13.

The term "personal information" means individually identifiable information about an individual collected online, including first and last name, home address, e-mail address, telephone number, social security number, or any combination of information that permits physical or online contact.

COPPA employs several other definitions including "communication," "disclosure" and "verifiable parental consent." For the complete listing of definitions see 16 CFR 312.2.

The following examination procedures should be consulted when examining an institution for whom any part of the company's website is directed to or captures information from children. At the close of the exam procedures, you will find the General Requirements of the COPPA regulation as well as a brief synopsis of the specific regulatory sections (e.g. Content, Notice to a Parent, Placement of Notice on website). Finally, the last document in this section is a COPPA Worksheet, a numbered checklist, to be used at the close of this particular section of the examination.

Initial Procedures

1. From direct observation of the institution's website or online service and through discussions with appropriate management officials, ascertain whether the financial institution is subject to COPPA by determining if it operates a website(s) or online service(s) that:

   - Is directed to children; or
   - Knowingly collects or maintains personal information from children. A thrift knowingly collects or maintains information from a child when it requests age or birth date information on its website and persons under age 13 can and do respond by providing age or birth date combined with other individually identifiable information.

   If the institution does <u>not</u> currently operate a website directed to children or knowingly collects information about them, the institution <u>is not</u> subject to COPPA and no further examination procedures are necessary.

2. If the institution is subject to COPPA, determine if it is participating in an FTC-approved self-regulatory program. If yes, obtain a copy of the program, and supporting documentation, such as reviews or audits, which demonstrate the institution's compliance with the program. If the self-regulatory authority (SRA) determined that the institution was in compliance with COPPA at the most recent review/audit, or has not yet made a determination, no further examination procedures are necessary. If however, the SRA determined that the institution was not in compliance with COPPA and the institution has not taken appropriate corrective action, complete the remaining procedures.
3. If an institution is subject to COPPA, review applicable audit and compliance program materials to determine whether:
   - Internal review procedures address the COPPA provisions applicable to the institution;
   - The audits or reviews performed were reasonable, accurate and include consideration of issues raised by consumer complaints;
   - Effective corrective action occurred in response to previously identified deficiencies;
   - Deficiencies, their causes, and the effective corrective actions are consistently reported to management or the members of the board of directors; and
   - The frequency of compliance review is appropriate for the level of changes to on-line content.
4. If an institution is subject to COPPA, but does not conduct satisfactory internal audits or compliance reviews, evaluate whether the institution's internal controls are adequate to ensure compliance with COPPA. Consider:
   - Who in the organization is responsible for the institution's compliance with COPPA;
   - Process flowcharts to determine how the institution's COPPAA compliance is planned for, evaluated, and achieved;
   - Policies, procedures and training programs;
   - How methods of collecting or maintaining personal information from the website or online service are vetted before implementation;
   - How data elements collected from a child are tracked for use and protected;
   - Whether data elements collected from a child are disclosed to third parties and how permission for such disclosure is implemented and tracked;
   - The resolution process for complaints regarding the treatment of data collected from a child; and
   - Any system triggers to alert operations staff about potential COPPA ramifications of web content decisions.
5. Based on the results of the foregoing, determine which verification procedures, if any, should be completed, focusing on the areas of particular risk. The selection of procedures to be employed depends upon the adequacy of the institution's compliance management system and level of risk identified. It may be most efficient to have management conduct any necessary review, correct any self-identified deficiencies and report to the Region a self-assessment of its COPPA compliance.

Verification Procedures

1. Through testing or management's demonstration of the website or online service, verify that the financial institution does not condition a child's participation in a game, offering of a prize, or another activity on the child's disclosure of more personal information than is reasonably necessary to participate in the activity [16 CFR 312.7].
2. Obtain a sample of data collected on children including data shared with third parties, if applicable, and determine whether:
   - The financial institution has established and maintained reasonable procedures to protect the confidentiality, security and integrity of personal information collected from a child [16 CFR 312.8 and 312.3];
   - Data are collected, used, and shared in accordance with the institution's website notice [16 CFR 312.4 and 312.3]; and
   - Parental permission was obtained prior to the use, collection or sharing of information, including consent to any material change in such practices [16 CFR 312.5(a)].
3. Through testing or management's demonstration of the website or online service and a review of a sample of parental consent forms or other documentation determine whether the financial institution has a reasonable method for verifying the person providing the consent is the child's parent [16 CFR 312.5 (b)(2)].
4. Review a sample of parent requests for personal information provided by their children and verify that the financial institution:
   - Provided, upon request, a description of the specific types of personal information collected [16 CFR 312.6(a)(1)];
   - Complied with a parent's instructions concerning the collection or disclosure of their child's information. [16 CFR 312.6(a)(2)];
   - Allowed parents to review any personal information collected from the child [16 CFR 312.6(a)(3)]; and
   - Verified that persons requesting information are parents of the child [16 CFR 312.6 (a)(3)].
5. Complete the COPPA Worksheet on access, clarity and content of electronic notices on the thrift's website or online service. (see "Attachment A").

Conclusions

1. Summarize all findings, supervisory concerns and regulatory violations.
2. For the violation(s) above, determine the root cause by identifying weaknesses in internal controls, audit and compliance reviews, training, management oversight, or other factors; also, determine whether the violation(s) are repetitive or systemic.
3. Identify action needed to correct violations and weaknesses in the institution's compliance system.
4. Discuss findings with the institution's management and obtain a commitment for corrective action.

General Requirements of the COPPA Regulations

The regulation requires an operator of a website or online service directed to a child, or any operators who have actual knowledge that they are collecting or maintaining personal information from a child, to:

- Provide a clear, complete and understandably written notice on the website or online service of their information collection practices with regard to children, describing how the operator collects, uses and discloses the information (16 CFR 312.4);
- Obtain, through reasonable efforts and with limited exceptions, verifiable parental consent prior to the collection, use or disclosure of personal information from children (16 CFR 312.5);
- Provide a parent, upon request, with the means to review the personal information collected from his/her child and to refuse to permit its further use or maintenance (16 CFR 312.6);
- Limit collection of personal information for a child's online participation in a game, prize offer, or other activity to information that is reasonably necessary for the activity (16 CFR 312.7); and
- Establish and maintain reasonable procedures to protect the confidentiality, security, and integrity of the personal information collected from children (16 CFR 312.8).

Placement of Notice on the Website [16 CFR 312.4(b)(1)]

An operator of a website or online service directed to children must post a link to a statement describing how it collects, uses and discloses information from and about any child on its homepage and everywhere on the site or service where it collects personal information from any child. An operator of a general audience website that has a separate children's area must post a link on the home page of the children's area.

These links must be placed in a clear and prominent place on the home page of the website or online service. To make a link clear and prominent, a financial institution may, for example, use a larger font size in a different color on a contrasting background. A link in small print at the bottom of a home page does not satisfy the clear and prominent guidelines.

Content [16 CFR 312.4(b)(2)]

The notice must state among other requirements:

- The name, address, telephone number and e-mail address of all operators collecting or maintaining personal information from any children through the website or online service;
- The types of personal information collected from any children and how the information is collected;
- How the operator uses the personal information;
- Whether the operator discloses information collected to third parties. If it does, the notice must state the types of businesses engaged in by the third parties, the purposes for which the information is used, and whether the third parties have agreed to maintain the confidentiality, security and integrity of the information. In addition, the notice must state that the parent has the option to consent to the collection and use of the information without consenting to the disclosure of the information to third parties;
- That the operator may not require as a condition of participation in an activity that a child disclose more information than is reasonably necessary to participate in such activity; and

- That a parent can review his or her child's personal information, have it deleted, and refuse to allow any further collection or use of the child's information, and state the procedures for doing so.

Notice to a Parent [16 CFR 312.4 (c)]

An operator is required to obtain verifiable parental consent before any collection, use or disclosure of personal information from any children. An operator also must make reasonable efforts to provide a parent with notice of the operator's information practices with regard to children, as described above, and in the case of a notice seeking consent, the following additional information:

- The operator wishes to collect personal information from the parent's child;
- The parent's consent is required for the collection, use and disclosure of the information; and
- How the parent can provide consent.

Methods for Obtaining Parental Consent [16 CFR 312.5 (b)]

Until April 2002, the FTC will use a sliding scale approach for obtaining parental consent in which the required method of consent will vary based on how the financial institution intends to use the child's personal information. If the information is used for internal purposes, which may include an operating subsidiary or affiliate, a less rigorous method of consent is required. If the financial institution discloses the information to others, the child's privacy is at greater risk, and a more reliable method of consent is required. Anticipating that technical developments soon will allow companies to use more reliable methods to verify identities, the FTC expects to phase out the sliding scale approach by April 2002, subject to an FTC review planned for October, 2001.

Internal Uses

Financial institutions that use the personal information internally may use e-mail to get parental consent provided the operator takes additional steps to verify that a parent is the person providing consent, such as by confirming receipt of consent by e-mail, letter, or telephone call.

Disclosure to Others

Disclosure of a child's personal information to others (e.g., chat rooms, message boards, and third parties) presents greater risk to a child's privacy, and the FTC's sliding scale approach noted above, requires a more reliable method of consent, including:

- Obtaining a signed consent form from a parent via postal mail or facsimile;
- Accepting and verifying a credit card number;
- Taking a parent call, through a toll-free telephone number staffed by trained personnel;
- E-mail accompanied by digital signature; or
- E-mail accompanied by a PIN or password obtained through one of the methods mentioned above.

Disclosures to Third Parties

A parent may permit an operator of a website or online service to collect and use information about a child while prohibiting the operator from disclosing the child's information to third parties. An operator must give a parent this option.

Parental Consent to Material Changes [16 CFR 312.5(a)]

The operator must send a new notice and request for consent to a parent if there are material changes in the collection, use or disclosure practices to which a parent has previously agreed.

Exceptions to Prior Parental Consent Requirement [16 CFR 312.5(c)]

A financial institution does not need prior parental consent when it is collecting:

- A parent's or child's name or online contact information solely to obtain consent or to provide notice. If the operator has not obtained parental consent after a reasonable time from the date of the information collection, the operator must delete such information from its records;
- A child's online contact information solely to respond on a one-time basis to a specific request from the child, if the information is not used to recontact the child, and is deleted by the operator;
- A child's e-mail address to respond more than once to a specific request of the child (e.g., a request to receive a monthly online newsletter), when the operator does not use the information to contact the child beyond the scope of the request, and a parent is notified and allowed to request that the information not be used further;
- The name and online contact information of the child to be used solely to protect the child's safety; or
- The name and online contact information of the child solely to protect the security of the site, to take precautions against liability, or to respond to judicial process, law enforcement agencies, or an investigation related to public safety.

Right to Review Information [16 CFR 312.6]

An operator of a website or online service is required to provide a parent with a means to obtain any personal information collected from his or her child. At a parent's request, an operator must provide a parent with:

- A description of the types of personal information it has collected from the child; and
- An opportunity to review the information collected from the child.

Before a parent can review a child's information, the operator must take steps to ensure that the person making the request is the child's parent. An operator or its agent will not be held liable under any federal or state laws for any disclosures made in good faith and following reasonable procedures to verify a requester's identity in responding to a request for disclosure of personal information.

The regulations allow parents to refuse to permit an operator to continue to use or to collect their child's personal information in the future and to instruct the operator to delete the information. If a parent does so, an operator may terminate its service to that child.

Confidentiality, Security and Integrity of Personal Information Collected from a Child [16 CFR 312.8]

The operator of a website or an online service is required to establish and maintain reasonable procedures to protect the confidentiality, security and integrity of personal information collected from any children. Operators must have adequate policies and procedures for protecting a child's personal information from loss, misuse, unauthorized access or disclosure. Operators are allowed to select an appropriate method for implementing this provision.

Safe-harbor [16 CFR 312.10]

Industry groups, financial institutions or others may establish, with the FTC's approval, a self-regulatory program. An operator of a website or online service that complies with FTC-approved self-regulatory guidelines will receive a "safe harbor" from the requirements of COPPA and the regulations. Self-regulatory guidelines must require that a website and an online service implement substantially similar requirements that provide the same or greater protections for a child as the FTC regulations (16 CFR 312.2-9). These guidelines also must include an effective, mandatory mechanism for assessing operators' compliance, as well as incentives to ensure that an operator will comply.

This page intentionally left blank

Attachment A

Children's Online Privacy Protection Act Worksheet for Notices

Website Notice (16 CFR 312.4)	**Yes**	**No**
1. A link is posted on the website to a notice of the financial institution's information practices with regard to children. [16 CFR 312.4 (b)].		
2. The link to the notice is clearly labeled as a notice of the website's information practices with regard to children, and is placed in a clear and prominent place on the home page of the website and at each area on the website where a child directly provides personal information [16 CFR 312.4(b)(1)].		
3. The notice states:		
• The name, address, telephone number, and e-mail address of any operator who collects or maintains personal information from a child through the website [16 CFR 312.4(b)(2)(i)];		
• The types of information collected from a child and whether the information is collected directly or passively [16 CFR 312.4(b)(2)(ii)];		
• How such information is or may be used [16 CFR 312.4(b)(2)(iii)];		
• Whether such information is disclosed to a third party and, if so, determine whether:		
- The notice states the types of businesses engaged in by the third parties;		
- The purposes for which the information is used;		
- The third parties have agreed to maintain the confidentiality, security and integrity of the information; and		
- That a parent has the option to consent to the collection and use of the information without consenting to the disclosure; [16 CFR 312.4(b)(2)(iv)];		
• The operator is prohibited from conditioning a child's participation in an activity on the disclosure of more information than is reasonably necessary to participate in such activity [16 CFR 312.4(b)(2)(v)]; and		
• A parent can review and have deleted the child's personal information; and		
- Refuse to permit further collection or use of the child's information; and		
- States the procedures for doing so [16 CFR 312.4(b)(2)(vi)].		

	Yes	No
4. The notice to a parent		
• States that the operator wishes to collect information from the child.		
• Includes the information contained in the §312.4(b) website notice (see step 3 above) [16 CFR 312.4(c)(1)(i).		
• If §312.5(a) applies, states that the parent's consent is required for the collection, use and/or disclosure of such information and states the means by which the parent can provide verifiable consent to the collection of information. [16 CFR 312.4(c)(1)(ii).		
• Includes additional information as detailed in the regulation if the exceptions in §312.5(c)(3) and (4) apply.		

Introduction

The Gramm-Leach-Bliley Financial Services Modernization Act (the Act) was enacted on November 12, 1999. Section 305 of the Act required the federal banking agencies (the Agencies) to prescribe and publish in final form, consumer protection regulations that apply to retail sales practices, solicitations, advertising, or offers of insurance products by depository institutions or persons engaged in these activities at an office of or on behalf of the institution. It directed the Agencies to include specific provisions relating to disclosures, advertising, sales practices, the physical separation of banking and nonbanking activities and domestic violence discrimination.

In addition to directing the Agencies to publish a regulation for the sales of insurance products, the Act establishes rules governing regulation of certain functionally regulated entities, including insurance companies. These rules govern when and how you may examine and request reports from organizations engaged in insurance activities. (See the discussion on functional regulation later in this Section).

OTS, the Office of Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Federal Reserve Board issued a joint final rule entitled, "Consumer Protection for Depository Institutions Sales of Insurance" (ICP rule) on December 4, 2000. It took effect on October 1, 2001. OTS codified the rule at 12 CFR 536. The final rule applies to all retail sales practices, solicitations, advertising, or offers of any insurance product or annuity by a depository institution or any person that is engaged in such activities at an office of the institution or on behalf of the institution.

This Section discusses various aspects of the regulation and how it relates to mitigating consumer protection issues that may arise from insurance sales activities.

Insurance Activity

The business of insurance sales is an area federal thrift institutions have engaged in through related organizations, such as service corporations.

Therefore, the area of insurance sales is not a new form of business to the thrift industry. An institution may engage in insurance activities for several reasons. These include the potential to increase earnings through fee income, promote cross selling opportunities of services and products, and diversify its investments.

Insurance activities, like any other business activities, present a variety of risks to the institution and to consumers. Risks to the institution include regulatory, reputation, market share, and legal. Consumer risks involve purchasing insurance products through misleading sales practices used to confuse and blatantly deceive a consumer. An example of this is selling an insurance product or annuity to a consumer by representing that the product is fully insured by the FDIC. This is a misleading sales practice that leads consumers to misunderstand the actual nature of the insurance product.

Thrift institutions may participate in insurance activities through a variety of organizational structures. In this section, we discuss the main types of organizational structures through which the thrift institution or person(s) at an office of or on behalf of the institution, solicits, advertises, offers, or sells insurance products or annuities. The Agency also discusses (in detail) the permissibility of insurance sales and types of insurance products in the Thrift Activities Handbook, Section 720 – Insurance.

Permissible Insurance Activities

Thrift institutions may provide insurance products or annuities to consumers through a variety of delivery arrangements. In this section, we discuss the following types of sales arrangements:

- Direct sales (includes sales through an operating subsidiary).
- Third-party arrangements:
  - Affiliate sales
  - Non-affiliate sales.
  - Service corporation sales.

Direct Sales

Federal thrift institutions may engage in the sale of credit life and disability insurance, and fixed-rate annuities on an agency basis (solely upon order and for the account of customers). When exercising this authority, the thrift institution must comply with all applicable federal, and state laws, as well as certain policies and conditions imposed by the OTS.

Third-Party Arrangements

OTS permits thrift institutions to enter into third-party arrangements to sell or offer insurance products or annuities. Third-party arrangements provide an institution with the expertise and services it otherwise would have to develop or purchase. Additionally, the range of products and services offered by third parties can address the specific needs of the institution.

In establishing these arrangements, the thrift institution may look to affiliated or nonaffiliated third parties to market or sell insurance products.

Sales of an Affiliate's Insurance Products

The sale of an affiliates' insurance or annuity products by a thrift institution is a growing business practice. Over the past several years, the Agency has granted federal thrift charters to several insurance companies. In the current financial service arena, insurance companies have taken on diverse business purposes. Generally, the business plans call for interstate marketing activities and cross selling of insurance services to customers of the thrift institution.

Sales of a Nonaffiliate's Insurance Products

Nonaffiliate third party arrangements are not new to thrift institutions. Institutions have used non-affiliated third parties to perform a variety of services and functions. The most common ones being loan servicing, internal loan review, compliance reviews, external audits, as well as a multitude of others. With the ever-changing financial services industry, many thrift institutions look to non-affiliate third party arrangements to provide insurance products and/or annuities. Institutions view these arrangements as a business strategy for gaining a competitive edge in their marketplace by producing and delivering products that customers may go elsewhere to purchase.

Service Corporations

Service corporations provide an institution with a variety of benefits, one of which is the ability to conduct a variety of insurance activities on a pre-approved basis. An institution's service corporation can establish a licensed insurance agency through which it may sell automobile, health, life, property, credit life, and mortgage life and disability insurance, and fixed rate annuities.

A service corporation may also rely on a third party arrangement to market, sell, or otherwise provide insurance products or annuities. These activities can be conducted at the thrift institution or branch offices. However, if an institution utilizes its service corporation's third party vendor to provide sales of insurance products or annuities, neither thrift management nor service corporation management can abdicate responsibility for maintaining oversight of the program to the third party vendor.

Controlling Risks Associated with Third-Party Arrangements

Regardless of the type of third party arrangement (affiliate, nonaffiliate or service corporation) the institution uses to conduct its insurance or annuity sales program, institution management must establish a comprehensive compliance-monitoring program to control all aspects of the sales program and to ensure compliance with all applicable laws and regulations.

Institutions engaged in or planning to engage in the sale of insurance products or annuities through third parties, must exercise sound management practices and appropriate due diligence when implementing an insurance sales program; including, the assurance that sales activities are performed in a responsible manner. Keys to responsible selling activities are adequate consumer protection, qualified employees, and appropriate sales practices by sales representatives. Additionally, there must be effective internal controls to facilitate both sales and their oversight.

An important element of controlling third party arrangements are the terms of the written contract or agreement between the parties. Management must ensure the agreement outlines what the institution and third party provider will do to market and sell insurance products or annuities; identify the duties and responsibilities of each party; describe third party activities permitted at an office of or on behalf of the institution; specify the duties and responsibilities of employees; identify training to be performed, and indicate compensation arrangements.

An institution relying on a third party arrangement (affiliated or nonaffiliated parties) must understand its role in the compliance process and closely monitor the arrangement to ensure compliance with the terms of the written agreement, applicable laws, and regulations. Active oversight by management is required to ensure third party sales representatives are not conducting inappropriate or prohibited sales practices targeted at confusing consumers looking to purchase an insurance product or annuity. This type of oversight must include implementation of policies, procedures, and internal controls that identify the role of third party providers, and address areas of risk presented by their sales activities. The adequacy of management's internal controls for monitoring and managing compliance in addressing areas of risk is the primary focus of OTS's review.

Compliance Risks in Selling Insurance Products

The most critical element in developing or entering into a program to sell insurance or annuities is that management recognize and understand the potential risks associated with such a program. These risks may include the following:

- Consumer protection risk. Prohibited sales practices, misleading advertisements, or failure to provide proper disclosures misinforms consumers and sows confusion that leads buyers to misunderstand the insurance product or annuity being purchased. Failure to afford the consumer protections required by law undermines consumer welfare and increases dissatisfaction that erodes customer loyalty. Consumer protection risk includes the hazards associated with litigation expenses and damages arising from the assertion of individual causes of action.

- Reputation risk. The institution's reputation may suffer from inappropriate sales practices. Reputation risk is the risk arising from negative public opinion. This risk may affect the institution's ability to establish new customers, or to continue servicing existing customers.

- Regulatory risk. The institution has regulatory exposure for noncompliance with applicable laws and regulations, including the imposition of fines by state insurance regulators.

- Counterparty risk. An institution exposes itself to this type of risk when using a third party provider to conduct insurance or annuity sales. To limit this type of risk, an institution must establish monitoring to assure the counterparty is meeting its compliance standards and that sales activities are performed in a responsible manner.

Institution management must identify and understand these risks, given the structure of the institution's insurance or annuity sales program and then must take appropriate steps to manage those risks.

Background Information on Functional Regulation

The Gramm-Leach-Bliley Act established rules, referred to as functional regulation, designed to minimize duplicative regulatory oversight of certain functionally regulated entities. Insurance companies and insurance agencies are included in the list of functionally regulated entities. Their primary regulators are the State insurance commissioners. However, with respect to the sale of insurance by depository institutions, the Act directed federal banking agencies to adopt regulations concerning consumer protections and to directly oversee these regulations (See Part 536 of the OTS regulations).

Essentially, functional regulation does not impede your ability to examine insurance sales activities carried out by thrift institutions or thrift holding companies for compliance with the ICP rule.

However, it may affect your ability to examine affiliates that are functionally regulated entities engaged in selling insurance or annuities at an office of or on behalf of a thrift institution.

Under functional regulation a banking agency may require reports from, examine, and take certain other actions with respect to affiliates that are functionally regulated entities, if certain conditions apply. You should consult with your regional office and review the latest agency guidance regarding examining functionally regulated entities, before finalizing your examination plan.

Information Sharing Agreements

As part of functional regulation, the Act encouraged information sharing among all regulatory agencies to reduce and prevent regulatory overlap. Accordingly, the Agency and the National Association of Insurance Commissioners (NAIC) developed and approved an information sharing agreement that has been executed by virtually all state insurance commissioners. The agreement covers the sharing of certain types of information between OTS and state insurance regulators, and outlines the standards that are followed in order for information sharing to take place.

Consumer Protection Concerns Relating to Insurance Sales

Prohibited Sales Practices

Although the ICP Rule prohibits certain sales practices by institutions or by anyone selling insurance products or annuities at an office of or on behalf of the institution, State insurance laws may afford additional consumer protections. State insurance regulators can consider certain sales practices not addressed by the ICP rule as being unethical or illegal. If you identify such practices, refer potential state law violations through your regional office to the State insurance regulator for action.

As mentioned earlier, the Agency coordinates the sharing of information with state insurance departments. This sharing of information can evolve around the unethical and sometimes illegal sales practices used to confuse and mislead consumers. Additionally, consumer complaints alleging violations of the federal regulation that raise issues under State law will be shared with State regulators pursuant to information sharing agreements.

Scope of the Regulation

Thrift institutions and other depository institutions have become increasingly involved in selling insurance products or annuities to consumers. The ICP rule establishes strict consumer protections in connection with the retail sale of insurance products or annuities to consumers.

The ICP rule applies to any thrift institution selling, soliciting, advertising, or offering insurance products or annuities to a consumer. It also applies to any other individual or entity (including a subsidiary or affiliate of the institution) selling, soliciting, advertising, or offering insurance products or annuities to a consumer at an office of or on behalf of the thrift institution. Under the ICP rule, the institution or any other individual or entity (including subsidiaries or affiliates) is considered to be a "covered person" when the individual or entity sells, solicits, advertises, or offers an insurance product or annuity and at least one of the following applies:

- The person represents to a consumer that the sale, solicitation, advertisement, or a offer of any insurance product or annuity is by or on behalf of the thrift institution;
- The thrift institution refers a consumer to a seller of insurance products or annuities and the institution has a written contractual arrangement to receive commissions or fees derived from the sale; or

- Documents evidencing the sale, solicitation, advertising, or offer of an insurance product or annuity identify or refer to the thrift institution.

The provisions of the regulation prohibit certain sales practices and misrepresentations and require disclosures to be made in connection with the sale of any insurance product or annuity to a consumer. These provisions enhance consumer protection and lessen the possibility of confusion that insurance products often present to consumers.

The regulation deals with three key areas: (1) prohibited practices, (2) disclosures and advertising, and (3) separation of banking and nonbanking activities.

Prohibited Practices (12 CFR 536.30)

Antitying and Anticoercion Prohibitions

Tying typically involves requiring a consumer to purchase a "tied product or service" from a thrift institution or an affiliate. However, these practices are generally illegal under section 5(q) of the Home Owners' Loan Act (12 U.S.C 1464(q)). The ICP rule makes clear that tying the availability of credit to the purchase of an insurance product or annuity is a prohibited practice.

Insurance and annuity sales practices must comply with the anti-tying and anti-coercion prohibitions of the ICP rule. Under the ICP rule, a thrift institution or any person at an office of the institution, or acting on behalf of the institution, may not engage in any sales practice that would lead a consumer to believe that an extension of credit, in violation of the anti-tying provisions under section 5(q) of the Home Owners' Loan Act, is conditional upon either:

- The purchase of the insurance product or annuity from the thrift institution or any of its affiliates; or
- An agreement not to obtain or a prohibition on the consumer from obtaining the insurance product or annuity from an unaffiliated entity.

Prohibition on Misrepresentations

A second prohibited practice is the misrepresentation of the characteristics of insurance products or annuities. Misrepresentations made through sales practices or used in advertisements are strictly prohibited in the sale of insurance products or annuities. Under the ICP rule, a thrift institution, or any person at an office of the institution, or acting on behalf of the institution (or a subsidiary of the institution), may not engage in any sales practice, or use any advertisement that may mislead a consumer or otherwise cause a consumer to reach an erroneous belief with respect to:

- The fact that insurance products or annuities are not backed by the federal government, or a thrift institution;
- The fact that insurance products or annuities are not insured by the Federal Deposit Insurance Corporation;
- The fact that in the case of insurance products or annuities which involve investment risk, that there is an investment risk, including the potential to lose principal value; or

In the case of a thrift institution or subsidiary of a thrift institution at which insurance or annuity products are sold or offered for sale, the fact that:

- The approval of any extension of credit to a consumer may not be conditioned on the purchase of an insurance product or annuity by the consumer from the thrift institution or a subsidiary of a thrift institution; and
- The consumer is free to purchase the insurance product or annuity from another source.

Domestic Violence Discrimination

The third prohibited practice covered in the ICP rule is domestic violence discrimination (536.30(c)). This prohibited practice includes any practice that considers domestic violence as a criterion in any decision with regard to the offering, selling, underwriting, pricing, renewal, or payment of claims of any life or health insurance product.

Disclosures and Advertisements

In order to address concerns of prohibited and inappropriate sales practices involving misrepresentation, tying of products and coercion, covered persons must provide certain disclosures to consumers. The regulation requires two types of disclosures - insurance and credit.

Insurance disclosures are required before the completion of the initial sale of any insurance product or annuity. Credit disclosures are required at the time the consumer applies for an extension of credit in connection with which an insurance product or annuity is solicited, offered, or sold.

All disclosures must be readily understandable, meaningful, conspicuous, simple, direct, and designed to call attention to the nature and significance of the information provided. While the ICP rule does not contain model forms for disclosures, it does provide examples of the types of methods to use that call attention to the nature and significance of the information contained in the disclosures.

Adherence to the disclosure provisions of the regulation is the foundation of a well-balanced insurance sales compliance program. It is essential that consumers be made to understand potential risks associated with insurance or annuity products.

Insurance Disclosures

When offering a consumer an insurance product or annuity, a thrift institution or the person engaged in insurance sales at an office of the institution or on behalf of the institution must disclose that:

- The insurance product or annuity is not a deposit of, or other obligation of, or guaranteed by a thrift institution, or any affiliates of a thrift institution;
- The insurance product or annuity is not insured by the Federal Deposit Insurance Corporation (FDIC) or any other agency of the United States, a thrift institution or an affiliate of a thrift institution; and
- In the case of an insurance product or annuity involving investment risk, that there is investment risk associated with the product including the possible loss of value.

There are however, some instances, where the first or second disclosures may not be accurate and would therefore not be required. An example of this is the disclosure that the product is not insured by any federal agency when it actually is, such as Federal Flood Insurance, which is backed by FEMA.

Generally, the insurance disclosures discussed here must be provided both orally and in writing before completion of the initial sale of any insurance product or annuity. However, several exceptions apply to the delivery of these disclosures

Exceptions to providing insurance disclosures are as follows:

- Oral disclosures are not required when a sale of an insurance product or annuity is conducted through the mail;
- If the sale is conducted by telephone, the written disclosures may be provided by mail within three business days, beginning on the first business day after the sale (Note: Oral disclosures must still be provided);
- Written disclosures may be provided electronically, if the consumer affirmatively consents AND the disclosures are provided in a form that can be printed out or stored electronically by a consumer; and
- Oral disclosures are not required when written disclosures are provided electronically.

Credit Disclosures

In connection with an application for extension of credit, with which a thrift institution intends to offer, solicit, or sell an insurance product or annuity, additional disclosures must be provided at the time of application. Under these circumstances, a thrift institution or the person engaged in insurance sales at an office of the institution or on behalf of the institution must disclose that the thrift institution may not condition an extension of credit on either:

- The consumer's purchase of an insurance product or annuity from the thrift institution or any of its affiliates; or
- The consumer's agreement not to obtain, or a prohibition on the consumer from obtaining, an insurance product, or annuity from an unaffiliated entity.

Credit disclosures must be provided orally and in writing at the time a consumer applies for an extension of credit with which an insurance product or annuity is solicited, offered, or sold. However, several exceptions apply to the delivery of credit disclosures.

<u>Exceptions:</u>

- If the consumer applies for credit through the mail, oral disclosures are not required;
- If the consumer applies for credit over the telephone, the written disclosures may be mailed to the consumer within three business days beginning on the first business day after the application is taken (Note: Oral disclosures must still be provided);
- The consumer expressly agrees to receive written disclosures electronically in a form that can be retained or obtained later, such as by printing or storing them electronically; and
- Oral disclosures are not required when written disclosures are provided electronically.

<u>Consumer Acknowledgment</u>

A thrift institution or any other individual or entity at an office of the institution or acting on behalf of the institution must obtain a written acknowledgement of receipt from the consumer at the time insurance or credit disclosures are provided or at the time of the initial purchase. These acknowledgements must be provided in paper form or in electronic format. However, oral acknowledgments are permitted for telephone transactions, provided the thrift institution or person at an office of the institution or acting on behalf of the thrift institution, maintains sufficient documentation showing the acknowledgment was received and makes "reasonable efforts" to obtain a written acknowledgment from the consumer.

Consumer acknowledgment is a key component of the regulation because it provides documented proof that the consumer received the disclosures before purchasing the insurance product or annuity.

Advertisements

Advertisements and promotional material for insurance products or annuities generally must include the insurance disclosures. However, short form model language insurance disclosures can be used in visual media, such as television broadcasting, ATM screens, billboards, signs, posters and in written advertisements and promotional materials, such as brochures. Examples of approved short form disclosures are:

- Not a deposit;
- Not FDIC insured;
- Not insured by any Federal Government Agency;
- Not guaranteed by the thrift institution; and
- May go down in value.

Short form disclosures can only be used for insurance disclosures and do not apply in the case of credit disclosures. The credit disclosure must be provided in full text each time it is required. Disclosures made through electronic media, such as those posted on a thrift institution's web site, must be configured to ensure the consumer affirmatively consents to the required disclosure to complete the transaction. This assures the disclosure is being "meaningfully provided" to the consumer. (<u>See</u> 12 CFR 536.40(c)(6)(iii)).

Disclosures are not required in advertisements and promotional material when the advertisements and promotional materials are considered of a general nature. Advertisements and promotional material are general in nature when describing or listing the products offered by the institution. For example, an institution may list "credit life" or "home owners" insurance as products available from the institution, without making the disclosures. However, the regulation does not explain what types of information on products may be included in an advertisement deemed to be of a general nature.

Segregation of Functions

Selling or offering insurance products or annuities on the premises of an institution may give the impression that these products are FDIC insured or guaranteed by the institution. In order to minimize consumer confusion, insurance sales activities are required “to the extent practicable” to be “physically segregated” from the areas in which the institution routinely accepts retail deposits from the public. The federal banking agencies clarified that the area where an institution routinely receives retail deposits is generally limited to the teller lines and teller windows.

Areas where insurance products or annuity sales take place must be clearly delineated, and distinguished from the teller lines and teller windows. However, in situations where physical space is limited, preventing sales from being conducted in a distinct area, the management of the institution has a heightened responsibility to ensure appropriate measures are in place to minimize consumer confusion.

<u>Referral Fees</u>

Institution employees, such as tellers and in limited circumstance platform personnel, who accept deposits from the public in an area where such transactions routinely take place, may refer a consumer seeking to purchase an insurance product or annuity to a qualified person selling that product. A qualified person must be appropriately licensed under applicable state insurance licensing standards with regard to specific insurance products or annuities being sold or recommended. The deposit taking person making the referral (typically a teller) is entitled to receive compensation, <u>ONLY</u> when two conditions occur:

- First, the compensation paid for the referral is no more than a one-time, nominal fee of a fixed – dollar amount for each referral; and
- Second, the compensation is paid regardless of whether a sale results from the referral.

A thrift institution must ensure that its employees receive adequate training regarding the strict limitations on their referral activities. In general, such employees are not permitted to discuss general or specific characteristics of insurance products or annuities being offered, advertised, or sold by the institution or on behalf of the institution.

<u>Consumer Grievance Process</u>

Any consumer who believes that a thrift institution or any person at an office of the institution or acting on behalf of the institution violated the requirements of the regulation may file a complaint with the appropriate OTS Regional office or the Washington, DC headquarters.

Examination Procedures

Examination Objectives

1. Determine the quality of the institution’s established compliance policies, procedures, practices, and oversight by management regarding insurance sales activities.
2. Assess the effectiveness of the institution’s internal compliance management program for monitoring insurance or annuity sales activities and applicable state regulatory requirements for these activities.
3. Determine whether the institution implements appropriate measures to ensure consumers receive, understand, and acknowledge the receipt of insurance and credit disclosures associated with initial sales of insurance products or annuities.
4. Determine whether the institution’s advertisements and promotional materials contain the minimum insurance disclosures.
5. Obtain commitments from management for corrective action when policies, procedures, or management oversight is deficient or when you identify violations.

Examination Procedures

A. Understand Insurance Operations

Understanding how to assess compliance risks associated with insurance or annuity sales programs presents a challenge in light of functional regulation (discussed earlier in Section 380 of the CAH) as enacted by the Gramm-Leach-Bliley Act (the Act). Functional regulation does not limit your ability to examine insurance activities carried out directly by the institution or a thrift holding company. Furthermore, it does not in any way limit the applicability of the insurance consumer protection regulation (12 CFR Part 536). Essentially, the insurance consumer protection regulation applies to thrift institutions, as well as other persons (including functionally regulated affiliates, subsidiaries, or any other entity) selling, soliciting, advertising, or offering an insurance product or annuity at an office of the thrift institution or on behalf of the thrift institution.

Where the institution relies on an insurance company or other functionally regulated entity, (affiliate or subsidiary of any insured depository institution) or any other third party provider to administer selling insurance or annuities at an office of the thrift institution or on behalf of the institution, management cannot abdicate its compliance management responsibility for maintaining oversight of the program to the third party. Under this structure, the role of institution management involves regular oversight and monitoring of the functionally regulated entity or third party sales operation for ensuring compliance with written agreements, institution policy, and applicable laws and regulations. This oversight includes establishing a compliance management program to evaluate compliance by the functionally regulated entity or other third party provider with the appropriate polices and procedures.

Regardless of the structure of the insurance sales program, institution management must ensure that it has adequate internal controls and procedures for accomplishing active oversight of sales activities conducted by the institution, at an office of the institution or on behalf of the institution.

B. Scoping (Level I)

You should obtain information necessary to conduct the scoping review through the PERK package, the functionally regulated entity and its primary regulator or from other available pre-exam preparation methods whenever feasible.

1. Through discussions with institution management and review of available reports and information, evaluate the institution's organizational structure (i.e. direct sales, service corporation, subsidiary, affiliates, or third - party arrangements) of insurance sales operations.

   Consider the following:

   a. Determine whether the institution conducts sales directly or through another entity and, if the latter, whether the entity is a functionally regulated entity;

   b. Determine the types of insurance products or annuities offered, solicited, advertised, or sold.

2. Review the assignment of management responsibilities for overseeing the institution's insurance activities, however conducted.

3. Review the reporting relationships, reporting frequency and standards established by the institution to achieve accountability, and the record of Board involvement in developing and overseeing the institution's insurance business plan and activities.

4. Obtain and review the consumer complaints record of the institution (or any entity engaged in insurance sales at an office of the thrift institution or on behalf of the institution) with OTS or any other relevant agency with respect to insurance or annuity sales practices, advertising, or other conduct related to the consumer protections afforded by the regulation.

5. Obtain and review any written agreements between the institution and entities engaged in insurance or annuity sales at an office of the thrift institution or on behalf of the institution

with respect to representations and warranties covering obligations of both parties.

6. Obtain and review any monitoring reports covering litigation involving insurance activities conducted by, at, or on behalf of the institution.

Use this review and analysis to identify areas of risk with respect to compliance with the regulation and plan your examination of the institution's insurance activities to best address those concerns and meet the objectives of this examination program. When identifying areas of risk, consider each substantive compliance area addressed by the regulation and identified as an element of **Level II analysis**.

C. Analysis of Compliance Management Capacity and Execution (Level II)

For each substantive compliance area that follows determine whether (i) policies and procedures establish standards for product delivery in accordance with enumerated regulatory obligations, and (ii) controls, monitoring, audits, and complaint resolution processes are used to manage insurance activities in compliance with those institutional standards and regulatory obligations.

Evaluate the compliance management program of the institution by making the determinations called for in each substantive area. When conducting an evaluation, you may consider judgmentally sampled transactions or other operational report checks where necessary to confirm your conclusions about the adequacy of management's compliance program.

For insurance and annuity sales operations conducted at an office of the thrift institution or on behalf of the institution by a functionally regulated entity: (i) obtain and review any public reports available from the institution used for its internal review and monitoring of the functionally regulated entity's insurance sales program; (ii) obtain and review any reports available from the functionally regulated entity pursuant to the latest agency guidance; and (iii) obtain and review any reports available from state insurance regulators with oversight responsibility for the functionally regulated entity involved in the institution's sales activities subject to the regulation.

Use these materials to make the determinations called for in the following Level II analysis when the activity being reviewed is conducted through a functionally regulated entity.

Where the institution's policies, procedures, systems, or internal controls fail to properly assure compliance by it or those who conduct insurance activities for it, you should conduct a more probative transactions or operations review of the deficient area **(Level III)**.

Sales Practices

1. Determine whether policies and procedures governing personnel engaged in insurance or annuity sales, prohibit practices such as:

    - misleading any person to believe that an extension of credit is conditional upon the purchase of an insurance product or annuity from the thrift institution or any of its affiliates (12 CFR 536.30(a)(1));
    - misleading any person to believe they cannot purchase insurance products from an unaffiliated entity (536.30(a)(2));
    - misleading any person concerning the lack of FDIC insurance or investment risk (12 CFR 536.30(b)) associated with an insurance product or annuity; and
    - discriminating against victims of domestic violence in the offering or sale of any life or health insurance products (12 CFR 536.30(c)).

    by reviewing:

    - institution's polices and procedures;
    - training programs and other means used by management to communicate and reinforce policies and procedures; and
    - the process used by management to maintain policies and procedures current with changes in regulatory obligations.

2. Determine whether management uses internal controls, monitoring, audits, and complaint resolution processes relating to sales practices to maintain compliance with the institution standards and regulatory obligations by evaluating:

   - record keeping rules that establish a compliance "paper" trail for sales practices and any audit of those rules or records;
   - any program of internal oversight of sales personnel activities including individual performance evaluations, or customer surveys or other feedback covering sales practices, or monitoring of live or taped sales calls or presentations;
   - any disciplinary or corrective personnel actions taken with respect to infractions of institution sales practice standards or regulatory sales practice requirements; and
   - management's handling of consumer complaints regarding sales practices.

3. Determine whether policies and procedures governing referral fees ensures that persons who accept deposits in areas where deposit-taking is routinely conducted, receive only a one-time nominal fee of a fixed dollar amount for each referral, independent of whether the referral results in a transaction,

   by reviewing:

   - institution policy and procedures;
   - training programs and other means of communicating compensation policies and procedures with eligible personnel, especially tellers; and/or
   - the understanding and experience of eligible personnel about referral compensation by interviewing them.

4. Determine whether internal controls, monitoring, audits, and complaint resolution processes relating to referral compensation are used by management to maintain compliance with institution standards and regulatory obligations by evaluating:

   - systems used to authorize payment of referral compensation;
   - reports generated by payroll accounting systems that track referral compensation and any audit reports of those systems; and
   - any program of internal oversight of compensation practices.

<u>*Advertising*</u>

1. Determine whether policies and procedures governing the preparation of advertising or promotional materials for the marketing of insurance or annuity products:

   (i) prohibit misleading any person concerning:

   - the federal guarantee status, or investment risk associated with an insurance product (12 CFR 536.30 (b));
   - the tying of credit approval to the purchase of an insurance product (12 CFR 536.30(b)(3)(i)); or
   - whether the person is free to purchase an insurance product from another source (12 CFR 536.30(b)(3)(ii)); and

   (ii) require that regulatory mandated disclosures are appropriately included in advertising copy or promotional materials (536.40(c)(5),

   by reviewing:

   - the institution's policies and procedures; and
   - any guidelines or specifications established for personnel (including advertising agencies) with respect to the requisite content of advertising copy or promotional materials.

2. Determine whether internal controls, monitoring, audits, and complaint resolution processes relating to advertising and promotional materials are used by management to maintain compliance with institution stan-

dards and regulatory obligations by evaluating:

- the role of compliance personnel in the vetting of advertising copy or promotional materials prior to publication;
- any programs of internal oversight or audit of advertising copy or promotional materials;
- any corrective action taken with respect to inaccurate, misleading or incomplete advertising copy or promotional materials that were published; and
- management's handling of consumer complaints regarding inaccurate, misleading, or incomplete advertising copy or promotional materials.

Disclosures and Acknowledgments

1. Determine whether policies and procedures governing the delivery of insurance and credit disclosures (12 CFR 536.40) require the following actions:

   - insurance disclosures be given to consumers prior to the initial purchase of insurance products or annuities (12 CFR 536.40 (c)(1));
   - credit disclosures be given to consumers at the time of application for an extension of credit in connection with which an insurance product or annuity is solicited, offered, or sold (12 CFR 536.40(c)(1));
   - electronic disclosures be provided in a format the consumer can retain or obtain later (Example - By printing or downloading) (12 CFR 536.40 (c)(4); and
   - receipt of consumer acknowledgment of insurance and/or credit disclosures (12 CFR 536.40(c)(7)).

by reviewing:

   - the institution's policies and procedures;
   - training programs and other guidelines used by management to communicate and reinforce disclosure requirements; and
   - sample application and other transaction forms to confirm correctness of content.

2. Determine whether policies and procedures governing the content of:

   (i) Insurance disclosures (12 CFR 536.40) require representations that the insurance product or annuity:

   - is not a deposit nor guarantee of the institution;
   - is not FDIC insured or backed by any other United States government agency;
   - involves investment risk including possible loss of principal; and

   (ii) Credit disclosures (anti-tying/anti-coercion) require representations that an extension of credit may not be conditioned on the purchase of an insurance product or annuity from the institution, an agreement by the consumer not to obtain an insurance product or annuity or prohibiting the consumer from obtaining an insurance product or annuity from an unaffiliated entity,

   by reviewing:

   - the institution's policies and procedures;
   - training programs and other guidelines used by management to communicate and reinforce disclosure requirements; and
   - sample application and other transaction forms to confirm correctness of content.

3. Determine whether management uses internal controls, monitoring, audits, and complaint resolution processes relating to disclosures to maintain compliance with institution standards and regulatory obligations by evaluating:

- the systems used to generate disclosures and to timely include them in transaction paperwork;
- record keeping rules that establish a compliance track record with respect to the delivery of disclosures;
- any program of internal oversight of disclosure content and delivery ensuring consumers receive and acknowledge the receipt of insurance and/or credit disclosures;
- the role of compliance personnel in monitoring disclosure content, ensuring it is presented in a timely and meaningful form; and
- management's handling of consumer complaints regarding incomplete, inaccurate, or untimely disclosures or non-receipt of disclosures.

Qualifications and Licensing (12 CFR 536.60)

1. Determine whether policies and procedures governing the qualifications and licensing of sales representatives establish standards that:

   - require all sales representatives be appropriately licensed and qualified under applicable state licensing standards to sell specific insurance or annuity products; and
   - ensure institution personnel not qualified or licensed are prohibited from marketing or selling insurance or annuity products.

   by reviewing:

   - the institution's policies and procedures;
   - guidelines established for ensuring sales representatives receive training on new or revised laws and regulations that may affect licensing requirements;
   - training programs and other guidance for personnel not qualified to sell insurance; and
   - any forms used for reporting or certifying to the institution the qualifications of sales representatives.

2. Determine whether management uses internal controls, monitoring, and audits that relate to the qualifications and licensing of sales representatives to maintain compliance with institution standards and regulatory obligations by evaluating:

   - whether personnel record keeping systems track qualifications, license renewals, and sanctions of insurance sales representatives;
   - any program of internal oversight or audit pertaining to the qualification and licensing requirements of sales representatives; and
   - the process used for conducting reference checks and license verifications when hiring or contracting with insurance sales personnel or agencies.

Location of Insurance Sales Activities

1. Determine whether insurance or annuity sales activities in an institution branch or office must be conducted in a location that is physically distinct and segregated from routine deposit taking areas of the institution (typically teller windows and teller lines, (12 CFR 536.50))

   by reviewing:

   - institution policies and procedures;
   - training programs and other guidance for personnel to assure they understand the physical segregation requirement; and
   - any standards or model floor plans established by the institution with respect to office layout when insurance activities are conducted in a branch or office of the institution;

2. Determine whether internal controls, monitoring, audits, and complaint resolution processes concerning physical location of insurance activities are used by management to maintain compliance with institution standards and regulatory obligations by evaluating:

- any method of reporting or verifying local management compliance;
- any program of internal oversight or testing used to confirm physical separation of insurance and deposit-taking activities; and
- management's handling of consumer complaints regarding the location of insurance sales activities.

Concluding Level II Analysis

Based on the results of the foregoing procedures, evaluate the performance of compliance management to determine whether a more extensive analysis is required. If you conclude that institution

- policies and procedures,
- internal controls and self evaluation, and
- management's record of taking appropriate corrective action,

demonstrate good management performance and thorough regulatory compliance, then further analysis to complete your examination is not necessary.

D. Transactions Analysis (Level III)

a. When the institution's compliance management performance is deficient for a particular area or the examiner cannot otherwise reach a substantiated conclusion about the adequacy of the institution's compliance performance, conduct sufficient transaction or operations analysis to determine the extent of the deficiency, the presence of regulatory violations, and the corrective action(s) required.

b. Conduct or expand transaction samples, account record reviews, or interviews of sales personnel covering the substantive areas where you have noted deficiencies.

This detailed analysis should enable you to determine whether regulatory violations:

- are thrift-wide or limited to a particular geographic market or decision-center;
- involve single or multiple product(s); or
- are systemic; repeated, but not systemic; or infrequent.

An institution may conduct an analysis at this level under the directions of the examiner, when the region is confident that the institution can do so reliably.

c. Where (1) the institution's compliance management is deficient in monitoring the insurance or annuity sales activities conducted by a functionally regulated entity engaging in the activity at an office of or on behalf of the institution and (2) those sales activities fail, or you suspect those sales activities fail, to comply with institution policies and the Insurance Consumer Protection Regulation (12 CFR Part 536) the following procedures should be applied:

    (i) Review and discuss your findings/concerns relating to the functionally regulated entity's sales activities with your supervisor, regional counsel, and assistant Regional Director;

    (ii) Consult the latest agency guidance regarding examining functionally regulated entities;

    (iii) If you determine an examination of the functionally regulated entity is deemed necessary, proceed in accordance with the latest agency guidance. Document the basis of your decision.

E. Formulate Conclusions

After performing the examination procedures, you should:

a. Summarize the results of your Level I Scoping Analysis and the focus it provides for Level II Compliance Review. Describe the basis for conducting any Level III review;

b. Identify and record weaknesses in internal controls, compliance management, or other areas;

c. Identify and record violations of regulatory requirements or other pertinent findings;

d. Discuss suspected violations of state law by the institution or its functionally regulated provider with your supervisor and regional counsel, to decide what information to share with State Insurance regulators.

e. Discuss findings with institution management and obtain a commitment for corrective action.

f. State conclusions and overall evaluation in report of examination;

g. Determine the need for supervisory or enforcement action.

References

OTS Rules and Regulations

Part 536 -	Consumer Protections in Sales of Insurance.

Office of Thrift Supervision Bulletins

TB 23-2	Interagency Statement on Retail Sales of Nondeposit Investment Products
TB 23-3	Joint Interpretations of the Interagency Statement on Retail Sales of Nondeposit Investment Products

Home Owners Loan Act - (12 U.S.C. 1464(q))

Office of Thrift Supervision Guidance

New Directions Bulletin – 00-03: Functionally Regulated Affiliates (August 8, 2000)