15TH ANNIVERSARY ISSUE

SECOND/THIRD ISSUE 2023

Consumer Compliance Outlook®

A FEDERAL RESERVE SYSTEM PUBLICATION FOCUSING ON CONSUMER COMPLIANCE TOPICS

Inside

Top Federal Reserve Compliance Violations in 2022: Data Collection and Reporting Requirements of the Home Mortgage Disclosure Act

By Kenneth J. Benton, Principal Consumer Regulations Specialist, Federal Reserve Bank of Philadelphia, and Alinda Murphy, Lead Examiner and Supervisory Specialist, Federal Reserve Bank of Kansas City

In the First Issue 2023 of *Consumer Compliance Outlook (CCO),* Governor Michelle W. Bowman of the Board of Governors of the Federal Reserve System announced the changes *CCO* is implementing this year.[1] In addition to our regular articles on federal consumer compliance laws and regulations, *CCO* will include data-driven articles that leverage the Federal Reserve System's supervisory data and observations from conducting consumer compliance examinations of state member banks.[2] To that end, *CCO* will be publishing articles on the top-cited violations in the prior year, including the nature of the violations, common mistakes, and risk mitigants. Financial institutions can use this information to help manage compliance risk.

As the examination data in **Table 1** (page 7) indicate, violations of the Home Mortgage Disclosure Act (HMDA) data collection and reporting requirements ranked first among the most cited violations.[3] Over 59 percent of all violations cited by the Federal Reserve in 2022 involved inaccurate collection of residential mortgage data. Because fair lending examinations rely, in part, on HMDA data, examiners validate these data. Thus, it is important for financial institutions subject to data collection and reporting to ensure their compliance management systems are able to meet existing and future requirements.

This is a two-part article that discusses the top HMDA violations based on Federal Reserve examination data. The first section dives deeper into the specifics of common HMDA data collection violations, while the second section provides sound practices on HMDA data collection.

PART 1 – TYPES OF HMDA VIOLATIONS

The majority of 2022 violations involve failure to properly collect and report the HMDA data fields for "covered loans"[4] as §1003.4(a) of Regulation C requires.[5]

CONTINUED ON PAGE 7

Consumer Compliance Outlook
Advisory Board

Karin Bearss
Vice President, SRC
Federal Reserve Bank of Minneapolis

Matthew Dukes
Counsel, Policy/Outreach
Federal Reserve Board

David Kovarik
Assistant Vice President, BS&R
Federal Reserve Bank of Chicago

Robin Myers
Vice President, SRC
Federal Reserve Bank of Philadelphia

Andrew Olszowy
Assistant Vice President, S&R
Federal Reserve Bank of Boston

Contributors

Kathleen Benson
Federal Reserve Bank of Chicago
Allison Burns
Federal Reserve Bank of Minneapolis
Dolores Collazo
Federal Reserve Board
Kate Loftus
Federal Reserve Bank of Minneapolis
Danielle Martinage
Federal Reserve Bank of Boston
Alinda Murphy
Federal Reserve Bank of Kansas City
Scott Sonbuchner
Federal Reserve Bank of Minneapolis

Staff

Editors....................................Kenneth Benton
Maura Fernbacher

Designer .... Monica Conrad

Project Manager.......................... Marilyn Rivera

Consumer Compliance Outlook is distributed to state member banks and bank and savings and loan holding companies supervised by the Board of Governors of the Federal Reserve System.

Disclaimer: The analyses and conclusions set forth in this publication are those of the authors and do not necessarily indicate concurrence by the Board of Governors (Board), the Federal Reserve Banks, or the members of their staffs. Although we strive to make the information in this publication as accurate as possible, it is made available for educational and informational purposes only. Accordingly, for purposes of determining compliance with any legal requirement, the statements and views expressed in this publication do not constitute an interpretation of any law, rule, or regulation by the Board or by the officials or employees of the Federal Reserve System.

Copyright 2023 Federal Reserve Banks. This material is the intellectual property of the 12 Federal Reserve Banks and cannot be copied without permission. To request permission to reprint an article, contact us at outlook@phil.frb.org.

Compliance Risk Assessments

By Kathleen Benson, Lead Examiner, Federal Reserve Bank of Chicago

Financial institutions are responsible for ensuring their compliance management systems (CMS) adequately mitigate the risk of violating consumer protection laws and regulations.[1] Compliance risk assessments are a helpful tool for institutions to identify, understand, and manage the consumer compliance risk in their financial products and services. While the Federal Reserve generally does not require the institutions it supervises to conduct consumer compliance risk assessments,[2] assessments scaled appropriately for the size and complexity of the institution provide significant benefits, including:

- identifying risks so management can take appropriate action to mitigate them;
- highlighting weaknesses in controls that need to be enhanced;
- aligning compliance risk with an institution's risk appetite; and
- demonstrating the adequacy of the CMS to examiners and other stakeholders.

Federal Reserve examiners use a risk assessment process, detailed in Consumer Affairs (CA) letter 13-19, "Community Bank Risk-Focused Consumer Compliance Supervision Program,"[3] when scoping examination activities. Although targeted to the examination process, the letter includes helpful definitions and concepts that can also be utilized by bank management. This article discusses risk assessment concepts, including those found in CA letter 13-19, that management may use to identify and manage consumer compliance risk.

RISK ASSESSMENT TERMINOLOGY

These definitions are discussed in CA letter 13-19. However, the discussion only provides highlights of the risk considerations, since the letter is directed at examiners' assessment of risk, rather than a process supervised institutions are required to use.

Inherent risk. Inherent consumer compliance risk is the likelihood and impact of noncompliance with consumer laws and regulations that apply to the institution's products and services before considering the mitigating effects of risk management. Factors to consider include the complexity of applicable laws and regulations and the risk of consumer harm if the risk is not properly mitigated. The level of regulatory change and the maturity of the product or service can be factors in assessing inherent risk. For example, many institutions assessed the inherent risk of residential real estate lending as high when the TILA-RESPA Integrated Disclosures (TRID) requirement became effective in 2015 because TRID significantly changed the closed-end, residential mortgage loan origination process. Additional factors, such as product volume, complexity, and stability or reliance on third-party vendors, are detailed in CA letter 13-19. Inherent risk components are typically categorized as high, moderate, or low, as defined by the institution.

Risk management. Consumer compliance risk management considers the adequacy of board and management oversight of compliance-related activities and includes policies and procedures, monitoring activities supported by management information systems, and internal controls. The formality of risk management processes varies with the size and complexity of the institution. Smaller institutions, with less complex products and services, may rely on less formal risk management processes. In contrast, larger and more complex institutions (or smaller institutions with a business model that relies on complex partnerships) generally require formal written policies and procedures, multifaceted monitoring activities based on comprehensive management information systems that provide information to various levels of management and the board, and comprehensively documented internal control processes. Change management processes are recommended, although the processes may also vary in formality depending on the size and complexity of the institution. The adequacy of risk management components is typically categorized as strong, satisfactory, or weak, as defined by the institution.

Residual risk. Residual product risk is the remaining risk after controls are implemented to mitigate inherent risk. Effective risk management reduces the likelihood or impact of an inherent risk occurring. Residual risk components are typically categorized as high, moderate, or low, as defined by the institution.

DEVELOPING THE RISK ASSESSMENT

A formal risk assessment may have both a *quantitative* aspect, such as the number of consumer complaints, and a *qualitative* process supported by a narrative about inherent risk levels and the adequacy of risk management processes. The risk assessment should involve business line management and compliance staff. Business line management owns the risk present in the business line and typically has the most detailed knowledge of products and services and business-line-embedded risk management processes, while compliance staff can oversee the process and ensure consistency among business lines, provide effective challenge, and ensure that compliance and audit controls are incorporated. An institution's compliance committee and board of directors should also be involved through the review and approval of the risk assessment. The components of the risk assessment each have a particular focus **(see Figure 1: Risk Assessment Process)**.

FIGURE 1: Risk Assessment Process

Inherent Risk

- Products
- Services
- Activities

Risk Management

- Board and Management Oversight
- Policies and Procedures
- Monitoring and Management Information Systems
- Internal Controls

Residual Risk

- Appropriate to Board Risk Appetite?
- Actions Necessary to Further Mitigate Risk?

Inherent risk identification. This process focuses on material products, business lines, or services. Commercial and agricultural lending generally have similar compliance risk profiles, so they are frequently combined in risk assessments unless there are unique risk management processes associated with each. Residential real estate lending is often considered the most complex product line because it is subject to many laws and regulations, including the disclosure and substantive protections of the Truth in Lending Act, the mortgage servicing requirements of the Real Estate Settlement Procedures Act, the data collection and reporting requirements of the Home Mortgage Disclosure Act, and the flood insurance purchase requirements of the Flood Disaster Protection Act.

Institution-specific attributes, such as the presence or absence of Special Flood Hazard Areas in the institution's market area or more complex product features such as adjustable-rate mortgages, escrow, and private mortgage insurance, are further considerations when performing an inherent risk assessment for residential real estate lending. Consumer loan products, including home equity lending and deposit products, typically round out the primary product and services categories. Institutions utilizing fintech products or offering deposit accounts with higher-risk add-on features, such as vendor-provided identity theft monitoring or other benefits, should explicitly include them in their risk assessment because of the higher risks of these products.

Fair lending risk associated with the institution's products and services should also be considered in the compliance risk assessment, although larger and more complex institutions often opt to develop a separate fair lending risk assessment. Regardless of the size of the institution, an assessment of fair lending risk should consider the fair lending risk indicators from the 2009 Interagency Fair Lending Examination Procedures:[4]

- Underwriting
- Redlining
- Pricing
- Marketing
- Steering
- Overt indicators of discrimination

Other important considerations to incorporate into a compliance risk assessment include the risk of unfair or deceptive acts or practices that is present when an institution develops and/or markets products and services.

Inherent risk assessments should also consider the following:

- Critical regulatory requirements and associated penalties for noncompliance
- The maturity of the product or service, since new products or services typically have greater risk levels
- Change affecting the products in terms of volume growth, competition, and new or changing regulations
- Reliance on external vendors
- Whether there are significant industry issues with the product or service, such as concerns with deposit overdraft services[5]

Risk management assessments. This process should consider whether board and management oversight and the institution's compliance program (policies and procedures, training, monitoring and internal controls, and complaint management) provide a sufficiently robust assessment of the effectiveness of risk management practices. Smaller, less complex institutions may find that extensive policies and procedures are not necessary; however, considerations such as the degree of centralized risk management processes, employee knowledge or experience, and turnover are also important when assessing the need for documented policies and procedures and the frequency of training on laws, regulations, policies, and procedures. The adequacy of existing risk monitoring reports or processes used by business line management and the compliance function should also be assessed. When issues are identified, action should be taken to identify the root cause, enhance controls, and/or decrease inherent risk to prevent similar findings in the future.

The assessment of internal controls should consider automated system capabilities to disclose transactions properly and the need for manual checkpoints when gaps are identified in system functionality. Other important risk management considerations include the adequacy of loan or deposit processing forms and compliance checklists and similar items or a second review of documents before they are provided to consumers. Similarly, the frequency and severity of findings identified in examinations, compliance reviews, and internal or external audits should be considered when developing a conclusion about risk management adequacy. In less complex institutions, examiners frequently find that annual compliance audits are one of the strongest aspects of an institution's CMS.

Even when risk management for a given product or service is deemed satisfactory after considering the items that have been noted, the risk assessment process provides the opportunity to identify and prioritize further improvements in risk management and/or to reduce risk, which can enable potential issues to be detected earlier.

Residual risk identification. After identifying residual risk, an institution should determine whether it aligns with the board's risk appetite. This assessment may determine that risk management practices should be enhanced and/or that inherent risk should be reduced; examples of this could be providing additional training or procedural guidance to enhance controls, or, if a higher-risk product feature has not proved to be sufficiently profitable or utilized relative to the risk level, considering whether modifying the product offering is desirable. The most effective compliance risk assessments specifically ask whether changes are necessary, and, if they are, the action items clearly identify the responsible parties and the time frames in which the desired change is expected to occur.

ADDITIONAL CONSIDERATIONS

Financial institutions may undertake formal compliance risk assessments using a product, service, and activity structure for the assessment. This approach allows business line management to identify inherent risk and assess the adequacy of risk management practices. In addition, narrative highlights or an executive summary can capture nuances of inherent risk and risk management practices that solely numeric assessments cannot. Examiners sometimes see risk assessments that are primarily structured around applicable laws and regulations. However, this type of assessment less frequently considers differences in business unit processes that may exist, which are critical to include. For example, adverse action processes under the Equal Credit Opportunity Act and the Fair Credit Reporting Act may differ on the commercial side of the institution compared with the consumer side, and the differences may not be noted and individually assessed for effectiveness without a business line approach. In addition, risk management practices are typically based around products and services and the areas responsible for them, rather than solely laws and regulations. Examiners have also noted that the use of highly numeric risk assessments can result in overly complex documents, or, at the opposite extreme, simplistic assessments that do not truly convey the nature of compliance risk, but instead reduce risks and risk management practices to mere numbers.

> "If an institution partners with a third party to develop its risk assessment, it is important for the institution to understand and agree with the third party's risk assessment approach, because an institution is ultimately responsible for managing its own risk."

Both regulation-based and highly numeric risk assessments can adequately reflect conclusions about residual risk and the need for additional risk mitigation. However, examiners have generally found that a risk assessment structure based on products, services, and activities is more effective in conveying the many factors that should be considered in compliance risk assessments. These structures, with appropriate narratives or executive summaries, may also make it easier for an institution's senior management and board to understand the risk assessment.

Finally, some institutions outsource the risk assessment process to qualified third parties. While this is a less typical approach, it may be particularly helpful for an institution undertaking a formal risk assessment process for the first time. After the initial risk assessment is completed with the third party, the institution may then be able to undertake the process itself. If an institution partners with a third party to develop its risk assessment, it is important for the institution to understand and agree with the third party's risk assessment approach, because an institution is ultimately responsible for managing its own risk.

> "The use of highly numeric risk assessments can result in overly complex documents, or, at the opposite extreme, simplistic assessments that do not truly convey the nature of compliance risk, but instead reduce risks and risk management practices to mere numbers."

EXAMINER REVIEW OF COMPLIANCE RISK ASSESSMENTS

An institution's risk assessment process is one of the factors considered in the Uniform Interagency Consumer Compliance Rating System. The Board and Management Oversight assessment factor includes in its rubric the "comprehension, identification, and management of risks arising from the institution's products, services, or activities."[6] Further, the qualitative description for 2-rated institutions indicates management "comprehends and adequately identifies compliance risks, including emerging risks, ..." and also "adequately manages those risks, including through self-assessments."[7] Examiners see a wide variety of risk assessment processes. A key consideration is that an institution's process must meet its needs and provide an accurate assessment of compliance risk. This includes examples at less complex institutions where the limited complexity of the institution's products, services, and activities allows seasoned institution management and compliance officers to orally convey their understanding of compliance risk and the effectiveness of risk management processes. However, most institutions the Federal Reserve examines, regardless of size, utilize formal compliance risk assessment processes because of the benefits provided.

CONCLUSION

Financial institutions have different ways to effectively identify, understand, and manage compliance risk. However, examiners have found that institutions with an effective CMS typically use formal compliance risk assessments. The work spent on the front end in conducting risk assessments to identify inherent risk and risk management processes can yield many benefits on the back end by ensuring that residual compliance risk is aligned with the institution's risk appetite and that risk management practices reduce the likelihood of significant compliance issues.

Because many methods can be used to assess compliance risk, institutions performing risk assessments for the first time or enhancing an existing process are encouraged to discuss their risk assessment plans during their examination or when they anticipate modifying existing processes. Specific questions and issues should be discussed with your primary regulator. ■

Endnotes*

1 See 2016 Uniform Interagency Consumer Compliance Rating System, 81 *Federal Register* 79473 (November 14, 2016).

2 In cases where examiners determine that compliance risk is not sufficiently identified or appropriately managed, examiners may require an institution to implement or enhance a compliance risk assessment.

3 See the Federal Reserve's "Community Bank Risk-Focused Consumer Compliance Supervision Program" (January 1, 2014).

4 See Interagency Fair Lending Examination Procedures.

5 Risks associated with deposit overdraft services are discussed in the 2016 Outlook Live – Interagency Overdraft Services webinar.

6 See 2016 Uniform Interagency Consumer Compliance Rating System, 81 *Federal Register* at 79478.

7 See 81 *Federal Register* at 79481.

* Note: The links for the references listed in the Endnotes are available on the *Consumer Compliance Outlook* website at consumercomplianceoutlook.org.

CONTINUED FROM PAGE 1

Top Federal Reserve Compliance Violations in 2022: Data Collection and Reporting Requirements of the Home Mortgage Disclosure Act

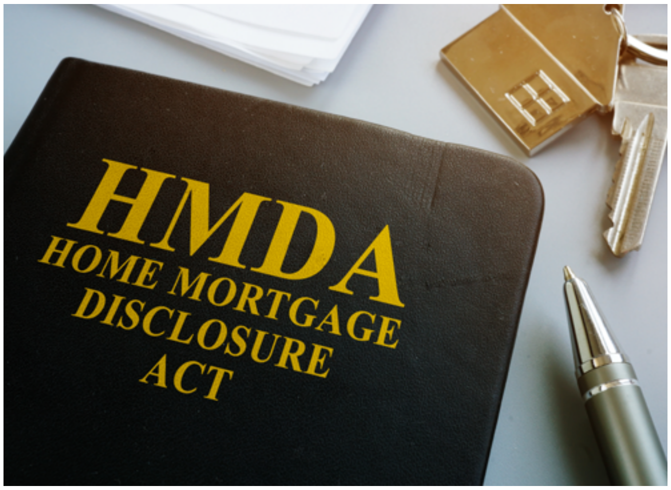
Loan Purpose: §1003.4(a)(3)

Whether the covered loan is, or the application is for, a home purchase loan, a home improvement loan, a refinancing, a cash-out refinancing, or for a purpose other than home purchase, home improvement, refinancing, or cash-out refinancing.

Examiners cited institutions for selecting the wrong "loan purpose" field when the purpose was a refinancing or a cash-out refinancing. The regulation defines refinancing as "a closed-end mortgage loan or an open-end line of credit in which a new, dwelling-secured debt obligation satisfies and replaces an existing, dwelling-secured debt obligation by the same borrower."[6] On the other hand, a loan is designated as a cash-out refinancing if it "is a refinancing as defined by §1003.2(p) *and* the institution considered it to be a cash-out refinancing in processing the application or setting the terms (such as the interest rate or origination charges) under its guidelines or an investor's guidelines." (Emphasis added). Thus, whether a loan is a *cash-out refinance* depends on the creditor's *internal* standards instead of a specific regulatory definition. For example, one institution may establish a relatively high threshold for a loan to be considered a cash-out refinance, such as a refinance loan in which the borrower

TABLE 1: Top Consumer Violations in 2022 for State Member Banks

Provision		Violations	% of All Violations
1	Regulation C (Home Mortgage Disclosure Act), 12 C.F.R. §1003.4(a): requires a financial institution to collect specific data on applications for covered loans it receives, originates, and purchases for each calendar year.	239	59.4
2	Regulation BB (Community Reinvestment Act), 12 C.F.R. §228.42(a): requires a bank to collect and maintain specific data for each small business or small farm loan originated or purchased by the bank.	29	7.2
3	Regulation E (Electronic Fund Transfers Act), 12 C.F.R. §1005.11(c): requires a financial institution to perform an investigation and determine whether an error occurred within 10 business days of receiving a notice of error.	9	2.2
4	Regulation E (Electronic Fund Transfers Act), 12 C.F.R. §1005.11(d): requires a financial institution to respond to a consumer's notice of error in writing if it determines no error occurred or an error occurred in a manner or amount different from the one the consumer described.	6	1.5
5	(tie) Fair Credit Reporting Act, 15 U.S.C. §1681m: requires a financial institution taking adverse action against a consumer based in whole or in part on information in a consumer report to provide an adverse action notice.	5	1.2
6	Regulation B (Equal Credit Opportunity Act), 12 C.F.R. §1002.7(d): prohibits a creditor from requiring the signature of an applicant's spouse or other person, other than a joint applicant, on any credit instrument if the applicant qualifies under the creditor's standards of creditworthiness for the amount and terms of the credit requested.	5	1.2
7	Regulation B (Equal Credit Opportunity Act), 12 C.F.R. §1002.9(a): requires a creditor to notify an applicant within 30 days after receiving a completed application concerning the creditor's approval of, counteroffer to, or adverse action on the application.	5	1.2
8	Regulation B (Equal Credit Opportunity Act), 12 C.F.R. §1002.14(a): requires a creditor to provide an applicant a copy of all appraisals and other written valuations developed in connection with an application for credit that is to be secured by a first lien on a dwelling.	5	1.2
9	Regulation X (Real Estate Settlement Procedures Act), 12 C.F.R. §1024.17(c): sets limits on the amount a servicer can require a borrower to deposit into any escrow account created in connection with a federally related mortgage loan.	5	1.2
Subtotal of top violations		**308**	**76.3**
Total of all violations cited in 2022		**402**	



receives $25,000 or more at closing, while another institution may define it with a lower threshold, such as a loan providing the borrower $1,000 or more at closing.

Comment 4(a)(3) clarifies these definitions with three examples:

> i. Assume a financial institution considers an application for a loan product to be a cash-out refinancing under an investor's guidelines because of the amount of cash received by the borrower at closing or account opening. Assume also that under the investor's guidelines, the applicant qualifies for the loan product and the financial institution approves the application, originates the covered loan, and sets the terms of the covered loan consistent with the loan product. In this example, the financial institution would report the covered loan as a cash-out refinancing for purposes of §1003.4(a)(3).
>
> ii. Assume a financial institution does not consider an application for a covered loan to be a cash-out refinancing under its own guidelines because the amount of cash received by the borrower does not exceed a certain threshold. Assume also that the institution approves the application, originates the covered loan, and sets the terms of the covered loan consistent with its own guidelines applicable to refinancings other than cash-out refinancings. In this example, the financial institution would report the covered loan as a refinancing for purposes of §1003.4(a)(3).
>
> iii. Assume a financial institution does not distinguish between a cash-out refinancing and a refinancing under its own guidelines, and sets the terms of all refinancings without regard to the amount of cash received by the borrower at closing or account opening, and does not offer loan products under investor guidelines. In this example, the financial institution reports all covered loans and applications for covered loans that are defined by §1003.2(p) as refinancings for purposes of §1003.4(a)(3).

Borrower Information: §1003.4(a)(10)

The following information about the applicant or borrower:

(i) Ethnicity, race, and sex, and whether this information was collected on the basis of visual observation or surname;

(ii) Age; and

(iii) Except for covered loans or applications for which the credit decision did not consider or would not have considered income, the gross annual income relied on in making the credit decision or, if a credit decision was not made, the gross annual income relied on in processing the application.

Gross Annual Income: Examiners cited institutions for reporting the gross income the *borrower provided* rather than the income the *institution relied upon* in the credit decision. Comment 4(a)(10)(iii)-1 clarifies this requirement:

> When a financial institution evaluates income as part of a credit decision, it reports the gross annual income relied on in making the credit decision… *If an institution relies on only a portion of an applicant's income in its determination, it does not report that portion of income not relied on.* For example, if an institution, pursuant to lender and investor guidelines, does not rely on an applicant's commission income because it has been earned for less than 12 months, the institution does not include the applicant's commission income in the income reported. Likewise, if an institution relies on the verified gross income of the applicant in making the credit decision, then the institution reports the verified gross income. (Emphasis added).

Credit Score: §1003.4(a)(15)

(i) Except for purchased covered loans, the credit score or scores relied on in making the credit decision and the name and version of the scoring model used to generate each credit score.

(ii) For purposes of this paragraph (a)(15), "credit score" has the meaning set forth in 15 U.S.C. 1681g(f)(2)(A).

Examiners observed lenders reporting the scoring model by the name of the credit reporting agency, such as TransUnion, when the regulation requires the institution to specifically identify the name and version of the *scoring model* used to generate each credit score. The Consumer Financial Protection Bureau (CFPB) has published a chart for institutions to use as a reference tool for data points required to be collected, recorded, and reported under Regulation C, which describes the codes that institutions can use to report the credit scoring model relied on in making the credit decision.[7] For example, instead of reporting TransUnion as the credit reporting agency used, an institution could comply with the regulatory requirement by reporting Code 3 – FICO Risk Score Classic 04.

Examiners also observed institutions improperly reporting the credit score field as "N/A" even though it was not a circumstance in which the official interpretations clarify that N/A should be used, such as transactions for which no credit decision was made[8] or transactions for which no credit score was relied on.[9]

Discount Points: §1003.4(a)(19)

For covered loans subject to the disclosure requirements in Regulation Z, 12 C.F.R. 1026.19(f), the points paid to the creditor to reduce the interest rate, expressed in dollars, as described in Regulation Z, 12 C.F.R. 1026.37(f)(1)(i), and disclosed pursuant to Regulation Z, 12 C.F.R. 1026.38(f)(1).

Lender Credits: §1003.4(a)(20)

For covered loans subject to the disclosure requirements in Regulation Z, 12 C.F.R. 1026.19(f), the amount of lender credits, as disclosed pursuant to Regulation Z, 12 C.F.R. 1026.38(h)(3).

Examiners observed errors for both of these fields when staff manually entered the data. Manual entry can increase the risk of institutions improperly reporting data fields — for example, an employee incorrectly entering the lender credit as $500 when it was actually $5,000. Institutions typically capture this information in their loan origination software (LOS) because discount points and lender credits are required information in both the "Loan Estimate" and the "Closing Disclosure" fields of the TILA/RESPA integrated disclosure forms. Institutions can help mitigate the risk of violating these requirements by populating this information from their LOS and eliminating the potential for error that manual entry of these fields introduces.

Business or Commercial Purpose: §1003.4(a)(38)

Whether the covered loan is, or the application is for a covered loan that will be, made primarily for a business or commercial purpose.

Examiners cited institutions for violating this requirement when they did not report covered loans made primarily for a business or commercial purpose. Often, the root cause of the violation was that bank staff did not understand the definition of a business or commercial purpose loan. To clarify the meaning, Comment 3(c)(10)-3 provides examples of loans that are not excluded from reporting under §1003.3(c)(10) because, although they primarily are for a business or commercial purpose, they also meet the definition of a home improvement loan under §1003.2(i), a home purchase loan under §1003.2(j), or a refinancing under §1003.2(p).

For additional clarification, Comment 3(c)(10)-4 provides examples of business or commercial purpose loans that are *not* reportable:

i. A closed-end mortgage loan or an open-end line of credit whose funds will be used primarily to improve or expand a business, for example to renovate a family restaurant that is not located in a dwelling, or to purchase a warehouse, business equipment, or inventory;

ii. A closed-end mortgage loan or an open-end line of credit to a corporation whose funds will be used primarily for business purposes, such as to purchase inventory; and

iii. A closed-end mortgage loan or an open-end line of credit whose funds will be used primarily for business or commercial purposes other than home purchase, home improvement, or refinancing, even if the loan or line of credit is cross-collateralized by a covered loan.

These examples provide helpful guidance for institutions to determine whether a commercial or business purpose loan is reportable because its purpose is primarily *home purchase, home improvement, or refinancing.*

PART 2 – SOUND PRACTICES TO MITIGATE HMDA RISKS

Part 1 of this article provided detailed analyses of specific HMDA data collection and reporting inaccuracies. This section explores sound practices and possible enhancements to a bank's compliance management system that can help ensure proper data collection and reporting. The information shared here draws substantially from *CCO*'s 2020 HMDA article, which discussed sound HMDA practices.[10]

Such practices can be particularly important in the current regulatory environment. In addition to the challenges of complying with the existing data collection and reporting requirements, many institutions will be subject to new requirements, such as the data collection and reporting requirements of §1071 of the Dodd–Frank Wall Street Reform and Consumer Protection Act for small business loans.[11]

Table 2 lists the processes examiners have observed at institutions with effective HMDA data collection and reporting processes. We then further describe examples of sound practices that an institution may implement for three of these processes — training, tools, and data verification — to promote effective compliance with HMDA requirements.

TABLE 2: Sound HMDA Practices — Ways to Strengthen the HMDA Process	
Board and Senior Management Oversight — **Tone at the Top**	• Recognize the inherent risk of the HMDA process • Provide necessary human and capital resources o Commit on the front end to save human resources and capital on the back end
Policies, Procedures, and Limits — **Standardized Processes**	• Detail policies and procedures to ensure a consistent and repeatable process. Examples where standard procedures could be established include: o Application date and action taken date o Credit score o Points/fees
Policies, Procedures, and Limits — **Training**	• Conduct regular training specific to the individual contributor's role in the process • Identify and train for difficult situations in the process • Include training when regulatory changes and/or procedural weaknesses are noted
Policies, Procedures, and Limits — **Tools**	• Provide flow charts, worksheets, job aids for staff • Distribute industry guidance, such as *A Guide to HMDA: Getting It Right!* and the annual *Filing Instruction Guide*
Risk Monitoring and Management Information Systems — **Risk-Based Monitoring**	• Institute a risk monitoring process commensurate with institutional risk; establish a lead or subject matter expert with ownership of the process • Monitor new applications to determine whether they are HMDA reportable
Internal Controls — **Data Verification**	• Develop an autonomous verification process to review source documents; do not rely on information on HMDA worksheets
Internal Controls — **Automation**	• Know how the institution's core system interfaces with its HMDA data collection software

While this list is not exhaustive, most institutions can implement these practices, regardless of the size and structure of the institution's HMDA program. It is important for an institution to determine its risk profile, assess the level of knowledge within the institution, commit the necessary resources to the compliance process, and apply the practices best suited for its level of risk and resources.

TRAINING

Regular in-depth training is an effective tool for an institution to help its staff understand HMDA reporting requirements and to ensure that the institution applies collection procedures consistently. Effective training is tailored to each individual's role in the collection process and provides sufficient detail to aid staff in identifying the transactions to be reported and the data to be collected.

Effective training also helps staff understand regulatory requirements and internal HMDA procedures and can be particularly beneficial for explaining the nuanced data fields discussed in this article. As Regulation C has been amended several times in recent years, training is important to ensure that employees understand the latest requirements. For example, the 2018 Economic Growth, Regulatory Relief, and Consumer Protection Act[12] exempted certain filers from collecting many of the data fields added in the 2015 amendment to Regulation C. Similarly, while a May 2020 final rule amended Regulation C to increase from 25 to 100 the threshold for reporting data about closed-end mortgage loans, a September 2022 court ruling vacated that portion of the rule, revising the reporting threshold back to 25 loans.[13] Regular training helps staff stay up to date on the rules and helps create consistency among business lines and staff involved in the HMDA process.

TOOLS

Providing tools for staff, such as flow charts, worksheets, and industry materials, can aid an institution in the data collection process. Flow charts may include guidance that helps staff determine whether a transaction is HMDA reportable. HMDA worksheets are an effective way to help staff collect data on all key fields during the loan application process. Worksheets may include references on where to find information in the loan file or reminders about HMDA's requirements.

For example, the worksheet may indicate where to find the verified gross income in the file, depending on the loan type, and could include a reference of when income should be reported as "N/A." Worksheets may also remind staff how to geocode the collateral securing the loan. Finally, providing staff with copies of industry guidance, such as *A Guide to HMDA Reporting: Getting It Right!* or the *Home Mortgage Disclosure (Regulation C) Small Entity Compliance Guide*, can also help staff understand HMDA data collection requirements, especially when they encounter unfamiliar or complex transactions.

Using an automated collection process reduces the burden of compiling HMDA data. Automated collection offers a consistent process using the information entered during loan origination as source documentation for HMDA data. The level of automated collection possible may vary by institution depending on factors such as origination volume and institutional complexity. Some financial institutions use their loan origination software to determine geocodes, while others use data collection software to compile the entire Loan Application Register.

DATA VERIFICATION

Comprehensively reviewing HMDA data before submission by comparing the data collected with the data in the source files can help an institution increase the accuracy of the reported information and correct errors. Depending on the volume of data an institution collects, this process may involve testing through sampling. An effective verification process provides an institution with an opportunity to measure the accuracy of its collection and reporting processes and identify weaknesses. The verification process can also test the effectiveness of processes the institution uses to identify all applicable HMDA loans and non-originated applications.

Institutions can conduct data reviews internally or through a reputable third-party vendor. The strength of the institution's data collection processes can help determine the scope and frequency of the review. The risk of HMDA noncompliance may be greater for institutions with a high origination volume or a decentralized collection process. Reviews may uncover errors that can range from simple typographical errors to more significant procedural errors that could lead to systemic reporting violations, data scrubs, and resubmission. Identification of errors or weaknesses during the review allows an institution the opportunity to correct the data before submission, assess the severity of the weaknesses, and take appropriate corrective actions to address the root cause. A thorough data verification process provides a last line of defense for HMDA reporters.

CONCLUDING REMARKS

As violations of HMDA data collection and reporting requirements are frequently cited across the federal banking agencies, and with new data collection requirements on the horizon, institutions may consider reviewing and validating their processes to ensure that they are accurately collecting and reporting HMDA data. Specific issues and questions about HMDA requirements should be raised with your primary regulator. ■

Endnotes*

1 Governor Michelle W. Bowman, "Introducing Our New Format," *CCO* (First Issue 2023).

2 The Federal Reserve is the primary federal regulator for state-chartered banks that are members of the Federal Reserve System (aka state member banks). The information is provided in the aggregate.

3 During 2022, Federal Reserve System examiners conducted 211 examinations. The table describes the most frequently cited violations in this period.

4 12 C.F.R. §1003.2(e).

5 12 C.F.R. §1003.4(a)

6 12 C.F.R. §1003.2(p).

7 See Reportable HMDA Data: A Regulatory and Reporting Overview Reference Chart.

8 Comment 4(a)(15)-4.

9 Comment 4(a)(15)-5.

10 Allison Burns and Angelo Parker, "HMDA Data Collection and Reporting: Keys to an Effective Program," *CCO* (Fourth Issue 2020).

11 See the CFPB's 2023 final rule on Small Business Lending under the Equal Credit Opportunity Act (Regulation B).

12 See "Compliance Alert," *CCO* (First Issue 2019).

13 See Consumer Affairs letter 23-1, "Changes to Home Mortgage Disclosure Act (HMDA) Loan Volume Reporting Threshold for Closed-End Mortgage Loans" (January 31, 2023).

* Note: The links for the references listed in the Endnotes are available on the *Consumer Compliance Outlook* website at consumercomplianceoutlook.org.

Supervisory Observations on Representment Fees

BACKGROUND AND OBSERVATIONS

Through supervisory examinations, the Federal Reserve recently analyzed the practice of imposing fees on represented transactions at several supervised institutions for compliance with applicable federal consumer financial laws.

As background, a representment occurs when, after a bank declines to pay a debit transaction from a consumer's checking account because of insufficient funds, the merchant presents that same transaction again to the bank for payment. Examiners identified more than one institution that charged a nonsufficient funds (NSF) fee when a transaction was first presented and declined and also charged additional NSF fees each time the same transaction was represented and declined.

At more than one supervised institution, examiners cited the assessment of NSF fees on represented transactions as an unfair practice in violation of Section 5 of the Federal Trade Commission (FTC) Act, which prohibits unfair or deceptive acts or practices (UDAP), based on the following findings:

- The assessment of NSF fees on represented transactions resulted in a substantial injury in the form of monetary harm that affected a large number of consumers.
- Consumers were not in a position to reasonably avoid this harm because:
    - once the bank had declined to pay a transaction because of insufficient funds, the merchant controlled the number and timing of representment; and
    - the bank determined whether it paid or declined the represented transaction, and whether it assessed an NSF fee on the represented transaction.
- NSF fees on represented transactions were retained by the bank and did not provide benefits to consumers or competition that outweighed the consumer harm.[1]

MANAGING RISKS

Examiners identified the following methods that institutions had effectively used to mitigate UDAP risk related to the assessment of fees on represented transactions:

- Institutions refrained from assessing an NSF fee on a represented transaction after the bank assessed an NSF fee on the transaction when it was initially presented for payment.
- Institutions that relied on a third party for their systems monitored the third party's system settings for compliance with applicable laws and regulations, including the prohibition on UDAP. Examiners also found it helpful when institutions informed their Federal Reserve contact if a third party was unable to comply with their directions relating to representments.[2]
- Institutions took steps to ensure that the information provided to consumers about represented transactions was accurate and consistent with the bank's policy and any systems limitations.

This list is based on supervisory observations to date and does not impose any legal obligations on banks. Other methods may also assist banks in managing their UDAP risks.

Endnotes*

1 Section 5(a) of the FTC Act (15 U.S.C. §45(a)) prohibits "unfair or deceptive acts or practices in or affecting commerce" and applies to all persons engaged in commerce, including banks. Under Section 5(a) of the FTC Act, a three-part test is used to determine whether an act or practice is unfair. See *Unfair or Deceptive Acts or Practices by State-Chartered Banks* (March 11, 2004). First, the act or practice must cause or be likely to cause substantial injury to consumers. Second, the injury cannot be reasonably avoided by consumers. Finally, the consumer harm must not be outweighed by countervailing benefits to consumers or competition. Multiple federal financial regulatory agencies have issued public statements addressing the risks of unfair or deceptive acts or practices related to assessing fees on representment transactions, including the OCC, *Overdraft Protection Programs: Risk Management Practices* (April 2023); the CFPB, *Supervisory Highlights Junk Fee Special Edition* (March 2023); and the FDIC, *Consumer Compliance Supervisory Highlights* (March 2022).

2 "Whether activities are performed internally or via a third party, banking organizations are required to operate in a safe and sound manner and in compliance with applicable laws and regulations. A banking organization's use of third parties does not diminish its responsibility to meet these requirements to the same extent as if its activities were performed by the banking organization in-house." *Interagency Guidance on Third-Party Relationships: Risk Management* (June 7, 2023).

* Note: The links for the references listed in the Endnotes are available on the *Consumer Compliance Outlook* website at consumercomplianceoutlook.org.

REGULATORY CALENDAR

EFFECTIVE DATE OR PROPOSAL DATE†	IMPLEMENTING REGULATION	REGULATORY CHANGE
08/29/23	Reg. B	Statement on Enforcement and Supervisory Practices Relating to the Small Business Lending Rule Under the Equal Credit Opportunity Act and Regulation B
07/21/23	FHA, Regs. Z and B	Proposed Interagency Guidance on Reconsiderations of Value of Residential Real Estate Valuations
07/06/23	Reg. B	Fair Lending Report of the Consumer Financial Protection Bureau
06/21/23	Reg. Z	Quality Control Standards for Automated Valuation Models
05/15/23	Reg. Z	Facilitating the LIBOR Transition Consistent with the LIBOR Act (interim final rule)
05/11/23	Reg. Z	Residential Property Assessed Clean Energy Financing
04/12/23	UDAAP	Proposed Statement of Policy Regarding Prohibition on Abusive Acts or Practices
Date varies with loan volume	Reg. B	Final rule under §1071 of the Dodd–Frank Act requiring lenders to collect small business loan data
03/29/23	Reg. Z	Rulemaking proposal to revise safe-harbor credit card late fees
01/01/23	Reg. Z	Final rule establishing loan exemption threshold for appraisals of higher-priced mortgages for 2022
01/01/23	Regs. M and Z	Final rules establishing annual dollar thresholds for credit exempt from Regulations M and Z
07/25/22	Reg. V	Final rule prohibiting furnishing consumer reports containing adverse information in cases of human trafficking
06/03/22	Reg. BB	Agencies issue rulemaking proposal to modernize their implementing regulations for the Community Reinvestment Act
05/31/22	Reg. H	Agencies release revised interagency questions and answers regarding flood insurance
04/13/22	n/a	Agencies propose changes to their Uniform Rules of Practice and Procedure
04/01/22	Reg. Z	Final rule amending Regulation Z to facilitate the transition from the LIBOR interest rate index
01/01/22	Reg. C	Final rule establishing 200 loans as the permanent Home Mortgage Disclosure Act data reporting threshold for open-end lines of credit

† Because proposed rules do not have an effective date, we have listed the *Federal Register* publication date.

In Case You Missed It…

CCO has been publishing articles on a variety of consumer compliance topics under federal law since 2008. In this table, we list some of our most popular articles.

Fair Lending	
Advanced Topics in Adverse Action Notices Under the Equal Credit Opportunity Act (ECOA) (Fourth Issue 2021) **Adverse Action Notice Requirements Under the ECOA and the FCRA (Second Quarter 2013)**	The 2021 article discusses advanced adverse action notice (AAN) requirements, including counteroffers, incomplete applications, and withdrawn applications, as well as the differences among an inquiry, a prequalification, and a preapproval, along with the notice requirements for each. The article also reviews the AAN requirements when multiple creditors are involved in a credit transaction. In addition, the article discusses the emerging issue of the AAN considerations when a credit decision is based on innovative credit practices, such as credit models using alternative data sets, artificial intelligence, or machine learning. The 2013 article reviews the AAN requirements of both the ECOA and the Fair Credit Reporting Act (FCRA), explains the disclosure requirements under the FCRA mandated by the Dodd–Frank Wall Street Reform and Consumer Protection Act, and discusses common adverse action violations.
From Catalogs to Clicks: The Fair Lending Implications of Targeted, Internet Marketing (Third Issue 2019) **Keeping Fintech Fair: Thinking About Fair Lending and UDAP Risks (Second Issue 2017)**	The 2019 article focuses on the risks of the increased use of internet-based marketing practices to target audiences by personal characteristics, geography, or even hobbies. This practice may explicitly or implicitly classify users by prohibited characteristics protected under fair lending laws — such as race, national origin, or sex — and risk making financial inclusion out of reach for millions of consumers. The 2017 article offers general guideposts for evaluating the risks of unfair or deceptive acts or practices and fair lending violations related to fintech, with a focus on alternative data.
Regulation B and Marital Status Discrimination: Are You in Compliance? (Fourth Quarter 2008)	Examiners frequently cite violations of the spousal signature requirements under the ECOA and Regulation B. This article reviews the requirements, including: • improperly requiring spousal signatures on loan documents; • failing to establish the intent to apply for joint credit; • improperly limiting additional parties to spouses; and • improperly taking marital status into account during underwriting.
Regulation E (Electronic Fund Transfers Act)	
Error Resolution and Liability Limitations Under Regulations E and Z: Regulatory Requirements, Common Violations, and Sound Practices (Second Issue 2021) **Error Resolution Procedures and Consumer Liability Limits for Unauthorized Electronic Fund Transfers (Fourth Quarter 2012)**	Regulation E specifies procedures that institutions must follow for investigating and resolving errors alleged by consumers for electronic fund transfers (EFTs), such as an unauthorized ATM withdrawal. The 2012 article reviews the regulation’s error resolution and consumer liability provisions. The 2021 article reviews the regulatory requirements for error resolution and liability issues under Regulations E and Z and discusses examiner observations and sound practices to help financial institutions comply with these regulations.
Regulation V (Fair Credit Reporting Act)	
Furnishers’ Obligations for Consumer Credit Information Under the CARES Act, FCRA, and ECOA (Second Issue 2020)	Most creditors rely on the information in credit reports in deciding whether to grant credit. These reports can also be used, among other permissible purposes, to help landlords determine eligibility for rental housing, to help insurers set premiums, and to help employers assess job applicants. The FCRA and the ECOA impose certain requirements on entities that furnish information about consumers to consumer reporting agencies. Because of the importance of credit reporting information, as well as the changes under the Coronavirus Aid, Relief, and Economic Security (CARES) Act to the FCRA requirements, this article reviews these requirements, including the duty to provide accurate information, the duty to investigate disputes filed with the CRAs, and additional duties under the Fair and Accurate Credit Transactions Act.

Regulation H (Flood Disaster Protection Act of 1973)	
Flood Insurance Compliance Requirements (Third/Fourth Quarter 2015) **Agencies Issue Final Rule for New Flood Insurance Requirements (Third/Fourth Quarter 2015)**	Floods are the most common and costly natural disaster in the United States. In 2005, for example, Hurricane Katrina resulted in claim payments of $16.3 billion from the National Flood Insurance Program (NFIP), ranking as the most expensive flood since the NFIP's inception in 1968. In 2015, *CCO* published a special issue focusing on flood insurance. The first article in the issue updated a 2011 article to reflect regulatory changes. A companion article reviewed the final rule implementing provisions of the Biggert–Waters Flood Insurance Reform Act of 2012 and the Homeowner Flood Insurance Affordability Act of 2014, including: • escrow requirements; • detached structure exemption; • recoupment of force-placed insurance premiums and fees; and • refunding premiums for duplicate coverage.
Commercial Flood Insurance Compliance — Washing Away Common Pitfalls (Second Issue 2022)	This article discusses some common pitfalls for commercial flood insurance compliance, provides examples to assist in ensuring that appropriate flood insurance coverage is in place, and reviews the Federal Emergency Management Agency's Risk Rating 2.0 initiative and its effect on premiums for commercial properties. It also includes eight examples showing how to calculate the correct amount of commercial coverage.
Regulation Z (Truth in Lending Act)	
Understanding Finance Charges for Closed-End Credit (First Issue 2017)	The finance charge disclosure under the Truth in Lending Act (TILA) informs consumers about the cost of credit expressed as a dollar amount. It is also used in calculating other TILA disclosures, including the annual percentage rate (APR). Accurately computing and disclosing the finance charge is important because consumers may rely on it as well as related disclosures whose calculations are based on it, particularly the APR, when shopping for credit and evaluating credit offers. In addition, inaccurate finance charges and APR disclosures can result in restitution to the consumer if the errors exceed regulatory tolerances and can trigger the right of rescission in mortgage transactions subject to rescission. This article reviews the regulation's requirements for determining when a charge must be included in the finance charge, identifies common pitfalls, and offers tips and tools to assist lenders in avoiding and detecting finance charge violations.
HELOC Plans: Compliance and Fair Lending Risks When Property Values Change (Third Quarter 2013)	Regulation Z imposes both disclosure requirements and substantive limitations on home equity lines of credit (HELOCs). This article provides an overview of the compliance requirements and fair lending risks when a creditor takes action on a HELOC because of a change in property value.
Credit and Debit Card Issuers' Obligations When Consumers Dispute Transactions with Merchants (First Issue 2016)	This article reviews a card issuer's obligations under Regulations Z and E when a cardholder disputes a transaction with a merchant for goods or services purchased with a credit or debit card.
Electronic Signatures in Global and National Commerce Act (E-Sign Act)	
Moving from Paper to Electronics: Consumer Compliance Under the E-Sign Act (Fourth Quarter 2009)	To facilitate and encourage electronic commerce, Congress enacted the E-Sign Act in 2000. The act states that the validity or enforceability of a contract, electronic record, or signature for a transaction affecting interstate commerce cannot be challenged solely because it is in electronic form or because an electronic signature or record was used in the formation of the contract. This article provides an overview of the E-Sign Act's consumer compliance requirements.
Regulation X (Real Estate Settlement Procedures Act)	
Mortgage Servicers' Duties Under Regulation X to Respond to Notices of Error and Requests for Information (Third Issue 2021)	Regulation X requires servicers to timely and properly respond to a written error notice and/or requests for information pertaining to a servicing issue. A servicer's failure to comply can lead to examination issues and legal risk because of the potential for consumer harm. This article reviews a servicer's obligations in responding to error notices under §1024.35 and requests for information under §1024.36.

How to Subscribe to *Consumer Compliance Outlook* and Outlook Live

CCO and Outlook Live are both Federal Reserve System outreach platforms provided at no charge. *CCO* is a quarterly newsletter focusing on federal consumer compliance topics, while Outlook Live is a webinar series focusing on consumer compliance topics.

To subscribe to *CCO* and Outlook Live, please visit consumercomplianceoutlook.org. There, you can choose to receive future editions of *CCO* in electronic or print format. If you provide your email address while subscribing, we will also notify you by email of upcoming Outlook Live webinars.

Suggestions, comments, and requests for back issues are welcome in writing, by telephone (215-574-6500), or by email (outlook@phil.frb.org). Please address all correspondence to:

Kenneth Benton, Editor
Consumer Compliance Outlook
Federal Reserve Bank of Philadelphia
SRC 7th Floor NE
Ten Independence Mall
Philadelphia, PA 19106

Scan with your smartphone or tablet to access *Consumer Compliance Outlook* online.

consumercomplianceoutlook.org