

# CONSUMER COMPLIANCE OUTLOOK<sup>®</sup>

## THIRD QUARTER 2013 INSIDE

The Importance of the Consumer Compliance Internal Audit Function ..... 2

New Compliance Requirements Under the Garnishment Rule for Accounts Receiving Certain Federal Benefits ..... 4

News from Washington ..... 6

On the Docket ..... 8

Calendar of Events ..... 20

A FEDERAL RESERVE SYSTEM  
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## HELOC PLANS: COMPLIANCE AND FAIR LENDING RISKS WHEN PROPERTY VALUES CHANGE

BY: DOLORES COLLAZO, SENIOR EXAMINER, FEDERAL RESERVE BANK OF ATLANTA

In the wake of the financial crisis, home property values declined significantly in many parts of the country. In response, many creditors suspended home equity lines of credit (HELOCs) or reduced credit limits, creating compliance and fair lending risks. While housing prices have rebounded from the lows of the crisis, creditors must still be mindful of their obligations under Regulation Z when a significant decline in a property's value that allowed a creditor to take these actions has been cured. Creditors must also recognize the fair lending risk associated with these actions. This article provides an overview of the compliance requirements and risks when a creditor takes action on a HELOC because of a change in property value.<sup>1</sup>

### REGULATION Z COMPLIANCE REQUIREMENTS

Section 1026.40 of Regulation Z imposes significant compliance requirements on HELOC creditors. This section not only requires disclosure of plan terms and conditions but also generally prohibits a creditor from changing them, except in specified circumstances. One circumstance permitting a creditor to suspend a HELOC or reduce its credit limit is when the property securing the HELOC experiences a significant decline in value, as provided in 12 C.F.R. §1026.40(f)(3)(vi)(A):

No creditor may, by contract or otherwise ... change any term, except that a creditor may... prohibit additional extensions of credit or reduce the credit limit applicable to an agreement during any period in which the value of the dwelling that secures the plan declines *significantly below* the dwelling's appraised value for purposes of the plan.<sup>2</sup> (Emphasis added.)

The regulation does not define a "significant decline." However, Comment 1026.40(f)(3)(vi)-6 of the Official Staff Commentary (Commentary) provides

CONTINUED ON PAGE 10

<sup>1</sup> *Outlook* previously published a high-level discussion of compliance risks for HELOCs. See Jason Lew, "HELOCs: Consumer Compliance Implications," *Consumer Compliance Outlook*, Third Quarter 2008. This article provides a more in-depth discussion and covers topics that did not appear in the prior article.

<sup>2</sup> The regulation also permits a creditor to suspend the HELOC or reduce the credit limit in certain other circumstances, including a borrower's default on a material obligation, the creditor's reasonable belief that the borrower cannot fulfill repayment obligations, and three other circumstances involving government action. See 12 C.F.R. §1026.40(f)(3)(vi). This article addresses the exception for a significant decline in value.

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# THE IMPORTANCE OF THE CONSUMER COMPLIANCE INTERNAL AUDIT FUNCTION

BY MARK D. SERLO, MANAGING EXAMINER,  
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## INTRODUCTION

To ensure compliance with consumer protection laws and regulations, financial institutions must manage risk. This task has become especially important because of the new compliance requirements under the Dodd-Frank Wall Street Reform and Consumer Protection Act and the heightened public scrutiny of financial institutions since the financial crisis. Further, new technologies, product innovation, and the size and speed of transactions have transformed the banking landscape. This dynamic, complex environment makes it challenging for a bank to maintain a consumer compliance risk management program (compliance program) that effectively identifies, analyzes, and mitigates risks.

The internal control and audit functions are important, complementary tools for mitigating risks. Internal controls are “designed to provide reasonable assurance that the institution will achieve the following internal control objectives: efficient and effective operations, including safeguarding of assets; reliable financial reporting; and compliance with applicable laws and regulations.”<sup>1</sup> The function of internal audit is to monitor and evaluate internal controls, risk management, and governance processes to ensure their effectiveness.<sup>2</sup> This article explores the key aspects of the internal audit function and provides tips for enhancing it.

## CONSUMER COMPLIANCE INTERNAL AUDIT FUNDAMENTALS

The internal audit function is the responsibility of the board of directors (board) and senior management.<sup>3</sup> This function may be formal, informal, committee-based, or outsourced. In addition, staff can be dedicated individuals or from other areas within the bank that are not being audited. The design of the internal audit function depends on the size of the institution.<sup>4</sup>

Regardless of the size, an effective internal audit function has several common characteristics. First, the bank’s board, or an audit committee of the board, and senior management must support and actively oversee the internal audit function. The internal audit function provides the board and senior management with analyses, findings, and corrective action recommendations on the activities, operations, and products tested. To that end,

<sup>1</sup> Federal Reserve Board, Office of the Comptroller of the Currency, and Office of Thrift Supervision, SR 03-5, *Interagency Policy Statement on the Internal Audit Function and Its Outsourcing* (2003 Policy Statement), March 17, 2003, at p. 1, fn. 1

<sup>2</sup> Board of Governors of the Federal Reserve System, SR 13-1/CA 13-1, *Supplemental Policy Statement on the Internal Audit Function and Its Outsourcing*, January 23, 2013, at p. 4 (Supplemental Policy)

<sup>3</sup> 2003 Policy Statement at p. 2

<sup>4</sup> 2003 Policy Statement at p. 2



the internal audit function is a critical aspect of maintaining an environment of continual improvement.

*“Clearly, senior management must take on a very active and involved role in risk management. Although this may seem somewhat obvious, a few recent cases demonstrate, unfortunately, that senior management may not always exercise proper oversight and may not have been as engaged as would have been wise. As supervisors, governance and controls is a key feature we look at in assessing risk management at an institution.”*

*Former Governor Randall S. Kroszner, “The Importance of Fundamentals in Risk Management,” at the American Bankers Association Spring Summit Meeting, Washington, D.C., March 11, 2008*

Second, the internal audit function must be independent and be able to report objective evaluations and unbiased findings to the board or audit committee. To maintain objectivity and independence, the audit function should report directly to the board or audit committee and have the ability to escalate findings. Further, internal auditors should not have management or operational responsibilities that could result in a conflict of interests and hinder their independence. The internal audit function may be assigned to an officer with other nonaudit responsibilities who can maintain independence from the areas being audited. Without independence, the internal audit function’s ability to deliver an unbiased and objective audit report will be questioned.<sup>5</sup>

Third, the internal audit function must identify and evaluate the highest risks associated with the bank. The risk identification and evaluation process is one of the most important aspects of an effective internal audit function. The focus should be on inherent risks (such as product materiality and regulatory requirements) and controls to mitigate those risks (such as procedures, risk monitoring, secondary reviews, and audits). Further, the process should be dynamic and evolve as the bank takes on more or less risk. Thus, internal audit should periodically update control

risk assessments to reflect changes in business lines, products, processes, systems of internal control, staff, platform systems, market expansion, and regulatory changes, and should also include external factors.

Fourth, management should prepare an audit plan, which provides the roadmap for the internal audit function. The audit plan should be risk-focused, with the areas selected for coverage and frequency based on the level of risk identified in the risk assessment. The plan should be approved by the board and consider all affiliates, business lines, and processes within the bank, including potential acquisitions and planned new products and services. On an annual basis, the plan should be revised, or the most significant risks should be evaluated.<sup>6</sup>

Finally, audit findings and management’s planned response should be communicated appropriately to the board or audit committee. This enhances their ability to provide oversight and ensure that the audit findings are resolved. Internal audit reports should be presented to members of senior management who are directly affected by the findings. Although the findings should be resolved promptly, a tracking mechanism, such as a report, that describes the findings, identifies the corrective action taken, and establishes timeframes for completion should be incorporated into this process. The resolution should correct the findings and, more importantly, address their root cause. Conversely, if findings remain unresolved, an escalation process should be employed to report them to higher management in the bank, such as to the board or audit committee, to ensure that senior management completes the corrective actions in a timely manner.

**OUTSOURCING THE INTERNAL AUDIT FUNCTION**  
Some financial institutions, particularly smaller ones, outsource the internal audit function. When outsourcing, it is important to remember that an institution has a *nondelegable* duty to maintain an effective consumer compliance program; the institution – not its vendor – is the one ultimately held accountable. The 2003 interagency guidance discussed this issue at

CONTINUED ON PAGE 14

<sup>5</sup> 2003 Policy Statement at p.5

<sup>6</sup> Supplemental Policy at p.10

# NEW COMPLIANCE REQUIREMENTS UNDER THE GARNISHMENT RULE FOR ACCOUNTS RECEIVING CERTAIN FEDERAL BENEFITS

BY KENNETH BENTON, SENIOR CONSUMER REGULATIONS SPECIALIST, AND ROBERT SHEERR, FORMER RESEARCH ASSISTANT, FEDERAL RESERVE BANK OF PHILADELPHIA

## INTRODUCTION

Federal law protects benefits provided through certain federal programs — such as Social Security and Veteran Affairs — from garnishment and the claims of judgment creditors.<sup>1</sup> However, compliance has been a challenge for financial institutions because benefits are usually electronically deposited into a consumer's deposit account and commingled with unprotected funds. Thus, when a financial institution receives a garnishment order for an account with commingled funds, it may not be clear whether any of the funds are protected. When financial institutions respond to a garnishment order by freezing all the funds in an account, protected funds could be garnished in error.<sup>2</sup> Garnishing protected funds can impose severe financial hardship on account holders, especially persons whose only income is the federal benefit.<sup>3</sup>

In response to this problem, the Department of the Treasury (Treasury), the Social Security Administration (SSA), the Railroad Retirement Board (RRB), the Department of Veterans Affairs (VA), and the Office of Personnel Management (OPM) (Agencies) issued an interim final rule, Garnishment of Accounts Containing Federal Benefit Payments (Garnishment Rule), that became effective on May 1, 2011, to establish the policies and procedures financial institutions must follow

to avoid garnishing protected funds.<sup>4</sup> The Agencies adopted a final rule on May 29, 2013, which became effective on June 28, 2013, that included changes to the interim final rule.<sup>5</sup> The rule is codified at 31 C.F.R. Part 212. This article reviews the compliance requirements of the final rule.

## Scope of Rule

The Garnishment Rule applies to deposit accounts at financial institutions to which a federal benefits payment may be directly deposited. Financial institutions are defined in the regulation as any bank, savings association, credit union, or other entity chartered under federal or state law to engage in the business of banking.<sup>6</sup> The following federal benefits are protected:

- Social Security benefits and Supplemental Security Income payments administered by the SSA
- veterans benefits administered by the VA
- federal railroad retirement, unemployment, and sickness benefits administered by the RRB, and
- Civil Service Retirement System and Federal Employee Retirement System benefits administered by the OPM.<sup>7</sup>

The federal banking agencies are charged with enforcing compliance with the Garnishment Rule.<sup>8</sup>

<sup>1</sup> See 42 U.S.C. §407(a) and 42 U.S.C. §1383(d)(1) (social security benefits); 38 U.S.C. §5301(a) (VA benefits); 45 U.S.C. §231m(a) and 45 U.S.C. §352(e) (federal railroad retirement benefits); 5 U.S.C. §8346 (Civil Service Retirement System benefits); and 5 U.S.C. §8470 (federal employees retirement systems).

<sup>2</sup> "Frozen Out: A Review of Bank Treatment of Social Security Benefits," Hearing Before the Senate Finance Committee, September 20, 2007; Ellen Schultz, "Closing the Benefits Loophole," *The Wall Street Journal*, May 30, 2009

<sup>3</sup> Garnishment of Accounts Containing Federal Benefit Payments, 76 Fed. Reg. 9939-40 (Feb. 23, 2011)

<sup>4</sup> 76 Fed. Reg. 9939 (Feb. 23, 2011)

<sup>5</sup> 78 Fed. Reg. 32099 (May 29, 2013)

<sup>6</sup> 31 C.F.R. §212.3

<sup>7</sup> U.S. Department of the Treasury, Guidelines for Garnishment of Accounts Containing Federal Benefit Payments (March 2011) at 3-4, available at <https://www.fms.treas.gov/greenbook/Garnishment-Guideline-06-13.pdf>

<sup>8</sup> 31 C.F.R. §212.11(a)

## PROCEDURES FOR FINANCIAL INSTITUTIONS

### *Receipt of Garnishment Order*

When a financial institution receives a garnishment order, it must determine within two business days whether a “Notice of Right to Garnish Federal Benefits” is attached.<sup>9</sup> This notice is used for garnishment by the United States or a state child support enforcement agency. The Garnishment Rule, 31 C.F.R. Part 212, does *not* apply to this type of garnishment. As a result, if this notice is attached, the institution simply follows its customary procedures for handling garnishment orders. But if the order does not contain this notice, the institution must follow the account review procedures set forth in 31 C.F.R. §§212.5 and 212.6, as discussed below.<sup>10</sup>

### *Account Review*

**Lookback Period.** “Account review” refers to the process of examining deposits in an account to determine whether the SSA, VA, RRB, or OPM deposited a benefit payment into the account during the “lookback period.” The “lookback period” is the two-month period beginning on the date preceding the date of the account review and ending on either the corresponding date of the month two months earlier or the last date of the month two months earlier if the corresponding date does not exist.<sup>11</sup> For example, if an institution begins the account review on October 15, 2013, the lookback period would run from August 14, 2013, through October 14, 2013.<sup>12</sup>

**Timing.** Generally, an institution must perform an account review no later than two business days after

receiving the garnishment order and sufficient information from the creditor to determine whether the debtor is an account holder.<sup>13</sup> The rule contains an exception for institutions receiving a large batch of garnishment orders.<sup>14</sup> In that circumstance, the institution may use a later date with the permission of the creditor serving the batch of orders.<sup>15</sup> The institution must also keep records of account activity and actions taken in response to such batches to demonstrate compliance with the Garnishment Rule.<sup>16</sup>

**Benefit Payments Deposited During Lookback Period.**<sup>17</sup> If an institution finds after performing an account review that no covered benefit payment was deposited into the account, the provisions of 31 C.F.R. §212.6 (rules and procedures to protect benefits) do not apply. Instead, the institution can follow its customary procedures for handling garnishment orders.<sup>18</sup> On the other hand, if covered benefit payments were deposited during the lookback period, the institution must follow the procedures in 31 C.F.R. §212.6 to protect the federal benefits.

**Protected Amount.** The Garnishment Rule prohibits financial institutions from freezing funds that make up an account holder’s “protected amount,” which is defined as the lesser of (a) the sum of all federal benefit payments deposited into the account between the close of business on the beginning date of the lookback period and the open of business on the ending date of the lookback period, or (b) the balance in the

CONTINUED ON PAGE 16

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<sup>9</sup> The model form for this notice is located in Appendix B to 31 C.F.R. Part 212.

<sup>10</sup> 31 C.F.R. §212.4

<sup>11</sup> 31 C.F.R. §212.3

<sup>12</sup> For more examples, see Appendix C to 31 C.F.R. Part 212

<sup>13</sup> 31 C.F.R. §212.5(a)(1)

<sup>14</sup> States often bundle garnishment orders and deliver them to financial institutions in large batches. The agencies created this exception to address the difficulty of complying with the two-business day deadline after receiving a large batch of garnishment orders. See 76 Fed. Reg. at 9944.

<sup>15</sup> 31 C.F.R. §212.5(a)(2)

<sup>16</sup> 31 C.F.R. §§212.5(a)(2), 212.11(b)

<sup>17</sup> “Benefit payment” is a federal benefit paid by direct deposit to an account with the character “XX” encoded in positions 54 and 55 of the company entry description field *and* the number “2” encoded in the originator status code of the batch header record of the direct deposit entry. (emphasis added) See 31 C.F.R. §212.3

<sup>18</sup> 31 C.F.R. §212.5(b)

# NEWS FROM WASHINGTON: REGULATORY UPDATES\*

## **Consumer Financial Protection Bureau (CFPB) issues final rule to clarify TILA and RESPA mortgage rules.**

On July 10, 2013, the CFPB issued a final rule clarifying the mortgage regulations it issued in January 2013 under the Real Estate Settlement Procedures Act (RESPA) and the Truth in Lending Act (TILA). Among the changes and revisions, the CFPB:

- clarified how to determine a consumer's debt-to-income ratio using Appendix Q
- explained that the CFPB's RESPA rule does not preempt the field of servicing regulations issued by the states
- clarified the mandatory compliance date for the adjustable rate mortgage (ARM) servicing provisions in 12 C.F.R. §1026.20(c) and (d)
- clarified which mortgage loans should be considered in determining whether an entity qualifies as a "small servicer"
- clarified that the 2013 amendment to the escrow rules did not affect the eligibility of construction and bridge loans and reverse mortgages from the escrow, ability-to-repay, and prepayment penalty rules, and
- clarified the eligibility standards for the temporary qualified mortgage provision.

## **Agencies propose three exemptions to appraisal requirements for higher-risk mortgages.**

In January 2013, six federal regulatory agencies (Agencies) jointly issued a final rule to implement the appraisal requirements for higher-risk mortgages in the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). The Agencies are now proposing three exemptions to the appraisal requirements of the January 2013 final rule. The Dodd-Frank Act defines a "higher-risk mortgage" as a higher-priced mortgage loan, namely, a consumer credit transaction secured by a consumer's dwelling whose annual percentage rate exceeds the Freddie Mac average prime offer rate by 150 basis points for first-lien loans, 250 basis points for jumbo loans, and 350 basis points for subordinate-lien loans. Under the proposed exemptions, the appraisal requirements would not apply to loans of \$25,000 or less, certain "streamlined" refinancings, and certain loans secured by manufactured housing. The comment period closed on September 9, 2013.

## **CFPB issues procedural rule for supervision of non-banks.**

On June 26, 2013, the CFPB issued a final rule that establishes procedures to bring under its supervisory authority certain nonbanks whose activities it has reasonable cause to determine pose risks to consumers. Nonbanks subject to the rule are companies that offer or provide consumer financial products or services but do not have a bank, thrift, or credit union charter. The rule details

the procedures the CFPB will follow to provide the nonbank with an opportunity to respond to a supervisory notification and creates a method for nonbanks to petition to terminate CFPB supervision after two years.

**CFPB proposes amendments to mortgage rules.** On June 24, 2013, the CFPB announced a proposal to amend certain aspects of some of the final mortgage rules issued in January 2013. The proposed changes would:

- outline procedures for obtaining follow-up information on loss-mitigation applications
- facilitate servicers' offering of short-term forbearance plans
- revise an exemption from the requirement to maintain escrows on certain higher-priced mortgage loans for small creditors that operate predominantly in rural or underserved areas
- extend an exception to the ban on high-cost mortgages featuring balloon payments to apply it to small creditors that do not operate predominantly in rural or underserved counties, as long as the loans meet certain restrictions
- clarify the prohibition on financing credit insurance premiums in connection with certain mortgage transactions
- clarify the circumstances under which a loan originator's or creditor's administrative staff would be deemed to be acting as a loan originator
- clarify for retailers of manufactured homes and their employees what compensation must be counted toward certain thresholds for points and fees under the ability-to-repay and high-cost mortgage rules, and
- revise the effective dates of the loan originator rule and the ban on financing of credit insurance.

The comment period closed July 22, 2013.

## **Agencies release list of distressed or underserved non-metropolitan middle-income geographies.**

On June 18, 2013, the Federal Reserve Board and the other federal bank and thrift regulatory agencies announced the release of the 2013 list of distressed or underserved communities where revitalization or stabilization activities will receive consideration as "community development" under the Community Reinvestment Act.

## **Federal Deposit Insurance Corporation (FDIC) and the CFPB develop a resource tool for older adults.**

On June 12, 2013, the FDIC and the CFPB launched a new financial resource tool, *Money Smart for Older Adults*, to help older adults and their caregivers prevent, identify, and respond to elder financial exploitation; plan for a secure financial future; and make informed financial decisions. The instructor-led module offers practical information and is designed to be delivered to older adults and their caregivers by repre-



sentatives of financial institutions, adult protective service agencies, senior advocacy organizations, law enforcement, and others that serve this population.

**CFPB issues final rule amending its ability-to-repay rule.** On May 29, 2013, the CFPB finalized amendments to the Ability-to-Repay (ATR) rule that it issued in January 2013. That rule will become effective on January 10, 2014. Among other things, the amendments create exemptions and modifications to the rule for small creditors, community development lenders, and housing stabilization programs. The amendments also revise the rule on how to calculate loan originator compensation for certain purposes. Specifically, the final rule:

- exempts from the ATR rule nonprofit lenders that help low- and moderate-income consumers obtain affordable housing, provided the nonprofit lenders make no more than 200 loans per year and lend only to low- and moderate-income consumers. Similarly, mortgage loans made by or through a housing finance agency, by certain homeownership stabilization programs, and by certain community development lenders will be exempted from the ATR rules.
- extends Qualified Mortgage status to certain loans made by small creditors that must have assets less than \$2 billion and make (together with its affiliates) 500 or fewer first-lien loans per year that are subject to the rule. Loans retained by these lenders in their portfolio for at least three years would be eligible for Qualified Mortgage status even if the consumer's debt-to-income ratio exceeds 43 percent.
- temporarily allows small creditors to make balloon loans that will meet the definition of a Qualified Mortgage, even though the areas they serve do not meet the definition of a rural or underserved area. The CFPB is reviewing the definition of rural and underserved areas, which some commenters suggested was too narrow, and will revisit this issue two years after completing its review.
- allows smaller creditors to charge a higher annual percentage rate for first-lien QMs while still receiving the stronger legal presumption of compliance with the ATR requirement. Smaller creditors will be permitted to charge 350 basis points over the average prime offer rate (APOR) instead of the 150 basis points over APOR that would otherwise apply. No change was made for the threshold for subordinate-lien loans.
- clarifies how to calculate loan origination compensation for purposes of the 3% limit on points and fees for Qualified Mortgages. Compensation paid by a mortgage broker or a lender to a loan originator employee will

not be counted toward the points and fees threshold. However, compensation paid by a creditor to a mortgage broker must be included in points and fees, in addition to any origination fees paid by a consumer to a creditor.

**CFPB revises rule protecting consumers sending money internationally.** On April 30, 2013, the CFPB issued the final rule amending its foreign remittance transfer rule. The remittance rule applies to transfers sent by consumers in the United States to individuals and businesses in foreign countries. This rule will take effect on October 28, 2013. The CFPB made three changes to the final rule:

- makes it optional, in some circumstances, for a remittance transfer provider to disclose fees imposed by the recipient's financial institution if that institution is not the provider's agent.
- makes it optional for the remittance transfer provider to disclose foreign taxes collected by persons other than the remittance transfer provider. (If either of the above options is used, a disclaimer must be provided indicating that the recipient may receive less than the disclosed total because of fees and taxes collected by a person other than the provider.)
- requires remittance transfer providers to attempt to recover funds that are deposited into the wrong account because the sender provided an incorrect account number or routing number, if certain other conditions are satisfied. However, the providers would not be liable for funds that cannot be recovered in such cases.

**CFPB issues amendments to CARD Act rule.** On April 29, 2013, the CFPB amended the rules that implement the Credit Card Accountability Responsibility and Disclosure Act of 2009 (CARD Act). The CARD Act requires card issuers to evaluate a consumer's ability to repay before opening a new credit card account or increasing the credit limit of an existing account. The rules that were previously issued to implement that requirement required creditors to determine whether the applicant has an independent source of income or assets from which they can make the required payments on the account. For applicants who are at least 21 years old, the CFPB's revision to the rule allows card issuers to consider third-party income if the applicant has a reasonable expectation of access to it. For example, a card issuer evaluating the ability to repay of a stay-at-home husband or wife applying for a credit card could consider the income of the working spouse even if the spouse is not a joint applicant.

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\* Links to the announcements are available in the online version of *Outlook* at: [www.consumercomplianceoutlook.org](http://www.consumercomplianceoutlook.org).



## ON THE DOCKET: RECENT FEDERAL COURT OPINIONS\*

### REGULATION Z — TRUTH IN LENDING ACT (TILA)

**Eighth Circuit holds that a borrower does not preserve the three-year statute of limitations for rescission claims by only sending the creditor a right to cancel but must also file suit within three years.** *Keiran v. Home Capital, Inc.*, 720 F.3d 721 (8th Cir. 2013). The Eighth Circuit affirmed the dismissal of two rescission lawsuits under TILA because they were not filed within three years of consummation. (Borrowers usually have three business days after consummation to rescind certain types of credit transactions secured by a dwelling, but TILA extends the rescission period to three years if the creditor fails to provide the notice of the right to cancel or the material disclosures.) The borrowers invoked their right of rescission by sending the creditors completed right-to-cancel forms within three years of consummation, but the creditors rejected the requests. The borrowers later filed lawsuits seeking rescission more than three years after consummation, which the trial courts dismissed as untimely.

On appeal, a divided three-judge panel of the Eighth Circuit affirmed the dismissals, with one judge dissenting. The court held that the three-year period for rescission claims under §1635(f) of TILA requires a borrower to file a lawsuit within three years and that sending the right-to-cancel form to the creditor did not preserve the statute of limitations, based on the Supreme Court's decision in *Beach v. Ocwen Federal Bank*, 523 U.S. 410 (1998). In *Ocwen*, the Court held that Congress intended for the right of rescission to terminate three years after consummation and could not be extended. The court also relied on recent decisions from the Ninth and Tenth Circuits, holding that rescission lawsuits must be filed within three years. See *Rosenfield v. HSBC Bank, USA*, 681 F.3d 1172 (10th Cir. 2012) and *McOmie-Gray v. Bank of America Home Loans*, 667 F.3d 1325 (9th Cir. 2012). The borrowers noted that the Third and Fourth Circuits have reached contrary results, holding that a rescission notice sent to a creditor within three years preserves the borrower's right to rescind. See *Sherzer v. Homestar Mortgage Services*, 707 F.3d 255 (3d Cir. 2013) and *Gilbert v. Residential Funding LLC*, 678 F.3d 271 (4th Cir. 2012). But the Eighth Circuit was not persuaded by the reasoning of these decisions.

**Obligation to notify borrower of new or current owner of loan does not apply to loan servicer.** *Henson v. Bank of America*, \_\_\_ F.Supp. \_\_\_ 2013 WL 1222095 (D. Colo. 2013). A federal court in Colorado dismissed claims under TILA against a loan servicer alleging that the servicer failed to respond to written requests to identify the current owner of the loan and failed to provide notice when the owner changed. The borrowers obtained a mortgage from a lender. The servicing rights were later acquired by Countrywide Home Loans Servicing, a company that Bank of America later acquired and renamed BAC Home Loans Servicing. After the borrowers defaulted, BAC Home Loans Servicing filed a foreclosure action. In response, the borrowers sued Bank of America, alleging various claims, including two claims under TILA. The court granted Bank of America's motion to dismiss the TILA claims because §1641(f) of TILA specifically provides that a servicer is not considered an assignee of a loan it is servicing unless the servicer also owns the loan. Because Bank of America was only a servicer, it was not subject to obligations that only apply to the creditor or its assignees, and the court dismissed the TILA claims.

### REGULATION V — FAIR CREDIT REPORTING ACT (FCRA)

**Eighth Circuit reviews damages under the FCRA.** *Taylor v. Tenant Tracker, Inc.*, 710 F.3d 824 (8th Cir. 2013). The Eighth Circuit affirmed the dismissal of a lawsuit under the FCRA against Tenant Tracker, a consumer reporting agency, because the consumer failed to present evidence that she suffered actual damages from incorrect information in her Tenant Tracker report. The plaintiffs, Catherine Taylor and her husband, ap-





plied for federal housing assistance from a federal housing agency. During a required background check, the agency pulled the applicants' consumer reports from Tenant Tracker, which showed two criminal records for a Chantel Taylor, who was born on the same day as the plaintiff. The report stated Chantel could be an alias for Catherine. The housing agency concluded that Chantel Taylor had a different physical description and was not an alias for Catherine and approved the housing application. After the housing agency provided updated information to Tenant Tracker, the consumer report was revised to remove the reference to Chantel Taylor and her convictions. The plaintiffs sued Tenant Tracker for violating the FCRA by failing to follow reasonable procedures to ensure that the information in her report was accurate. The lower court dismissed the lawsuit because the plaintiff failed to establish that the information was technically inaccurate. On appeal, the Eighth Circuit affirmed, but for a different reason: the plaintiff failed to show that she suffered any actual damages from the allegedly incorrect information.

## REGULATION B — EQUAL CREDIT OPPORTUNITY ACT (ECOA)

**Lender's acceleration of mortgage debt triggers duty to provide adverse action notice.** *Schlegel v. Wells Fargo Bank, N.A.*, 720 F.3d 1204 (9th Cir. 2013). The plaintiffs defaulted on their mortgage loan and filed for bankruptcy protection. While the bankruptcy case was pending, Wells Fargo (Wells) acquired the loan and entered into a loan modification agreement that extended the maturity date from February 2039 to February 2050. A few months later, Wells inadvertently sent a default notice to the borrowers stating that the loan balance would be accelerated if payment were not made. When the borrowers inquired about the notice, Wells said to ignore it. However, Wells sent four additional default notices to the borrowers, two of which stated that the loan balance was accelerated and that the matter would be referred to an attorney to begin foreclosure proceedings. The plaintiffs then filed a lawsuit alleging that Wells violated ECOA by failing to send an adverse action notice when the loan balance was accelerated and the loan modification agreement was effectively terminated. The plaintiffs also alleged violations of the Fair Debt Collection Practices Act (FDCPA). The trial court dismissed both claims. On appeal, the Ninth Circuit affirmed the dismissal of the FDCPA claim because Wells was collecting debts for its own account and did not meet the statutory definition of a debt collector. But the court reversed the dismissal of the ECOA claim. The court noted that ECOA defines adverse action to include "revocation of credit" and found that the acceleration notice terminated the modification agreement and the borrowers' ability to defer repayment of debt, thus constituting adverse action.

## PROTECTING TENANTS AT FORECLOSURE ACT (PTFA)

**Ninth Circuit holds that the PTFA does not provide a private cause of action.** *Logan v. U.S. Bank National Association*, 722 F.3d 1163 (9th Cir. 2013). Congress passed the PTFA to prevent tenants in residential leases from being evicted when the property they occupy is in foreclosure. The law requires 90 days' notice to a tenant in a foreclosed property before eviction and also allows, with exceptions, tenants to stay in a foreclosed property until their lease expires. The plaintiff sued U.S. Bank for damages because after the bank foreclosed on the landlord's property it served the plaintiff with a three-day eviction notice instead of providing the 90 days required by the PTFA. The issue on appeal was whether the PTFA provides tenants with a private cause of action to sue for damages. After examining the PTFA and its legislative history, the court determined that Congress did not intend to provide such remedies and instead intended that the PTFA be raised by tenants as a defense to eviction proceedings to which it applied. Accordingly, the Ninth Circuit affirmed the trial court's dismissal of the lawsuit.

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\* Links to the court opinions are available in the online version of *Outlook* at: [www.consumercomplianceoutlook.org](http://www.consumercomplianceoutlook.org).

# HELOC PLANS: COMPLIANCE AND FAIR LENDING RISKS WHEN PROPERTY VALUES CHANGE

creditors with a safe harbor: If the difference between the initial credit limit and the available equity is reduced by 50 percent because of a property value decline, the decline is deemed significant, permitting creditors to refuse additional credit extensions or reduce the credit limit for a HELOC plan.

When determining whether a significant decline in value has occurred, creditors should compare the dwelling's appraised value at origination against the current appraised value. The bank should not, however, try to impose any current lending standards to evaluate the HELOC plan under review. The table below provides an example.<sup>3</sup>

	Initial Application	Current Analysis
House Appraised Value	\$100,000	\$90,000
Less First Mortgage Amount	\$50,000	\$50,000
Equals Equity	\$50,000	\$40,000
Less HELOC Credit Limit	\$30,000	\$30,000
Equals Residual Equity	\$20,000	\$10,000

In this example, the creditor could prohibit further advances or reduce the credit limit if the value of the property declines from \$100,000 to \$90,000. Management should be mindful that although they may be permitted to reduce the credit limit, the reduction cannot be below the amount of the outstanding balance if doing so would require the consumer to make a higher payment.<sup>4</sup>

## Property Value Methods

The creditor is not required to obtain an appraisal before reducing or freezing a HELOC when the home value has dropped.<sup>5</sup> However, for examination and recordkeeping purposes, the creditor should retain the documentation upon which it relied to establish that a significant decline in property value occurred before taking action on the HELOC.

In May 2005, the *Interagency Credit Risk Management Guidance for Home Equity Lending* was published, which includes a discussion of collateral valuation management.<sup>6</sup> The guidance provides examples of risk management practices to adopt when using auto-

mated valuation models (AVMs) or tax assessment valuations (TAVs). Further guidance on appropriate practices for using AVMs or TAVs is provided in the *Interagency Appraisal and Evaluation Guidelines*.<sup>7</sup> Management may want to consider the

guidance when using AVMs or TAVs to determine whether a significant decline has occurred.

In addition to regulatory compliance, institutions should be aware that a number of class action suits have been filed challenging the use of AVMs to reduce credit limits or suspend HELOCs.<sup>8</sup> The plaintiffs in these cases have challenged various aspects of compli-

<sup>3</sup> Comment 1026.40(f)(3)(vi)-6

<sup>4</sup> Comment 1026.40(f)(3)(vi)-1

<sup>5</sup> Comment 1026.40(f)(3)(vi)-6

<sup>6</sup> Interagency Credit Risk Management Guidance for Home Equity Lending (May 16, 2005). An addendum to this guidance was published in Sept. 2006. See Addendum to Credit Risk Management Guidance for Home Equity Lending (Sept. 9, 2006).

<sup>7</sup> Interagency Appraisal and Evaluation Guidelines, App. B, 75 Fed. Reg. 77450 (Dec. 10, 2010)

<sup>8</sup> See, e.g., *In re: JPMorgan Chase Bank Home Equity Line of Credit Litigation*, 794 F.Supp.2d 859 (N.D.Ill.2011); *Hickman v. Wells Fargo Bank N.A.*, 683 F.Supp.2d 779 (N.D.Ill.2010); *In re: Citibank HELOC Litigation*, 2010 WL 3447724 (N.D.Cal. Aug. 30, 2010).

ance, including the use of geographic location, rather than individual property valuation, as a basis for a lender's finding of reduction in value; the AVM's accuracy; and the reasonableness of the appeals process in place by which a borrower may challenge the reduction of the line of credit. In light of this litigation risk, it is important for institutions to pay careful attention to compliance requirements.

### *Notice to Consumer*

When a creditor prohibits additional extensions of credit or reduces the credit limit under §1026.40(f)(3)(i) or (f)(3)(vi), it must provide notice to the consumer within three business days after taking this action.<sup>9</sup> The notice must indicate why the creditor took the action. If the bank requires the consumer to request that credit privileges be reinstated when the conditions triggering the action have been cured, this requirement must be stated in the notice. This notice is required by Regulation Z (Truth in Lending Act) and should not be confused with adverse action requirements under the Equal Credit Opportunity Act (ECOA) and the Fair Credit Reporting Act (FCRA), which are discussed later in this article.

Management should be mindful that borrowers may have questions about the action or need further clarification after receiving the notice. Staff should be trained and prepared to assist consumers with understanding the reasons for the action, which can in turn help the consumer take steps to have the credit line reinstated to its original amount.

### *Creditor's Responsibility When Significant Decline in Value Is Cured*

It is important to note that a HELOC suspension or reduction of the credit limit is temporary and can only continue while one of the permissible circumstances in the regulation for such action exists, such as a significant decline in property value. As stated in Comment 1026.40(f)(3)(vi)-2: "When the circumstance justifying the creditor's action ceases to exist, credit

privileges *must* be reinstated, assuming that no other circumstance permitting such action exists at that time." (Emphasis added.) Thus, if the property value increases sufficiently, and no other conditions justify a reduction or suspension of the credit limit, the bank must reinstate the HELOC credit privileges as soon as reasonably possible.<sup>10</sup> This requirement is particularly significant in light of recent reports that real estate prices are rising appreciably from the low point of the financial crisis. According to the Case-Shiller index, real estate prices in May 2013 were on average 12.2% higher than a year earlier for the index's twenty-city composite. In May 2013, prices in two cities exceeded the highs from before the financial crisis – Dallas in June 2007 and Denver in August 2006.<sup>11</sup>

This requirement raises the question of who bears the responsibility for monitoring whether a property no longer is experiencing a significant decline in value, triggering a creditor's duty to remove the suspension of the credit line or restore the prior credit limit. By default, the regulation requires the creditor to monitor whether the significant decline has been cured. However, the Commentary allows creditors to shift this duty to the consumer by stating in the initial suspension/reduction in credit limit notice under 12 C.F.R. §1026.9(c)(1)(iii) that the consumer is responsible for requesting reinstatement.<sup>12</sup>

### *Fees*

Under Comment 40(f)(3)(vi)-3, the bank can only impose bona fide and reasonable appraisal fees actually incurred in investigating whether the condition permitting the line of credit freeze or reduction still exists, unless state law prohibits such fees. Further, when the insufficient property value condition no longer exists, the bank cannot charge a fee to reinstate the line of credit.

## ADVERSE ACTION NOTICES

Both the ECOA and the FCRA have adverse action requirements that may apply when a creditor suspends

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<sup>9</sup> 12 C.F.R. §1026.9(c)(1)(iii)

<sup>10</sup> Comment 1026.40(f)(3)(vi)-4

<sup>11</sup> "Home Prices Continue to Increase in May 2013 According to the S&P/Case-Shiller Home Price Indices," S&P Dow Jones Indices, July 30, 2013

<sup>12</sup> Comment 1026.40(f)(3)(vi)-4



a HELOC or reduces the credit limit because of a significant decline in the value of a property.

### **ECOA Requirements**

The regulation defines adverse action to include “an unfavorable change in the terms of an account that does not affect all or substantially all of a class of the creditor’s accounts.”<sup>13</sup> If a creditor suspends a HELOC or reduces the credit limit, and the action does not affect all or substantially all of a creditor’s HELOC accounts, the creditor has taken adverse action. However, the regulation also states that adverse action does *not* include “a change in the terms of an account expressly agreed to by an applicant.”<sup>14</sup> Thus, an adverse action notice would not be required if the HELOC agreement specified that the creditor could suspend the HELOC or reduce its credit limit in the event the value of the property significantly declined.<sup>15</sup>

### **FCRA Requirements**

Section 615 of the FCRA requires adverse action notices in three circumstances:

- when adverse action is taken based on information in a consumer report;
- when consumer credit is denied or a charge for credit is increased based on information obtained from third parties other than consumer reporting agencies bearing upon the consumer’s creditworthiness, credit standing, credit capacity, character, general reputation, personal characteristics, or mode of living; or
- when adverse action is taken based on information furnished by a corporate affiliate of the person taking the action bearing upon the consumer’s creditworthiness, credit standing, credit capacity, character, general reputation, personal characteristics, or mode of living (unless the in-

formation provided by the affiliate relates solely to transactions and experiences between the affiliate and the consumer or is information in a consumer report).<sup>16</sup>

If a creditor’s decision to suspend a HELOC or reduce its credit limit is based on any of these three circumstances, an FCRA adverse action notice is required. For example, if a creditor learned about the significant decline in value from an affiliate that monitors real estate values, a notice is required. Or suppose a creditor has a policy that when it learns of a significant decline in property value, it automatically pulls the borrower’s credit report. If the creditor takes adverse action, in whole or in part, because of information in the report, an FCRA notice is required. Model forms are available for ECOA and FCRA adverse action notices in Appendix C to Regulation B. When adverse action notices are required under both the FCRA and the ECOA, model forms are available that combine the notices.<sup>17</sup>

### **FAIR LENDING CONSIDERATIONS**

The ECOA, as implemented by Regulation B, and the Fair Housing Act (FHA), as implemented by 24 C.F.R. Part 100, apply during *all* stages of credit transactions within their scope — not simply at origination. Thus, a lender’s decision to review consumer HELOC accounts because of declining property values or to restore a HELOC account when real estate prices rise has fair lending implications. In particular, the manner in which HELOC accounts are selected for review could increase the risk of disparate treatment or disparate impact on a prohibited basis. Disparate impact occurs when a creditor implements a facially neutral policy that disproportionately harms borrowers on a prohibited basis.<sup>18</sup> Disparate treatment occurs when a credi-

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<sup>13</sup> 12 C.F.R. §1002.2(c)(1)(ii)

<sup>14</sup> 12 C.F.R. §1002.2(c)(2)(i)

<sup>15</sup> The regulation specifically states that when a creditor’s action appears to meet both the definition of what an adverse action is under §1002.2(c)(1) and the definition of what an adverse action is not under §1002.2(c)(2), adverse action has *not* occurred. See 12 C.F.R. §1002.2(c)(3)

<sup>16</sup> FCRA sections 615(a), 615(b)(1), 615(b)(2)

<sup>17</sup> *Outlook* previously published a detailed article on adverse action requirements. See Sarah Ammermann, “Adverse Action Notice Requirements under the ECOA and the FCRA,” *Consumer Compliance Outlook*, Second Quarter 2013.

<sup>18</sup> Comment 1002.6(a)-2 of Regulation B. The Department of Housing and Urban Development recently amended its implementing regulation for the FHA to clarify that the FHA encompasses disparate impact. See 78 Fed. Reg. 11460 (Feb. 13, 2013) and 24 C.F.R. §100.500 (“Liability may be established under the Fair Housing Act based on a practice’s discriminatory effect, as defined in paragraph (a) of this section, even if the practice was not motivated by a discriminatory intent. The practice may still be lawful if supported by a legally sufficient justification, as defined in paragraph (b) of this section.”)

tor treats borrowers differently on a prohibited basis, such as on the basis of race or gender.<sup>19</sup> For example, assume a lender originated HELOCs in two counties that both had significant declines in property values. County A is majority-Hispanic while County B is majority-non-Hispanic white. If the creditor only undertook HELOC reviews in County A, it would have increased the risk of disparate treatment.

Discrimination risk may also be present when different methods are used to value properties to determine whether a significant decline occurred. Using the example described above, if a lender used AVMs in County A while conducting full appraisals in County B, the fair lending risk would be elevated. Finally, a creditor's discretion in any aspect of the credit transaction, including collection activity, increases fair lending risks. For example, if a lender has the ability to override a decision to suspend a HELOC, the manner in which that discretion is exercised could raise fair lending concerns.

To manage fair lending risks, lenders should ensure that policies are uniformly applied to all affected borrowers. In addition, lender discretion to override a decision to take action on a HELOC plan should be documented and closely monitored to ensure that similarly situated borrowers are treated consistently. To manage disparate impact risk, lenders can analyze whether a proposed policy or action will negatively and disproportionately impact borrowers on a prohibited basis and, if so, whether the lender has a business justification. The Interagency Fair Lending Examination Procedures are available to creditors to assist in analyzing fair lending risks.<sup>20</sup>

Strong control systems can also help manage risks. Examples of risk controls include policies and proce-

dures approved by the institution's board that comply with applicable regulations and staff training on the regulatory requirements. Regularly monitoring compliance can confirm that board-approved procedures are implemented, followed, and work as intended. Exceptions to policies and procedures should be appropriately approved, documented, and monitored to help ensure consistency among borrowers. Finally, monitoring customer complaints and providing metrics on consumer HELOC actions can help senior management oversee the process more effectively.

Financial institutions that use third parties for managing HELOC plans should be mindful of the compliance-related risks associated with third-party service providers. See Cathryn Judd and Mark Jennings, "Vendor Risk Management – Compliance Considerations," *Consumer Compliance Outlook*, Fourth Quarter 2012. As stated in that article, "If bank management is not monitoring a vendor's activity, it will not be aware of problems that may be occurring with the vendor."

### Conclusion

When a significant decline in the value of property securing a HELOC occurs and the creditor responds by suspending the HELOC or reducing its credit limit, good communication between the consumer and the creditor is important to ensure the best possible solution for both parties. In addition, if the significant decline is cured, additional compliance obligations can be triggered. Creditors can minimize fair lending and compliance risk by understanding the requirements of the regulations, appropriately identifying compliance-related risks, taking action to mitigate these risks, and monitoring property values where the creditor has originated HELOCs. Specific issues and questions should be raised with your primary regulator. ©

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<sup>19</sup> Comment 1002.4(a)-1 of Regulation B

<sup>20</sup> The Interagency Fair Lending Examination Procedures are available at: [www.ffiec.gov/pdf/fairlend.pdf](http://www.ffiec.gov/pdf/fairlend.pdf). The appendix to the procedures is available at: [www.ffiec.gov/pdf/fairappx.pdf](http://www.ffiec.gov/pdf/fairappx.pdf).

## THE IMPORTANCE OF THE CONSUMER COMPLIANCE INTERNAL AUDIT FUNCTION

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length and offered these recommendations for drafting an outsourcing contract for internal audit:

- define the expectations and responsibilities under the contract for both parties
- set the scope and frequency of, and the fees to be paid for, the work to be performed by the vendor
- set the responsibilities for providing and receiving information, such as the type and frequency of reporting to senior management and directors about the status of contract work
- establish the process for changing the terms of the service contract, especially for expansion of audit work, if significant issues are found, and stipulations for default and termination of the contract
- state that internal audit reports are the property of the institution, that the institution will be provided with any copies of the related workpapers it deems necessary, and that employees authorized by the institution will have reasonable and timely access to the workpapers prepared by the outsourcing vendor
- specify the locations of internal audit reports and the related workpapers
- specify the period of time (for example, seven years) that vendors must maintain the workpapers
- state that outsourced internal audit services provided by the vendor are subject to regulatory review and that examiners will be granted full and timely access to the internal audit reports and related workpapers prepared by the outsourcing vendor
- prescribe a process (arbitration, mediation, or other means) for resolving disputes and for determining who bears the cost of consequential damages arising from errors, omissions, and negligence
- state that the outsourcing vendor will not perform management functions, make management decisions, or act or appear to act in a capacity equivalent to that of a member of management

or an employee and, if applicable, will comply with regulatory independence guidance.<sup>7</sup>

### ENHANCING THE CONSUMER COMPLIANCE INTERNAL AUDIT FUNCTION

Here are some suggestions for enhancing the consumer compliance internal audit function:

- When the internal audit function is unable to identify the appropriate risks and measure their severity and impact, the bank is subjected to the risk that significant deficiencies exist within the procedures, internal controls, and risk management practices. The deficiencies may be small at first, but if they are not identified and addressed, they may become systemic in nature, resulting in a negative impact to consumers and the bank. Thus, the board should always monitor and assess the quality of work performed by the internal audit function, particularly given the changing regulatory landscape.
- The scope and frequency of internal audits should be driven by the comprehensive control risk assessment. The internal audit function should complete this assessment for all business lines and operational functions that are responsible for ensuring compliance with applicable laws and regulations, as appropriate. The risk assessment process can be severely constrained with fragmented or manual efforts by keeping risks in silos rather than providing a holistic view of risk. For example, if a bank's risk assessment and risk reporting systems cannot aggregate risk data from all areas of the institution simultaneously and on a timely basis, the data generated by these systems may be erroneous. This disjointed risk reporting process could lead to incorrect identification of the areas of highest risk or even the possibility of failure to identify a risk. As a result, the risk assessment must

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<sup>7</sup> 2003 Policy Statement at p. 8-9. For additional information on vendor risk management, see the article by Anthony Ricks and Timothy Stacy, "Vendor Risk Management," *Consumer Compliance Outlook*, First Quarter 2011, and the *Consumer Compliance Outlook Live* webinar "Vendor Risk Management – Compliance Considerations," May 2, 2012.



be all-encompassing with timely reporting of risks in order to create a holistic view.

*“Clearly, senior managers also need to ensure that they have proper understanding of the risks assumed by their firm, but this does not always happen. For example, we have seen some evidence that information was kept in silos within firms and not adequately distributed both vertically and horizontally within certain firms. This segregation prevented senior managers from developing an enterprise-wide perspective on risks to the whole entity. It meant that managers were not fully aware of the extent to which the risks of the different activities undertaken by the firm could, first, become correlated in times of stress and, second, result in high concentrations of risk exposures.”*

*Former Governor Randall S. Kroszner, “The Importance of Fundamentals in Risk Management,” at the American Bankers Association Spring Summit Meeting, Washington, D.C., March 11, 2008*

- Typically, the audit plan includes business lines, operations, and products. In addition to these areas, the bank’s consumer compliance program should be audited. The assessment of the consumer compliance program is often overlooked, resulting in a limited evaluation of its adequacy. Validating the consumer compliance program demonstrates a strong control culture able to maintain ongoing compliance.
- Although the audit plan should be risk-focused, it also should be comprehensive. If the examiners, internal auditors, external auditors, and internal compliance reviewers are all applying risk-focused procedures, it is possible that some areas are not being evaluated. All areas should be audited at varying degrees, with the scope and frequency being determined by the risk assessment. For example, a lower-risk area may not need to be audited on an annual basis, but it probably should be considered within an appropriate audit cycle. As a result, this approach reduces the possibility of areas going too long without an audit to validate the effectiveness of the bank’s procedures, internal controls, and risk management practices.
- The audit plan should include the deposit and loan platform systems as well as underwriting and

pricing models. The internal auditor should ensure that the platform systems and models accurately reflect the bank’s practices and meet the regulatory requirements. Testing is especially important on new platforms and models as well as updates to existing ones. Further, upfront validation of the defaults and settings may reduce the number of transactions tested. For example, in verifying the rate adjustment settings upfront, the number of adjustable rate mortgages subjected to testing may be reduced since the adjustments are controlled by the system platform. If the defaults and settings are proven to be accurate in the beginning, then there is a high probability that they are in compliance. This approach can be used for many of the defaults and settings within the platform systems, which then may reduce transaction testing for technical compliance and allow for more focus on higher-risk areas.

- Internal audit functions should leverage technology as much as possible. Many platforms provide standard reports and allow new reports to be designed to assist in assessing the bank’s risk. These reports can help identify product or feature materiality to determine the universe, potential impact, and severity of the findings. For example, if an internal auditor identified concerns with adjustable rate mortgages resetting incorrectly, a report can be generated to determine the universe and impact on the portfolio. These types of reports make the process of identifying, analyzing, and resolving issues more efficient and precise.
- Documentation, documentation, and more documentation. This area does not receive a lot of attention and is often a secondary thought in the internal audit function process. Documentation provides an audit trail of the review and support for corrective action recommendations. Documentation should focus on the scope, level of testing, deviations, file expansions, impact of findings on the portfolio (such as restitution or file searches), and follow-up on corrective actions. Documentation is especially important when examiners are evaluating the adequacy of the internal audit function.

As a final takeaway, here are a few questions to consider:


1. What is the level of oversight activities provided by the board, audit committee, and senior management?

2. Is the internal audit function appropriate for the bank based on its scope of activities, products, and operations?
3. Do the knowledge and abilities of the internal audit function match the risk profile of the bank?
4. Is the risk assessment comprehensive of all business lines and products so that it considers the regulatory requirements and identifies the corresponding procedures, internal controls, and risk management?
5. Are internal audit plans determined by the risk assessment? Do the audit plan and risk assessment consider a product lifecycle evaluation?
6. Does the internal audit function leverage the management information system's capabilities of

the bank's software platforms?

7. How are audit findings monitored and resolved? Is the root cause identified and addressed?

## CONCLUSION

Regardless of the bank's size and complexity, the internal audit function plays an important role in managing the risk profile with ongoing improvement in procedures, internal controls, and risk management. This article illustrates the importance of the consumer compliance internal audit function as well as ways to build on the fundamentals, especially in the changing banking landscape of new regulatory requirements and technologies. Specific issues and questions should be raised with your primary regulator. 

CONTINUED FROM PAGE 5...

## NEW COMPLIANCE REQUIREMENTS UNDER THE GARNISHMENT RULE FOR ACCOUNTS RECEIVING CERTAIN FEDERAL BENEFITS

account when an account review is performed.<sup>19</sup>

After an institution receives a garnishment order, verifies that it does not contain a "Notice of Right to Garnish Federal Benefits," performs an account review, and finds one or more covered benefit payments deposited during the lookback period, the institution must immediately calculate the protected amount for each account in the account holder's name and ensure the account holder has full access to these funds.<sup>20</sup>

*Separate Account Reviews.* After receiving a garnishment order against an account holder, institutions must perform account reviews for each account in the account holder's name. However, institutions are prohibited from tracing the movement of funds between accounts to associate funds from a benefit payment deposited into one account and later transferred to

another.<sup>21</sup> For example, if (1) a \$500 Social Security benefit was deposited into account A; (2) on the same day, the account holder transferred \$300 of the \$500 into account B in the holder's name at the same institution; and (3) the next day, the institution receives a garnishment order with no "Notice of Right to Garnish" against the account holder. In this circumstance, the institution must perform separate reviews of both account A and account B. The entire \$500 social security benefit deposit — including the \$300 transferred out of the account — will be added to the protected amount for Account A, while none of the \$300 transferred into Account B will be added to the protected amount for Account B.<sup>22</sup>

### *Customary Procedures for Funds in Excess of Protected Amount*

After calculating and establishing the protected amount

<sup>19</sup> 31 C.F.R. §212.3

<sup>20</sup> 31 C.F.R. §212.6(a)

<sup>21</sup> 31 C.F.R. §212.5(f)

<sup>22</sup> "Treasury Garnishment Guidelines" at p. 7

in each account in the account holder's name, the financial institution should follow its customary procedures for handling garnishment orders against any funds in excess of the protected amount in each account.<sup>23</sup>

### *Garnishment Fee Restrictions*

Financial institutions may not charge or collect garnishment fees either against protected amounts or after the date of the account review.<sup>24</sup> For example, the Garnishment Rule prohibits an institution from charging a garnishment fee against an account where an account contains only a protected amount on the date of the account review and non-protected funds are deposited into the account on the date after the account review.<sup>25</sup> But if funds other than a benefit payment are deposited into the account during the account review period, institutions can charge or collect a garnishment fee up to five business days after an account review but the fee cannot be more than the amount of nonbenefit deposited funds.<sup>26</sup>

### *Notice*

Financial institutions are required to notify account holders within three business days of the account review only if it shows:

- a covered benefit payment was deposited into the holder's account during the lookback period
- the balance in the account on the date of account review was greater than \$0 and the institution established a protected amount, and
- funds in the account exceed the protected amount.<sup>27</sup>

Any method of delivery for notices is permitted, including electronic delivery, if agreed to by the financial institution and the account holder.<sup>28</sup>

*Content of Notice.* If the institution is required to notify an account holder under 31 C.F.R. §212.7(a), the notice must contain the following information in "readily understandable language":

- the institution's receipt of a garnishment order against the account holder
- the date on which the institution was served the garnishment order
- a succinct explanation of garnishment
- an explanation of the institution's requirement, when a covered benefit is deposited into one of the account holder's accounts within the last two months, to calculate and establish a protected amount and ensure that the protected amount is made available to the account holder
- the account or accounts subject to the garnishment order

FINANCIAL INSTITUTIONS MAY NOT CHARGE OR COLLECT GARNISHMENT FEES EITHER AGAINST PROTECTED AMOUNTS OR AFTER THE DATE OF THE ACCOUNT REVIEW.

- the protected amount the institution established
- the institution's requirement to freeze funds in excess of the protected amount, if applicable, pursuant to state law to satisfy the garnishment order
- the amount of any garnishment fee charged to the account, consistent with 31 C.F.R. §212.6(h)
- a list of all federal benefit payments covered by the Garnishment Rule, as identified in 31 C.F.R. §212.2(b)

<sup>23</sup> 31 C.F.R. §212.6(d)

<sup>24</sup> 31 C.F.R. §212.6(h)

<sup>25</sup> "Treasury Garnishment Guidelines" at p. 11

<sup>26</sup> 31 C.F.R. §212.6(h)

<sup>27</sup> 31 C.F.R. §212.7(a)

<sup>28</sup> 78 Fed. Reg. at 32106



- the account holder's right to assert exemption for amounts above the protected amount against the creditor that initiated the garnishment order by taking an action customarily applicable in a given jurisdiction, such as completing exemption claim forms, contacting the court of jurisdiction, or contacting the creditor
- the account holder's right to obtain legal aid in asserting exemption against the creditor that initiated the garnishment order
- the name of the creditor, and
- the means of contacting the creditor if contact information was included in the order.<sup>29</sup>

Financial institutions have the option under 31 C.F.R. §212.7(c) to include the following content in the required notice, provided it is in "readily understandable language":

- means of contacting a local attorney or legal aid service
- means of contacting the financial institution, and
- a statement that the financial institution is not providing legal advice by issuing the notice required by 31 C.F.R. §212.7(a).<sup>30</sup>

Institutions can amend the required notice under 31 C.F.R. §212.7(d) to integrate information about a state's garnishment rules and protections to avoid potential confusion, harmonize the notice with state requirements, or provide more complete information about an account. Institutions may issue a single notice to an account holder with more than one account at the institution, provided that the notice contains the information required by §212.7(b) for each account.<sup>31</sup>

### *Obligations After Account Review*

Financial institutions may perform an account review only one time for each garnishment order after ser-

vice of the first order. If the same garnishment order is served again, the institution may not repeat the account review or take any other action related to the order. Institutions are required to review an account holder's account again only if the institution is served a new or different garnishment order against the same account holder.<sup>32</sup>

The Garnishment Rule further prohibits financial institutions from garnishing amounts deposited or credited to an account holder's account after the account review. Institutions may not freeze funds deposited or credited to an account after the account review unless the institution is served a new or different garnishment order against the same account holder.<sup>33</sup>

### **SAFE HARBORS FOR FINANCIAL INSTITUTIONS**

Financial institutions that comply in good faith with the regulation receive safe harbor protection from certain types of liability. The safe harbors are discussed below.

#### *During Receipt and Review of the Garnishment Order*

Institutions complying with the Garnishment Rule receive a safe harbor from liability to a creditor that initiates a garnishment order and for any penalty under state law, contempt of court, civil procedure, or any other law if the institution fails to honor a garnishment order for account activity.<sup>34</sup> This protection applies during the two business days after the institution receives the garnishment order, during which time the institution must determine whether a Notice of Right to Garnish Federal Benefits was attached pursuant to 31 C.F.R. §212.4, or during the time between when the institution receives the order and the date by which the institution must perform the account review under 31 C.F.R. §212.5.

#### *When Protecting or Freezing Funds*

Compliance with the Garnishment Rule also exempts

<sup>29</sup> 31 C.F.R. §212.7(b); a Model Notice to Account Holder can be found in Appendix A to 31 C.F.R. Part 212.

<sup>30</sup> 31 C.F.R. §212.7(c). Section 212.7(h) states that giving the notice required by 31 C.F.R. §212.7 neither obligates the institution to provide legal advice nor may be deemed an offer of legal advice by the institution.

<sup>31</sup> 31 C.F.R. §212.7(e)

<sup>32</sup> 31 C.F.R. §212.6(f)

<sup>33</sup> 31 C.F.R. §212.6(g)

<sup>34</sup> 31 C.F.R. §212.10(a)

an institution from liability to a creditor that initiates a garnishment order, to an account holder for any frozen amounts, and for any penalty under state law, contempt of court, civil procedure, or other law for failing to honor a garnishment order.<sup>35</sup> This protection applies when a benefit agency deposited a covered benefit payment into an account during the lookback period or the institution determined that the order was obtained by the United States or issued by a state child support enforcement agency by following the procedures in 31 C.F.R. §212.4.

### *When Providing Additional Information to Account Holder*

Financial institutions also receive a safe harbor when providing in good faith any optional information set forth in 31 C.F.R. §212.7(c) and (d) in the notice to an account holder.<sup>36</sup>

### *Safe Harbors for Other Potential Liabilities*


Finally, 31 C.F.R. §202.10(d) protects institutions from liability for:

- bona fide errors that occur despite reasonable procedures put in place by the institution to pre-

vent such errors

- customary clearing and settlement adjustments that affect an account balance, including a protected amount (such as deposit reversals caused by the return of unpaid items or debit card transactions settled for amounts higher than originally authorized), and
- honoring an account holder's express written instruction to use an otherwise protected amount to satisfy the order, as long as the instruction is both dated and provided by the account holder to the financial institution following the date on which the institution has been served a particular garnishment order.

## CONCLUSION

The Garnishment Rule will help protect consumers who receive certain federal benefits when their accounts are garnished. Financial institutions should review their policies and procedures and provide training to the appropriate staff to ensure they are complying with the requirements of the new rule. Specific issues and questions should be raised with your primary regulator. 

<sup>35</sup> 31 C.F.R. §212.10(b)

<sup>36</sup> 31 C.F.R. §212.10(c)

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|------------------|--|
| Oct. 1, 2013     | <b>Compliance Supervisory Perspectives Seminar Series</b><br>Federal Reserve Bank of Kansas City (Oklahoma City branch)<br>Oklahoma City, OK |
| Oct. 2, 2013     | <b>Compliance Risk Assessments and CRA Self Assessments</b><br>FDIC Teleconference   |
| Oct. 3, 2013     | <b>Compliance Supervisory Perspectives Seminar Series</b><br>Federal Reserve Bank of Kansas City (Denver branch)<br>Denver, CO               |
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| Oct. 17-18, 2013 | <b>3rd Annual FDIC Consumer Research Symposium</b><br>L. William Seidman Center (Hove Auditorium)<br>Arlington, VA                           |
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