

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

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A FEDERAL RESERVE SYSTEM PUBLICATION WITH A FOCUS ON CONSUMER COMPLIANCE ISSUES



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## COMMUNITY REINVESTMENT ACT: DEVELOPING A STRATEGY FOR SUCCESS

BY CATHY GATES, SENIOR PROJECT MANAGER, FEDERAL RESERVE BOARD, AND MARIA VILLANUEVA, SENIOR EXAMINER, FEDERAL RESERVE BANK OF SAN FRANCISCO

Congress passed the Community Reinvestment Act (CRA or the act) in 1977 to encourage depository institutions to help meet the credit needs of their local communities, including low- and moderate-income (LMI) neighborhoods, consistent with safe and sound operations. The Board of Governors of the Federal Reserve System (the Federal Reserve Board, Board), the Federal Deposit Insurance Corporation (FDIC), and the Office of the Comptroller of the Currency (OCC)(the agencies), have rulewriting and supervisory authority for the CRA.<sup>1</sup> While the act and its implementing regulations have been updated over time, the core principles of the CRA remain unchanged. This article discusses some of the changes to the CRA since its enactment and offers suggestions for institutions in setting CRA strategy and goals and monitoring CRA performance.

### THE CRA'S EVOLUTION

Since its enactment, the CRA and its implementing regulations have been updated. Some of the updates have focused on the role of the public in the CRA evaluation process. For example, in 1989, the act and, subsequently, the regulations were amended to require CRA ratings and performance evaluations to be made public.<sup>2</sup> Most recently, the regulations were updated in 2010 to encourage institutions to support eligible development activities in areas designated under the U.S. Department of Housing and Urban Development's (HUD) Neighborhood Stabilization Program.<sup>3</sup> The most significant update to the CRA regulations was the comprehensive regulatory revision undertaken by the agencies to make the CRA regulations more performance oriented pursuant to an executive order issued in July 1993. The final

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<sup>1</sup> See the Board's Regulation BB, 12 C.F.R. part 228, for state-chartered member banks. The Federal Deposit Insurance Corporation (FDIC) and the Office of the Comptroller of the Currency (OCC) have substantially similar regulations at 12 C.F.R. part 345 (state-chartered nonmember banks), 12 C.F.R. part 195 (state- and federally chartered savings and loan associations), 12 C.F.R. part 25 (national banks).

<sup>2</sup> 12 U.S.C. §2906. As added by the act of August 9, 1989 (103 Stat. 527), and amended by the acts of December 19, 1991 (105 Stat. 2306), and September 29, 1994 (108 Stat. 2364)

<sup>3</sup> 75 Fed. Reg. 79278 (Dec. 20, 2010)

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# CONSUMER COMPLIANCE MANAGEMENT PROGRAM — COMMON CONCERNS AND BEST PRACTICES WEBINAR QUESTIONS AND ANSWERS

BY KATINA TSAGAROULIS, COMPLIANCE RISK SPECIALIST, FEDERAL RESERVE BANK OF BOSTON

On April 10, 2014, the Federal Reserve System conducted an *Outlook Live* webinar titled “Consumer Compliance Management Program — Common Concerns and Best Practices.” Participants submitted a significant number of questions during the session. Because of time constraints, only a limited number of questions were answered during the webinar. This article addresses some additional questions we received.<sup>1</sup>

**As examiners, do you expect to see a consumer compliance management program instituted in all banks, or is it first a recommendation and then a requirement beyond a certain asset size?**

In November 2013, the Federal Reserve Board (Board) announced in Consumer Affairs Letter (CA Letter) 13-19 that it was implementing a new Community Bank Risk-Focused Consumer Compliance Supervision Program (RFS Program).<sup>2</sup> As discussed in the CA Letter, the RFS Program outlines compliance risk management practices for state member banks with assets of \$10 billion or less, including their subsidiaries.<sup>3</sup> The Board expects the institutions it supervises to have an effective consumer compliance management program in place, appropriate to the institution’s risk profile.<sup>4</sup> In addition, Supervisory Letter (SR Letter) 08-8/CA 08-11 outlines compliance risk management program information for large banking organizations with complex compliance profiles.

Although there is no specific formula for creating a consumer compliance management program, every program should be tailored to the size, complexity, market, and assessment area of the institution. A sound program contains the following four essential elements:<sup>5</sup>

<sup>1</sup> The webinar has been archived and is available at <http://www.philadelphiafed.org/bank-resources/publications/consumer-compliance-outlook/outlook-live/2014/common-concerns-and-best-practices.cfm>.

<sup>2</sup> CA Letter 13-19, “Community Bank Risk-Focused Consumer Compliance Supervision Program,” November 18, 2013

<sup>3</sup> Under Section 1025 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), the Consumer Financial Protection Bureau conducts consumer compliance examinations of depository institutions with assets greater than \$10 billion. See 12 U.S.C. §5515.

<sup>4</sup> See CA Letter 08-11, “Community Risk Management Programs and Oversight at Large Banking Organizations with Complex Compliance Profiles,” October 8, 2008.

<sup>5</sup> See RFS Program at 12.



- Board and senior management oversight
- Policies, procedures, and limits
- Risk monitoring and management information systems
- Internal controls

When developing a consumer compliance management program, management should consider, among other things, the institution's organizational structure (taking into account the level of independence of functions responsible for compliance oversight, as well as the institution's hiring, turnover, and succession planning practices), business model and strategy, new product development, and internal compliance testing and audit procedures.<sup>6</sup>

An institution's senior management and board of directors should ensure that the consumer compliance management program focuses on identifying, measuring, monitoring, mitigating, and controlling risks related to consumer protection laws and regulations.<sup>7</sup> For small institutions that engage solely in traditional banking activities in which senior management is actively involved in daily operations, relatively basic risk management systems may be adequate. In such institutions, these systems may include an informal compliance program with both written and unwritten policies addressing material areas of operation, such as lending, basic internal control systems, on-the-job training, and management and board reports.<sup>8</sup> Larger, more complex institutions likely require more formal and comprehensive programs to maintain satisfactory levels of compliance, including detailed policies and sophisticated management reporting to allow senior management to evaluate and mitigate risks.<sup>9</sup>

#### Is there guidance for a bank's compliance risk assessment?

Compliance risk assessments are detailed in the Board's CA Letter 13-19. As discussed in the guidance, "the risk

assessment presents a comprehensive view of the institution, delineating the areas of supervisory concern, and serves as a platform for the supervisory plan."<sup>10</sup> To conduct a risk assessment, an institution first gauges the inherent consumer compliance risk, which is defined as the likelihood and consequences of violating consumer laws and regulations associated with the products and services offered by the institution. Risk management and controls are evaluated in the context of their likely effectiveness in achieving compliance. The assessment then considers residual risk, which is defined as the risk that remains for a product or service after considering the effects of risk mitigants (i.e., residual risk equals inherent risk controlled by risk mitigants).

It is important that an institution examine *all* of the products and services it offers to document each of the laws, regulations, and guidance that may apply and evaluate the effectiveness of its compliance controls. In addition, the institution may determine that some laws and regulations should always be considered regardless of the products and services offered. Typically, these are laws and regulations in which violations can create significant consumer harm, such as fair lending laws, and Unfair or Deceptive Acts and Practices under Section 5 of the Federal Trade Commission Act. For further details on risk assessments for state member banks, refer to CA Letter 13-19.

#### Must the bank have a vendor management policy? What are the bank's responsibilities when using a third-party service provider?

In December 2013, the Board issued "Guidance on Managing Outsourcing Risk" to highlight to financial institutions the potential risks arising from the use of service providers and to describe the elements of an appropriate service provider risk management program.<sup>11</sup> The guidance discussed several key points, including:

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<sup>6</sup> See RFS Program at 9.

<sup>7</sup> See RFS Program at 3.

<sup>8</sup> See RFS Program at 22.

<sup>9</sup> See RFS Program at 22 and CA Letter 08-11.

<sup>10</sup> See RFS Program at 12.

<sup>11</sup> See CA Letter 13-21, "Guidance on Managing Outsourcing Risk," December 5, 2013.

## NEWS FROM WASHINGTON: REGULATORY UPDATES\*

### **Consumer Financial Protection Bureau (CFPB) Begins Accepting Complaints About Virtual Currencies and Issues an Advisory to Consumers.**

On August 11, 2014, the CFPB issued a consumer advisory to explain virtual currencies to consumers and to warn about the risks of using them. A virtual currency is a digitally stored value used as a medium of exchange. The risks to consumers from using virtual currencies include unclear or high transaction costs, volatile exchange rates, computer security risks, and fraudulent schemes. The advisory also notes that consumer protections that apply under federal law for bank accounts and payment cards do not apply to virtual currencies. For example, if a consumer has an unauthorized transaction for virtual currency, the consumer generally has no recourse under federal law. Similarly, when a depository institution fails, the account holder is generally protected through the applicable federal insurance fund. But virtual currencies are not covered by the fund. Finally, the CFPB announced that consumers who encounter a problem with a virtual currency product or service can submit a complaint to the CFPB.

**CFPB Issues Study on Overdraft Fees.** On July 31, 2014, the CFPB issued a research report on checking account overdraft fees. The report analyzes average checking account fees, distribution of overdraft frequency, overdrafts by transaction type, and negative balance data. Here are the key findings:

- Overdraft and nonsufficient funds (NSF) fees constitute the majority of the total checking account fees that consumers incur. For consumers opting in for overdraft coverage, overdraft and NSF fees account for about 75 percent of their total checking account fees and average more than \$250 per year.
- A small fraction of customers pay most overdraft fees: 8 percent of customers incur nearly 75 percent of all overdraft fees.
- The propensity to overdraft generally declines with account holder age, with 10.7 percent of the 18–25 age group having more than 10 overdrafts per year, but only 2.8 percent of the 62 and older age group are in this category.
- The number of overdraft transactions and fees varies substantially with opt-in status. Opted-in accounts are three times as likely to have more than 10

overdrafts per year as accounts that are not opted in. Opted-in accounts have seven times as many overdrafts that result in fees as accounts that are not opted in.

- Transactions leading to overdrafts are often small. For debit card transactions, the median amount that leads to an overdraft fee is \$24; for all transactions, the median amount that leads to an overdraft fee is \$50.
- Most consumers who overdraft return their accounts to a positive balance quickly, with more than half becoming positive within three days and 76 percent within one week.

### **CFPB Issues Proposal to Add New Home Mortgage Disclosure Act (HMDA) Data Collection Fields to Regulation C.**

On July 24, 2014, the CFPB issued a rulemaking proposal under Regulation C to implement Section 1094 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). Section 1094 directed the CFPB to add certain new HMDA data fields and provided the CFPB with the discretion to add additional data fields. According to the proposal, the new fields fall into four categories:

- Information about applicants, borrowers, and the underwriting process, such as age, credit score, debt-to-income ratio, reasons for denial if the application was denied, the application channel, and automated underwriting system results
- Information about the property securing the loan, such as construction method, property value, lien priority, the number of individual dwelling units in the property, and additional information about manufactured and multifamily housing
- Information about the features of the loan, such as additional pricing information, loan term, interest rate, introductory rate period, nonamortizing features, and the type of loan
- Certain unique identifiers, such as a universal loan identifier, property address, loan originator identifier, and a legal entity identifier for the financial institution

The proposal would also exempt institutions that originate fewer than 25 “covered loans,” as defined in the proposal. The comment period closes on October 29, 2014.

### **CFPB Begins Accepting Consumer Complaints on Prepaid Cards and Additional Nonbank Products.**



July 21, 2014, the CFPB announced that it would begin accepting consumer complaints for prepaid cards, pawn and title loans, and debt settlement and credit repair services, including issues with excessive or unexpected fees, marketing practices, and disclosures. The CFPB asks companies to respond to complaints within 15 days and describe the steps they have taken or plan to take to address the complaint. The CFPB also expects companies to close complaints within 60 days, except for unusually complicated cases. Consumers can track the status of their complaints through the CFPB website.

**Federal Reserve Board (Board) Issues Final Rules to Repeal Its Regulations DD and P and Amend Regulation V.**

On May 29, 2014, the Board repealed its Regulation DD (Truth in Savings) and Regulation P (Privacy of Consumer Financial Information). The Dodd-Frank Act transferred rulemaking authority for these regulations from the Board to the CFPB. Because the CFPB has issued interim regulations substantially identical to the Board's, the Board is repealing its version of these regulations. The rulemaking also amends the Identity Theft Red Flags rule in subpart J of the Board's Regulation V, 12 C.F.R. Part 222, which did not transfer to the CFPB. The final rule implements legislation that amended the Fair Credit Reporting Act to clarify that the provisions apply only to creditors that regularly extend credit or obtain consumer reports.

**CFPB Proposes Rule to Streamline Regulation P Privacy Notices.**

On May 6, 2014, the CFPB proposed a rule that would allow companies that limit their consumer data sharing and meet other requirements to post their annual privacy notices online rather than mailing them individually. Under the Gramm-Leach-Bliley Act, financial institutions currently send annual privacy notices to customers, and the notices must describe whether and how the financial institutions share consumers' nonpublic personal information. Consumers must be notified of their right to opt out of the sharing and must be informed of how to do so if institutions share this information with an unaffiliated third party. Institutions whose privacy policies have not changed since the prior year have questioned the need to send annual notices to customers who already have received a copy of the privacy policy. The proposal would allow institutions to post privacy notices online instead of distributing an

annual paper notice, assuming certain conditions are satisfied. Among other things, institutions would need to inform consumers annually about the availability of disclosures, but they could do so by including an insert in regular consumer communication, such as a monthly billing statement for a credit card, letting consumers know that the annual privacy notice is available online and in paper by request at a toll-free telephone number. Institutions that choose to rely on this new method of delivering privacy notices would be required to use the model disclosure form developed by the federal regulatory agencies in 2009.

**CFPB Proposes Minor Changes to the Ability to Repay/Qualified Mortgage (ATR/QM) Rule.**

On April 30, 2014, the CFPB proposed amending its ATR/QM rule, 12 C.F.R. §1026.43, issued under the Dodd-Frank Act. This rule requires creditors to make a reasonable, good faith determination of a consumer's ability to repay most closed-end loans secured by a dwelling. Creditors offering QMs receive a presumption of compliance with the ATR requirement. QM status generally requires, among other things, that the points and fees a creditor charges the borrower cannot exceed 3 percent of the loan principal. One concern for creditors is that if they originate a loan believed to be a QM, but it turns out after consummation that points and fees exceeded 3 percent because a fee or charge was inadvertently omitted, the loan would not receive QM status. The proposal lays out limited circumstances in which the excess fee or charge may be refunded within 120 days of the loan's consummation, and the loan would still meet the requirements of a QM.

The proposed amendments also respond to concerns about origination and servicing issues for nonprofit housing providers. The proposal would 1) provide an alternative definition of a nonprofit small servicer that would be eligible for the small servicer exemption and 2) amend the nonprofit ATR exemption to permit certain nonprofits to offer "soft seconds." The CFPB is also seeking input on the impact on larger lenders that do not meet the definition of small creditor and may address these issues in future rulemakings. The comment period closed in July 2014.

\* 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 B — EQUAL CREDIT OPPORTUNITY ACT (ECOA)

**Sixth and Eighth Circuits issue conflicting decisions on the validity of Regulation B's definition of "applicant" for the purposes of spousal signature rules.** *RL BB Acquisition, LLC v. Bridgemill Commons Development Group, LLC*, 754 F.3d 380 (6th Cir. 2014) and *Hawkins v. Community Bank of Raymore*, 761 F.3d 937 (8th Cir. 2014). The scope of the ECOA is generally limited to credit applicants, except that implementing Regulation B — as promulgated by the Federal Reserve Board and later republished by the Consumer Financial Protection Bureau — defines "applicant" to include "guarantors" solely for the purposes of the spousal signature provisions of 12 C.F.R. §1002.7(d). *Outlook* reviewed these provisions in 2008; see Carol Evans and Surya Sen, "Regulation B and Marital Status Discrimination: Are You in Compliance?" (Fourth Quarter 2008 *Outlook*). In these two recent cases involving alleged spousal signature violations, the creditors argued that Regulation B's definition of "applicant" to include "guarantors" is contrary to Congress's definition of "applicant" in Section 702 of the ECOA (15 U.S.C. §1691a(b)) and its intent when it enacted the statute, and is therefore invalid. The Sixth and the Eighth Circuits issued conflicting decisions on this issue.

In *Bridgemill*, a husband and wife guaranteed a loan to the husband's closely held corporation and were later sued in a collection action when the loan went into default. The wife argued that the creditor violated §1002.7(d) by requiring her guaranty and that the violation was an affirmative defense to the collection case against her. The district court held that the wife could not raise violations of the ECOA and Regulation B as an affirmative defense to the creditor's breach-of-guaranty claim. On appeal, the Sixth Circuit reversed. First, the court addressed the creditor's argument that the ECOA does not apply to guarantors. The court found that the ECOA's definition of "applicant" was ambiguous and could "encompass all those who offer promises in support of an application — including guarantors, who make formal requests for aid in the form of credit for a third party." The court also examined the Federal Reserve Board's rationale when it included "guarantors" in Regulation B's definition of "applicant" solely for purposes of §1002.7(d)(5) (which it referred to as the "spouse-guarantor rule") and found it was reasonable. Accordingly, the court rejected the argument that the spouse guarantor rule is invalid.

The Sixth Circuit also reviewed the district court's holding that a debtor cannot raise a spousal signature violation as a complete affirmative defense. The court found that the ECOA does not prohibit recoupment — a defense that goes to the foundation of a plaintiff's claim by deducting from the plaintiff's recovery all just allowances or demands accruing to the defendant with respect to the same contract or transaction — and that permitting it would further the ECOA's goal of eradicating credit discrimination because a creditor violating the regulation can lose the guaranty. The case was remanded for further proceedings because the parties disputed whether the creditor required the spouse's guaranty.

In *Hawkins*, the Eighth Circuit concluded, to the contrary, that guarantors are not applicants and therefore are not covered by the ECOA. A company obtained a loan for which the creditor required guaranties from the company's principals and spouses. The business defaulted, and the creditor sought payment from the guarantors. The spouses filed a lawsuit alleging violations of §1002.7(d) and state law. The district court dismissed the case, concluding that guarantors are not applicants under the ECOA. On appeal, the Eighth Circuit affirmed. The court noted that the ECOA defines an applicant as a person who "applies to a creditor directly for ... credit, or ... indirectly by use of an existing credit plan for an amount exceeding a previously established credit limit." The court found that a "guarantor does not request credit and therefore cannot qualify as an applicant under the unambiguous text of the ECOA." This decision applies in the states of Arkansas, Iowa, Minnesota, Missouri, Nebraska, North Dakota, and South Dakota.

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

**Seventh and Ninth Circuits clarify the TILA requirement that consumers seeking rescission must return money or property received.** *Iroanyah v. Bank of America*, 753 F.3d 686 (7th Cir. 2014) and *Merritt v. Countrywide Financial Corp.*, 759 F.3d 1023 (9th Cir. 2014). Under the TILA (15 U.S.C. §1635; 12 C.F.R. §1026.23), if warranted by the circumstances of a particular case, a court may require that a consumer exercising the right of rescission to first tender any money or property received from the creditor as a condition for granting rescission. Such a requirement does not present an issue when rescission is exercised during the regular three-day rescission period because Regulation Z prohibits creditors from disbursing the loan proceeds (other than in escrow) until after this period expires. However, the rescission period can be extended to three years if a creditor fails to provide two copies of the right to rescind or all material disclosures. When rescission is sought during the three-year period, tendering the disbursed funds or property can pose a challenge for consumers because the funds have already been disbursed. These two federal appeals court decisions address whether a court can dismiss a rescission lawsuit if the borrower fails to establish the ability to tender the money or the property received.



In *Iroanyah*, the borrowers sought rescission because the lender allegedly only provided one copy of the notice of the right to rescind and was missing information in the TILA payment schedule. After the parties filed motions for summary judgment, the court ordered the borrowers to tender the money advanced to them within 90 days as a condition of granting rescission. When the borrowers failed to do this, the district court dismissed their rescission claim. On appeal, the borrowers argued that the district court erred in conditioning rescission upon their repayment, claiming that even if they were unable to tender the unpaid loan amount, they were still entitled to rescission because of the TILA violations. But the Seventh Circuit rejected this argument, indicating that “rescission is an equitable remedy involving mutual obligations” and holding that if a borrower cannot tender the money or property, rescission may not take place: “Tender is inherently part of rescission, not an occasional effect of it ... a borrower’s inability to satisfy his tender obligations may make rescission, even if based on a TILA violation, impossible.” The court therefore affirmed the dismissal of the rescission claim.

In *Merritt*, the borrowers alleged they were entitled to rescission, nearly three years after consummation, because Countrywide provided a TILA disclosure statement in which the material disclosures were left blank. The district court granted Countrywide’s motion to dismiss at the pleading stage because the borrowers did not tender the rescindable value of their loan to Countrywide prior to filing suit or allege their ability to tender its value in their complaint. On appeal, the Ninth Circuit reversed, holding that a borrower seeking rescission does not have to state in the complaint the ability to tender the money or property. The court held that rescission requires a court to consider equitable factors, which can only be done on a fully developed evidentiary record. At the pleading stage (i.e., before discovery), some critical facts relevant to a rescission claim may not be known to the borrower. Thus, the court held that a creditor can raise the tender requirement as a defense to the rescission claim at the summary judgment stage, when the factual record will be complete and a court can evaluate equitable considerations, but a creditor cannot do so at the pleading stage, when the lawsuit is initially filed. The case was remanded for further proceedings.

**U.S. Supreme Court agrees to review statute of limitations issue for filing rescission cases.** *Jesinoski v. Countrywide Home Loans, Inc.*, 134 S.Ct. 1935 (April 28, 2014). Pursuant to the TILA (15 U.S.C. §1635(a); 12 C.F.R. §1026.23(a)), if a creditor fails to provide a consumer with two copies of the notice of the right to rescind or all material disclosures in a transaction in which a security interest is or will be retained or acquired in a consumer’s principal dwelling, the consumer’s right to rescind the credit transaction is extended from three business days to three years. The Supreme Court has agreed to resolve a split among the federal appeals courts as to whether a consumer exercises and thus preserves the right of rescission during the three-year period by notifying the creditor in writing within three years of consummation of the transaction, as the Third, Fourth, and Eleventh Circuits have held, or instead must file suit within three years of consummation of the transaction, as the First, Sixth, Eighth, Ninth, and Tenth Circuits have held. The case will be decided during the Supreme Court’s 2014–2015 term.

## FAIR CREDIT REPORTING ACT (FCRA)

**Eighth Circuit affirms dismissal of FCRA class-action lawsuit because violation was not willful.** *Hammer v. Sam’s East, Inc.*, 754 F.3d 492 (8th Cir. 2014). The Fair and Accurate Credit Transactions Act (FACTA) amended the FCRA to prohibit persons accepting credit or debit cards from printing more than the last five digits of the card number or expiration date provided on an electronically printed receipt provided at the point of sale (15 U.S.C. §1681c(g)(1)). The plaintiffs’ class-action lawsuit alleged that the defendant retailer violated this prohibition by printing membership numbers on receipts that included 10 digits of members’ credit card numbers. The district court dismissed the case. Although the court determined that the defendant violated the FCRA, it found the violation was not willful, a necessary requirement to impose statutory damages, and dismissed the case. On appeal, the Eighth Circuit affirmed, finding that the defendant’s interpretation of the relevant FCRA requirements was not objectively unreasonable, which is the legal standard for determining willful behavior under the FCRA pursuant to the Supreme Court’s FCRA decision in *Safeco Ins. Co. v. Burr*, 551 U.S. 47 (2007). The defendant interpreted the relevant FCRA requirements to prohibit printing more than five digits of a credit card number that is labeled as a *credit card* number but not apply to a *membership* number (even though it included 10 digits of a credit card number). Although the defendant’s interpretation was erroneous, the court found that it was not objectively unreasonable, especially because no authoritative guidance from a court or regulatory agency was available when the violation occurred. The court therefore affirmed the dismissal of the case.

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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).



## COMMUNITY REINVESTMENT ACT: DEVELOPING A STRATEGY FOR SUCCESS

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regulations that were issued in 1995 laid out several evaluation methods tailored to an institution's size and business model.<sup>4</sup> Since 1995, CRA examinations have not evaluated an institution's process for achieving performance, only the result of its lending, investment, and service activities. Nonetheless, institutions with a CRA strategy and monitoring plan are in a better position to meet the CRA performance expectations set out by their management and boards of directors.

### SELECTING A CRA STRATEGY

All institutions, regardless of size or business model, benefit from having a strategy for CRA performance. Whether formal or informal, a strategy focuses bank management on helping to meet the credit, service, and community development needs of an institution's assessment area(s) and on the institution's goals, not just for its more prosperous customers and areas but also for LMI customers and areas. An effective CRA strategy will consider both the institution's particular business advantages and the needs and opportunities that exist in its assessment area(s). This is important because examiners are instructed to evaluate an institution's CRA performance within the context of its business strategy, its capacity and constraints, the overall economic conditions and credit needs in its assessment area(s), the availability of community development activities appropriate to the institution, its past performance, and the performance of similarly situated lenders. These elements are commonly referred to as the performance context.

The first step in developing an effective CRA strategy is to take stock of the institution's business model and operational strengths:

- Does the institution focus on a particular customer base?
- Is the institution a consumer lender, a business

lender, or a full-service bank?

- What products and services does the institution offer?
- Is business growing, stable, or shrinking?
- Where are the current branches located and what plans does the institution have for branching in the future?
- Is the institution's business model very specialized? For example, does it offer only one type of credit product or several?

The answers to these questions will vary from institution to institution and will influence the activities that a particular institution chooses to include in its CRA strategy. In fact, the answers could even influence which CRA examination method an institution chooses. For example, if the institution offers only a narrow product line, such as credit cards, it may decide to request a limited purpose bank designation, and to be examined under the community development test for wholesale or limited purpose banks. Or if the bank has an unusual business model, it may choose to develop, and to be examined under, an approved strategic plan.

After considering an institution's characteristics, the next step is to understand the needs of its assessment area(s) and the opportunities available to help meet those needs. Most bankers have access to a great deal of information about the demographics, economic conditions, and needs of their assessment area(s) through the normal course of business. Additional information may be available from government agencies, local businesses and community groups, nonprofit service providers, community development organizations, and universities. For example, HUD maintains a list of approved Consolidated Plans online.<sup>5</sup> These plans are developed by state and local governments to assess affordable housing and community development needs. Moreover, they include community de-

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<sup>4</sup> The CRA regulation includes criteria for small banks, intermediate small banks, large banks, wholesale and limited-purpose banks, and banks that elect to be evaluated under a strategic plan. See 12 C.F.R. §§228.21–228.27.

<sup>5</sup> See [http://portal.hud.gov/hudportal/HUD?src=/program\\_offices/comm\\_planning/about/conplan/local](http://portal.hud.gov/hudportal/HUD?src=/program_offices/comm_planning/about/conplan/local).



velopment priorities for the areas covered by the plan that are helpful for coordinating various sources of funding and expertise.

In addition to these readily available sources of community-level data, it is useful to ask the bank's employees and board members for input. The relationships that bankers build through community outreach and involvement are critical to identifying and understanding community needs and opportunities. An institution's branch managers; commercial, consumer, and small-business lending officers; and other retail banking management can provide their understanding of community credit, service, and community development needs based on information learned through both their interactions with customers and their personal experiences.

Building relationships with community groups, government officials, community leaders, and financial intermediaries (such as community development corporations, small-business investment corporations, and community development financial institutions) for their perspective on community needs is also extremely helpful. A community with a sophisticated network of community organizations, financial intermediaries, and government officials will provide a rich base from which to understand community needs. For an institution that operates in a small community with few community organizations, relationships with local business leaders and government officials, such as the local economic development authority or the farm service agency, will likely be helpful sources of information and partnership possibilities.

The community development departments in each of the Federal Reserve Banks also serve as valuable sources of information regarding community needs and potential partners. The Interagency CRA community contact procedures include useful information, too. These procedures can be a resource for considering the types of organizations that may be helpful to the bank because they describe the various types of organizations that are active in communities and the information each type may be able to provide.

Reviewing the procedures offers insight into the factors examiners consider as they work to understand a bank's performance context.<sup>6</sup>

## SETTING GOALS

Once an institution is armed with the knowledge of its business strategy, its capacity and constraints, and the needs and opportunities in the community, it is much easier to set appropriate CRA goals. Setting such goals is not required by the act or CRA regulations unless an institution has chosen to be evaluated under the strategic plan option. Examiners do not measure performance against internal goals. They evaluate performance in context, including the performance of other similarly situated institutions. Nonetheless, financial institutions find that setting goals is an effective way of focusing on desired outcomes. The goals may cover all retail and community development activities or focus on those most important to the institution's effort to meet the credit needs of LMI areas and individuals. They can be stated in terms of numbers or percentages of loans, investments, or services provided or in terms of the numbers of people that benefited from the activity. The key to developing effective CRA goals is to make them measurable, relevant, and appropriate to your institution. Aligning the CRA goals with the bank's lines of business and relative market strengths and community credit needs enables an institution's board of directors and management to facilitate and encourage efforts to achieve them.

Before setting any goal, an institution should discuss the rating it wants to achieve with senior management and the board of directors or with the board's CRA committee. Assuming an institution would like to achieve at least a satisfactory rating, it can develop goals by reviewing past performance (as recorded in previous performance evaluations), performance since the last examination, and information in the public file, including complaints about CRA performance. Because examiners evaluate performance relative to other similarly situated institutions, it is also helpful to know what other institutions have done by reviewing their public CRA performance evaluations in the institution's assessment area(s). These evaluations

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<sup>6</sup> See the supplementary information included in Section 6 of the Federal Reserve Board's *Consumer Compliance Handbook*, available at [www.federalreserve.gov/boarddocs/supmanual/cch/cch.pdf](http://www.federalreserve.gov/boarddocs/supmanual/cch/cch.pdf).

provide insight into the credit, service, and community development needs and opportunities captured in those reports and will give the institution a sense of how examiners viewed its performance. This additional information is helpful to understanding the institution's comparative advantages and may even point to missed opportunities.

While considering past performance can provide valuable information, it is important to remember that goals are set for actions that will be undertaken in the future. Once you understand what your institution and its competitors have done to address the needs of LMI areas and individuals in the past, be sure to review changes in your community's demographics, economic conditions, needs, and opportunities. Of course, any changes to the institution's capacity and constraints should be evaluated, too.

All of this information should be analyzed to determine the role that the institution can play in helping to meet its community's needs, and your goals should reflect this analysis. Discussions with community organizations and local government agencies can provide a good check on whether the goals are aligned with the needs of the community. Identifying gaps through analysis and outreach may lead you to set goals for activities that are new to the institution or may signal that the institution's involvement in ongoing activities should increase. In some instances, an institution may have to adjust the manner in which community needs are addressed based on changes in economic conditions or constraints that the institution is facing. Refining goals to address current business conditions should be part of the process.

### THE BENEFITS OF CRA MONITORING

Monitoring CRA activity can help identify weaknesses, allow the institution time to make adjustments where needed, help provide accurate reporting to the institution's management and board of directors, and make it possible to respond to questions from examiners and community organizations. Examination periods can be as short as one year and as long as five years; therefore, without monitoring, it can be difficult to know if your institution is staying on course.

Only by monitoring performance can you see when your performance is lagging, take the time necessary to figure out the cause, and address the issue before your next examination.

Perhaps the best way to appreciate the benefits of monitoring performance between examinations is to consider the consequences of not monitoring. Institutions that do not monitor performance may miss opportunities and risk a negative CRA rating. The public nature of CRA ratings can expose the institution to significant reputation risk and endanger plans to acquire or merge with other financial institutions since CRA ratings are considered in the application process.<sup>7</sup>

### BEST PRACTICES FOR CRA MONITORING

Good CRA monitoring is a continuous process and requires the participation of the entire bank, including the board of directors, senior management, and staff. A solid understanding of the CRA helps everyone at the institution identify CRA opportunities and remember to report activities that should be considered during a CRA examination. This means that CRA training is essential for many bank employees, particularly investment officers; commercial, consumer, and small-business lending officers; and retail banking management and staff. Having a broad training program for bank employees reduces the risk of not having qualified lending, investment, and service activities identified, reported, and considered during a CRA examination.

Once directors, management, and staff are engaged, it is important to have an accessible and easy-to-use system for reporting CRA activity. Larger financial institutions often facilitate the collection of data online using proprietary intranet systems so that data can be collected about events or activities as they occur. Real-time or periodic data collection is more effective, and likely more accurate, than last-minute preparation. Gathering data at the time of loan approval is an efficient method used by many financial institutions to collect information related to CRA performance. By collecting data electronically on an ongoing basis, bankers can review performance periodically and even share it with examiners.

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<sup>7</sup> For more information, see Charles Fleet, "CRA and Consumer Protection Issues in Banking Applications" (First Quarter 2010 *Outlook*).

Some institutions conduct self-assessments to help them gauge CRA performance. Effective self-assessments generally include a review of lending levels within census tracts of various income levels and a review of the dispersion of loans throughout the institution's assessment area(s), to identify any areas with unusually low penetration. Most institutions use mapping software for this analysis. The CRA does not require, nor do examiners expect to see, lending in every geography or census tract. However, by monitoring your performance, you may identify conspicuous gaps in lending or areas with abnormally low lending penetration that may not be readily apparent. Most institutions would want to have an opportunity to address the shortcomings in their CRA performance or, at a minimum, to be able to explain the reasons behind the gaps in performance rather than have them raised for the first time in the context of an examination.

Similarly, reviewing the distribution of loans by borrower income and business revenue is a good way to determine whether the institution is lending to borrowers of all income levels, including LMI borrowers, and to small businesses and farms. Whenever a lending analysis reveals performance that does not meet the goals the institution set for itself, it is important to refer to the performance context factors and consider whether there were significant changes in the institution's capacity and constraints or the needs and opportunities within its assessment area(s). This analysis should also consider the performance of other local institutions to determine whether opportunities were missed or whether the goals set for the institution are unreasonable under the circumstances. Other good sources for putting performance into context are CRA-related complaints and public comments about the institution's CRA performance.

It is often helpful to refer to the Interagency CRA Examination Procedures<sup>8</sup> when monitoring progress toward CRA goals. The procedures can guide an institution to the appropriate proxies to use for various analyses. For example, when assessing the geographic distribution of small-business loans, an appropriate proxy to compare lending levels would be the percentage of small businesses within a given geography.

SIMILARLY, REVIEWING THE DISTRIBUTION OF LOANS BY BORROWER INCOME AND BUSINESS REVENUE IS A GOOD WAY TO DETERMINE WHETHER THE INSTITUTION IS LENDING TO BORROWERS OF ALL INCOME LEVELS, INCLUDING LMI BORROWERS, AND TO SMALL BUSINESSES AND FARMS.

For home-purchase, home-refinance, and home-improvement loans, the percentage of one- to four-family owner-occupied units within a given geography can be used, together with appropriate performance context information, to help assess performance. If an institution has multiple assessment areas or has assessment areas in multiple states, it will also want to use the examination procedures as a guide to evaluating its performance at the assessment area, state, and institution level to identify potential gaps.

Finally, another important part of CRA performance is ensuring that the bank complies with consumer protection laws and regulations. Fair lending violations and certain other illegal credit practices will have a negative effect on the institution's performance and could result in a rating downgrade. In addition to violations of the fair lending laws (both the Equal Credit Opportunity Act and the Fair Housing Act), other il-

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<sup>8</sup> See Federal Financial Institutions Examination Council (FFIEC) Examination Procedures (April 2014 and July 2007), available at [www.ffiec.gov/cra/examinations.htm](http://www.ffiec.gov/cra/examinations.htm).

legal credit practices can negatively impact a rating including (but not limited to) violations of the Home Ownership and Equity Protection Act, Section 5 of the Federal Trade Commission Act, Section 8 of the Real Estate Settlement Procedures Act, and the Truth in Lending Act provisions regarding a consumer's right of rescission.<sup>9</sup>

### TESTING YOUR ANALYSIS

Once you have conducted an analysis and compared the results with the goals the institution sets for itself, you should identify any significant variances. When the institution fails to meet a goal, you will first want to check for data accuracy. If it appears that your data are accurately reported, you should identify the issues, or change in performance context, that caused you to miss the goal. If a change in performance context is temporary, the bank's goals may still be reasonable. If the change is expected to have a longer-term impact on loan demand, the bank may want to adjust its goals to fit the economic realities of the assessment area or the institution's ability to meet assessment area needs.

Another possible cause for weak lending performance could be changes in the competitive environment. An analysis to identify new entrants to the lending market in your assessment area may be helpful. It is also possible that a bank's product offerings are not responsive to the needs of the borrowers in the assessment area. Depending on the needs of the community, it may be a matter of adjusting current prod-

uct offerings, developing new products, or partnering with community development organizations, including community development financial institutions, to help reach the customer base the bank wants to serve.

If a bank's goals exceeded expectations, it may be because the bank grew and the CRA goals were not adjusted to reflect that growth. It could also be that the local economy is growing. Again, it is important to identify the reason for the variances, determine if the reason for the variances will have a temporary or longer-term impact, and adjust the bank's internal goals accordingly.

### CONCLUSION

Developing a CRA strategy, setting goals, and monitoring results can make CRA performance more predictable and more meaningful. An effective CRA monitoring program can help ensure the CRA is not just the responsibility of the bank's CRA officer but of every employee at the institution. Regular reporting to the bank's management and board of directors engages them in the process and reinforces the bank's commitment to the credit and community development needs of its community. Moreover, regular monitoring helps remove the stress that surrounds CRA examinations by making it easier to answer questions regarding the bank's performance and the factors that affected its performance during the examination period.

Specific issues and questions should be raised with your primary regulator.

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<sup>9</sup> See 12 C.F.R. §228.28 (c).

## ACKNOWLEDGMENT

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Cathy Gates, senior project manager at the Federal Reserve Board, wrote the article titled "Risk-Focused Supervision Webinar Questions and Answers" in the Second Quarter 2014 *Outlook*. We inadvertently omitted her name and title in the print copy mailed to readers.



## CONSUMER COMPLIANCE MANAGEMENT PROGRAM — COMMON CONCERNS AND BEST PRACTICES WEBINAR QUESTIONS AND ANSWERS

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The use of service providers does not relieve a financial institution's board of directors and senior management of their responsibility to ensure that outsourced activities are conducted in a safe-and-sound manner and in compliance with applicable laws and regulations. Policies governing the use of service providers should be established and approved by the board of directors, or an executive committee of the board. These policies should establish a service provider risk management program that addresses risk assessments and due diligence, standards for contract provisions and considerations, ongoing monitoring of service providers, and business continuity and contingency planning.<sup>12</sup>

Institutions should manage third-party vendor relationships as they would any other business line, division, or function of the bank. If not managed effectively, the use of third-party vendors may expose an institution to significant compliance risks. Therefore, institutions must take adequate precautions to ensure that the vendor complies with all appropriate laws and regulations, considers the institution's specific business needs, and aligns its practices with those needs.

Finally, senior management has a duty to establish acceptable performance metrics, effectively monitor contractual requirements, and keep the board of directors properly informed about the performance of the vendor management program. Effective board oversight is critical to ensuring a successful vendor management program. Therefore, the board should routinely review the policy, along with the risk assessment(s), internal testing and monitoring reports, and formal audit reports.

For additional information, refer to [Guidance](#) and the recent [Outlook Live](#) webinar and [Outlook](#) articles on Vendor Risk Management.<sup>13</sup>

### Are there examples of a change management process that you can share with us?

Given the changing regulatory landscape with additional responsibilities of banks under new or revised regulations and pressures to follow competitors as new products are introduced in the marketplace, establishing a change management process can be an effective tool not only to manage changes but also to track any steps the institution has taken to mitigate potential harm and risks to consumers and the institution. The methods of developing and implementing a change management process may vary based on the institution's size, complexity, and resources available.

Change management should be a structured and disciplined process that can be repeated since change can always be expected. The RFS Program describes that an effective change management process:

- requires management and staff from all affected functions — potentially including compliance, accounting, risk, internal audit, and line management — to review and recommend a response or change proposal for senior management or board approval that clearly articulates expected results. The entire life cycle of a product or service affected by the change must be considered, whether it involves the introduction of a new product or service or a change affecting existing bank operations.
- incorporates appropriate approval processes associated with implementation.

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<sup>12</sup> See CA Letter 13-21, "Guidance on Managing Outsourcing Risk."

<sup>13</sup> Cathryn Judd and Mark Jennings, "Vendor Risk Management — Compliance Considerations," (Fourth Quarter 2012 *Outlook*); Anthony Ricks and Timothy Stacy, "Vendor Risk Management," (First Quarter 2011 *Outlook*), and "Vendor Risk Management—Compliance Considerations," *Outlook Live* webinar, May 2, 2012.

- requires that operating policies and procedures are updated to provide clear guidance to staff on how to comply with all legal or regulatory requirements.
- requires that staff be properly trained regarding the change.
- incorporates monitoring of the deployment of the new or revised process, product, or service.
- requires a review after implementing a change to determine whether the actions taken achieved the expected results.<sup>14</sup>

An effective regulatory change management process will identify new or revised regulations, consider their complexity and impact (i.e., potential harm and risk) to consumers and the institution, and assign responsibility as appropriate for implementing compliance with new rules. For example, to implement recent changes to the federal flood insurance law (i.e., the Biggert-Waters Flood Insurance Reform Act and the Homeowner Flood Insurance Affordability Act), the institution must assess whether it has the resources to implement the change, as well as the effect of the changes on its systems and processes, and the need to provide training for staff. If vendors are involved, the institution must ensure that they are aware of the changes and that they are properly implementing them.

Some elements of a regulatory change management process can include:

- A standing agenda item for regulatory change on a consumer compliance committee meeting that incorporates members enterprise-wide, such as risk, operations, lending, vendor management, training, internal audit, and legal
- Dedicated staff to research, develop, and publish a regulatory change management newsletter for distribution to management and staff with daily consumer compliance responsibilities for information and training purposes

- A robust training system that includes industry training, conferences, webinars, and seminars whereby participating individuals return to their institutions to share knowledge gained, updates, and tips with management and staff with consumer compliance responsibilities
- A subscription to the regulatory monitoring services to learn about current and future regulatory activities

Regulatory change has become the new norm in the aftermath of the financial crisis and the passage of the Dodd-Frank Act. Regardless of the size of the institution, an effective process must be in place to manage change. A successful program will help to ensure that institutions implement regulatory changes in a timely manner and that institutions conduct appropriate due diligence and analyses before offering new products and services.

**What are some insights that you might be able to offer financial institutions, particularly community banks, considering the use of social media?**

Compliance risks for social media were discussed extensively in the Federal Financial Institutions Examination Council's recent guidance, "Social Media: Consumer Compliance Risk Management Guidance."<sup>15</sup> For additional information, refer to the recent article by Kurtis Haygood, "Consumer Compliance Risk Management for Social Media," *Outlook* (Second Quarter 2014).

## CONCLUSION

A strong consumer compliance management program helps to ensure that a bank is complying effectively with federal consumer protection laws and regulations. Specific issues and questions should be raised with your primary regulator.

<sup>14</sup> RFS Program at 23

<sup>15</sup> CA Letter 13-22, "Social Media: Consumer Compliance Risk Management Guidance," December 11, 2013

## REGULATORY CALENDAR\*

Effective Date	Implementing Regulation	Regulatory Change	Outlook Live Webinar
†		Proposal to define larger nonbank participants in automobile financing market	
†	Reg. BB	Proposal to revise Interagency Community Reinvestment Act Q&As	
†	Reg. C	Proposal to add new Home Mortgage Disclosure Act data fields to Reg. C	
†	Reg. P	Consumer Financial Protection Bureau (CFPB) proposes to streamline privacy notices	
†	Reg. Z	CFPB Proposal for Cure Procedure for points/fees error	
†	Various	Proposal to establish minimum requirements for appraisal management companies	
†	Reg. E	Proposal to extend until July 21, 2020, temporary provision allowing use of estimates for foreign remittance transfer pricing disclosures	
†	Reg. H	Proposal to implement Biggert-Waters Flood Insurance Reform Act	
8/1/15	Regs. X and Z	Final rule integrating Real Estate Settlement and Procedures Act (RESPA) and Truth in Lending (TILA) mortgage disclosures	6/17/14 8/26/14 10/1/14
12/1/14	Reg. E	Final rule defining larger nonbank participants in international money transfer market	
1/18/14	Reg. B	Final rule on Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) appraisal requirements under the Equal Credit Opportunity Act	
1/18/14**	Reg. Z	Final rule exempting subset of higher-priced mortgage loans (HPMLs) from appraisal requirements	
1/18/14	Reg. Z	Final rule on Dodd-Frank Act appraisal requirements for HPMLs	
1/10/14 (interim final rule)	Regs. X and Z	Amendment to RESPA and TILA mortgage rules	
1/10/14	Regs. X and Z	Final rule on Dodd-Frank Act requirements for high-cost mortgages and homeownership counseling	
1/10/14	Reg. Z	Final rule delaying effective date of Dodd-Frank Act prohibition on single-premium credit insurance	
1/10/14***	Reg. Z	Final rule on Dodd-Frank Act ability-to-repay/qualified mortgage rule CFPB later amended the rule to clarify inclusion of loan originator compensation in points and fees test. CFPB also amended rule in June 2013 concerning ATR and loan servicing rules.	12/4/13
11/10/13	Reg. BB	Revised Interagency Questions and Answers Regarding Community Reinvestment	7/17/14

† Rulemaking proposals generally do not have an effective date.

\* Links to the regulatory changes are available in the online version of *Outlook* at [tinyurl.com/calendar-cco](http://tinyurl.com/calendar-cco).

\*\* For manufactured homes, the effective date for the HPML appraisal requirement is July 18, 2015.

\*\*\* The amendment for mandatory arbitration was effective on June 1, 2013; amendments for SAFE Act and single-premium credit insurance took effect January 10, 2014.

**ADDRESS SERVICE REQUESTED**

## CALENDAR OF EVENTS 2014

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|---------------|---|
| October 15    | <b>30th Annual Minnesota Policy Conference</b><br>University of Minnesota<br>St. Paul, MN                                 |
| October 16–17 | <b>FDIC 4th Annual Consumer Research Symposium</b><br>L. William Seidman Center<br>Arlington, VA                          |
| October 23–24 | <b>2014 Rural Housing Summit</b><br>Asilomar Conference Grounds<br>Pacific Grove, CA                                      |
| October 29    | <b>Interagency CRA Roundtable: Wyoming</b><br>Federal Reserve Bank of Kansas City<br>Casper, WY                           |
| November 6–7  | <b>17th Annual International Banking Conference (Regulatory Reform)</b><br>Federal Reserve Bank of Chicago<br>Chicago, IL |
| November 7    | <b>Tenth Annual Community Bankers Symposium</b><br>Federal Reserve Bank of Chicago<br>Chicago, IL                         |
| November 7    | <b>FTC 100th Anniversary Symposium</b><br>FTC Conference Center<br>Washington, D.C.                                       |