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CC | CRA Compliance Corner

FEDERAL RESERVE BANK OF PHILADELPHIA

Prepared for institutions supervised by the Consumer Compliance & CRA Unit

Establishing and Maintaining an Effective Compliance Program (Part II)

The Federal Reserve Bank of Kansas City recently prepared a publication entitled *A Banker's Guide to Establishing and Maintaining an Effective Compliance Management Program* (the Guide). With their permission, we are presenting the Guide in two issues of *Compliance Corner*. Part I of the Guide appeared in the Third Quarter 2002 issue of *Compliance Corner*. Part II appears here.

The Guide is designed to outline some considerations to help organizations manage an effective compliance program. It includes sections on compliance risk assessment, program structure, audit coverage, compliance aids, "red flags," frequent violations, communication, and training. Since this is a generic publication, each topic should be considered within the context of an organization's size and complexity. In addition, since both regulations and the compliance environment change, some of the information contained in the Guide may become outdated at some point in time.

The topics covered in this issue include:

- Training
- Communication
- Compliance aids
- Compliance management "red flags"
- Frequent violations

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Training

The importance of having a staff that is knowledgeable of regulatory requirements cannot be overstated. Regardless of an institution's philosophy and policies, ultimately it is line staff who process transactions and interact with customers. If employees are not adequately trained in compliance matters, errors are certain to occur. Likewise, if bank management is not aware of compliance issues, it is unlikely to devote adequate time and other resources to compliance. Every effective compliance program includes training procedures or guidelines to address changes in regulations, employee turnover, and the need for refresher training. You may wish to consider the following items concerning training as you review your compliance program.

Training Methods – A wide variety of compliance training methods may be used. Training conducted by the compliance officer, a department "expert," or a holding company trainer may be beneficial. Compliance consulting and banker training companies offer diverse compliance training tools, including formal outside classes, videos, and quizzes designed to stimulate discussion. Seminars and conferences sponsored by the Federal Reserve Bank and other organizations are another tool to keep the institution's personnel knowledgeable about compliance matters.

Job-specific Training – Employees new to a job should be given the training necessary to ensure that they are aware of the specific regulatory requirements of the transactions they will be processing. Training should be given as part of the orientation process and before they begin their new responsibilities. This training need applies both to new employees and to employees transferring from other work assignments.

Institution-wide Training – Certain topics are worthy of regular training for all employees who have customer contact. As an example, all employees with customer contact should have fair lending training to ensure that "level of service" discrimination, inappropriate pre-screening, or other issues do not arise.

Refresher Training – Ongoing training should be considered to ensure that employees maintain adequate compliance knowledge and are aware of changes in the regulatory environment. At many institutions, this type of training is incorporated into departmental staff meetings.

Follow-up of Examination/Audit/Review Findings – When compliance errors are noted, the compliance officer should consider the level of additional training needed. One-on-one training or group training sessions should be conducted, as warranted.

Dealers – To ensure compliance with the anti-discrimination and disclosure laws, the institution may consider providing training to dealers.

Flexibility – A strong compliance program addresses all of an institution's forecasted training needs, yet incorporates flexibility to change when the need arises. For example, a training plan may need to be revised (i) to address issues identified in an audit or an examination, (ii) due to unexpected turnover, (iii) when substantive changes occur in the regulatory requirements, or (iv) when new products or services are offered.

Records – Maintaining a written record noting the dates and attendees of training sessions is one way to ensure that adequate training is provided for the appropriate personnel.

Branch Consistency – Training efforts should be structured so that employees receive the same guidance regardless of their location. Inconsistencies, particularly in the lending area, may result in serious compliance violations. Written training guidance, especially flow charts and quick reference sheets, may be helpful in ensuring consistent training.

Communication

Effective communication is a critical part of almost all business success. Compliance is no exception. Appropriate information directed to the right people in an organization is one characteristic of a sound compliance program. Suggestions for effective communication are discussed below.

Senior Management and the Directorate – Senior management and the directorate should be aware of the institution's ongoing compliance activities (e.g., training and audits). Such communication may be obtained from periodic written reports or presentations to the board or to a board committee from the compliance officer.

Management and the directorate cannot correct compliance problems if they are unaware of them. Senior management must be regularly informed of the bank's compliance position, so that attention can be focused on correcting problem areas. When compliance performance is not adequate, senior management and the directorate should consider requiring more in-depth, frequent, and fully documented reports on compliance efforts.

Staff – Senior management should ensure that its compliance expectations are communicated to and understood by all employees. Newsletters, memorandums, required policy reviews, or the performance evaluation process could be effective communication vehicles.

Regulatory Changes – A central contact should be established to ensure that all materials related to regulatory changes are properly disseminated.

Communication of regulatory changes thereafter could be disseminated via staff meetings, training sessions, newsletters, or memorandums.

Form of Communication – Communication about ongoing compliance matters is handled differently across institutions. The form of the communication will depend on the size of the bank and the structure of its compliance program. Some effective communication methods include staff meetings, training sessions, newsletters, memorandums, and break room postings.

Compliance Aids

Consumer compliance regulations are detailed and at times difficult to apply. Below is a list of compliance aids that your organization may find helpful.

Written Procedures – Detailed compliance procedures that are easily accessible to operating personnel may help improve performance. Such procedures are especially useful when key staff members are absent or in the case of employee turnover. Written procedures that contain checklists and examples of correctly completed transactions are ideal.

File Checklists – Checklists kept with each loan file in process can help ensure compliance. Given the loan type, any required disclosures may be marked as needed. As the loan is processed, each item can be checked off as completed. At loan closing, a glance at the file checklist could ensure that all necessary documents have been provided and all procedures completed.

File checklists may also be used as an audit tool. The checklists may be audited in lieu of each piece of paper documentation. This allows for broader audit coverage when resources are limited. A small sample of files should, however, always be audited at the document level to ensure that the checklists were completed accurately.

Tickler Systems – Tickler systems may be invaluable for ensuring timely compliance with a variety of consumer compliance provisions. For example, a tickler calendar may show reporting deadlines for HMDA and CRA data. Flood insurance ticklers ensure that required flood insurance policies are renewed in a timely manner.

Advisory Visits – Visits by consumer compliance examination staff of the Federal Reserve Bank of Philadelphia to Third District institutions supervised by the Federal Reserve can be arranged on an individual basis. These visits, which are uniquely structured for each institution, consist of forms, policy, and transaction reviews and/or discussions of regulatory and supervisory issues.

Web Sites – The Consumer Compliance/CRA Examinations Unit of the Federal Reserve Bank of Philadelphia maintains a web site on the Internet. These pages include information on the department's functions and goals, consumer compliance regulations, and the consumer compliance-related services available to Third District state member banks. The site also provides links to other consumer compliance-related sites.[1]

[1] The Consumer Compliance/CRA Examinations Unit web site can be accessed through the Supervision, Regulation and Credit link on the Reserve Bank's home page at <www.phil.frb.org> or directly at <www.phil.frb.org/src/compliancecra/index.html>.

Compliance Management "Red Flags"

The following section lists situations where an institution's susceptibility to compliance problems may increase. If these "red flag" situations occur, heightened compliance attention may be warranted.

Rapid Growth/New Branches/Mergers – Compliance resources may be stretched during periods of expansion. Sometimes compliance becomes a secondary concern, thus allowing problems to take hold and spread quickly. Acquisitions of existing banks or establishment of de novo branches often results in compliance difficulties. Managing compliance for several branches presents different compliance challenges than at a single office. Computer conversion issues and new personnel associated with expansion are also compliance management "red flags."

Employee Turnover – Whenever trained staff members are replaced, the possibility of errors increases. Timely training and written procedures are critical. Additionally, a "succession plan" for all compliance-related responsibilities may help ensure that another employee is trained and available to proceed with compliance tasks, at least on a temporary basis.

Computer Conversions – Whenever there is a change in an institution's computer systems, compliance errors are likely to occur. During testing phases of the conversion and once the new system is running in production mode, it is important to check to ensure continued compliance. Disclosures and system calculations should be reviewed after computer conversions.

Small changes to computer systems, such as adjusting interest rates or minimum balance requirements, may also result in unexpected errors. Reviews of system output after such changes may reduce compliance errors.

Reprinting of Standard Forms – Standard forms should be carefully scrutinized when reprinted, especially when changes were made.

Frequent Violations

The following table shows the most common types of problems by regulation and section number identified in recent Third District compliance examinations. The citations are in alphabetical order and do not reflect any order of importance or commonality.

As always, feel free to contact Connie Wallgren, Consumer Compliance/CRA Examinations Unit Manager (connie.wallgren@phil.frb.org) at (215) 574-6217 with any questions on your institution's compliance programs. ■

Regulation B – Equal Credit Opportunity Act	
202.9(a)(2)	Content of the Notice of Adverse Action Form
Regulation BB – Community Reinvestment Act	
228.42(b)(1)	Geographic data relative to the aggregate number of originations and purchases of small-business and small-farm loans
Regulation C – Home Mortgage Disclosure Act	
203.4(a)(4)	The amount of the loan or application
203.4(a)(6)	The location of the property, geographic information
203.4(a)(7)	The race or national origin and sex of the applicant, and the gross income relied upon to make the credit decision
Regulation DD – Truth in Savings Act	
230.8(b)	Disclosure of the Annual Percentage Yield
230.8(c)(3)	Minimum balance required to obtain the Annual Percentage Yield
Regulation H – Flood Insurance	
208.25(c)(1)	Perform flood hazard determination, and require flood insurance prior to consummation
208.25(f)(1)	Use of standard flood hazard determination form
Regulation Z – Truth in Lending	
226.7(d)	Disclosure of each periodic rate used to compute a finance charge and the range of balances to which it applies
226.18(d)(1)(i)	Finance charges understated by more than $100
226.24(c)(2)(ii)	Advertising must state the terms of repayment under certain conditions
226.24(c)(2)(iii)	Disclosure and use of the term "Annual Percentage Rate," and whether or not the rate may increase after consummation

Overdraft Privilege Programs: What Financial Institutions Should Be Aware Of

by Robert Snarr, Supervising Examiner

For many years, commercial banks and other federally insured depository institutions have offered overdraft protection services to retail customers. Usually, traditional overdraft protection is offered to a depositor as an overdraft line of credit linked to a specific transaction account. The overdraft line is evidenced by a written agreement, which contains various terms and conditions, between the institution and the depositor.

Because the overdraft arrangement is previously agreed to in writing, any charges or fees that an institution routinely imposes on overdrafts under the written agreement are considered finance charges for purposes of the federal *Truth In Lending Act* as implemented by Regulation Z, *Truth in Lending*. Moreover, the institution is defined as a creditor under Regulation Z and must provide the depositor or consumer with applicable Regulation Z disclosures, including an annual percentage rate (APR) on the overdraft line.

In recent years, many community banks have implemented what have come to be known generally as overdraft privilege programs. Unlike traditional overdraft protection, overdraft privilege programs are largely offered through external vendors, are informal in nature, and are not evidenced by any prearranged written agreement executed by a depositor and an institution.

Instead, banks offer and actively promote overdraft privilege programs through written marketing brochures to all retail depositors under such brands as "Bounce Protection" or "OOPS! (Occasional Overdraft Privilege Service)." Overdraft privilege brochures usually tout the benefits of additional convenience and flexibility in managing funds, fewer charges from retailers for non-sufficient (NSF) checks, and less embarrassment from the issuance of NSF checks.

At the same time, the brochures also disclose, albeit in a somewhat less conspicuous manner, that the overdraft privilege is just that–a privilege –and that the institution approves overdrafts of NSF checks at its discretion as a noncontractual courtesy. In effect, such language enables an institution to refuse to pay an overdraft at any time for any depositor for any reason, even though an institution may have previously paid similar overdrafts for the depositor.

Generally, overdraft privilege programs are not subject to Regulation Z because institutions offering the programs are not legally obligated to pay the overdraft. In addition, the Official Staff Commentary to section 226.5(c) of Regulation Z specifies that applicable state law determines whether or not a particular arrangement is a legal obligation for purposes of the regulation. Further, section 226.4(c)(3) specifies that fees imposed for paid overdrafts are not finance charges as defined by Regulation Z unless the payment of overdrafts and the imposition of charges for paying the overdrafts was agreed to in writing by the account holder and the institution.

SRC staff has become increasingly aware of vendors aggressively soliciting community banks within the Third Federal Reserve District and elsewhere to implement overdraft privilege programs. Anecdotes abound of vendors telling banks of the potential for significantly increased fee income and a return on

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assets that may be enhanced by 25 basis points or more from overdraft privilege activity.

Consumer Protection Concerns

With the nationwide increase in the number of overdraft privilege programs offered by banks, consumer advocates and some regulators have raised various concerns regarding consumer protection issues. Among such concerns are the following:

Implicit versus Explicit "Obligation"

- It is well established that banks have traditionally paid overdrafts at their discretion. Despite such tradition and the nonbinding obligation language in marketing brochures for overdraft privilege programs, does an institution's promotion and marketing of overdraft programs lead a consumer to believe that a bank routinely will pay NSF checks? For example, SRC examiners have been informed that some institutions that promote overdraft privilege programs reflect the available overdraft privilege amount in the available balance of a transaction account on transaction receipts from automated teller machines (ATMs) and through automated telephone banking systems.

- In form, overdraft privileges are intended to address inadvertent NSF checks. However, due to the implicit promises in promotional materials, do overdraft privileges, in substance, more often than not actually address a revolving credit need?

- Could frequent and substantial use of overdraft privileges by a consumer be interpreted through applicable state law as a legal obligation, and in effect a written agreement to extend credit, thereby subjecting an overdraft privilege program to the disclosure requirements of Regulation Z?

Annual Percentage Rates

- Generally, an institution will impose a standard or normal overdraft fee, which usually ranges from $20 to $25 for each NSF check presented for payment on a consumer's account, up to a coverage limit of usually no more than $1,000. Additionally, some banks impose a per diem fee during the time that the account has a negative balance. When considered on an annualized basis, such fees effectively translate to APRs of three or possibly four digits.

- In the context of current marketing practices for overdraft privilege programs and the absence of Regulation Z disclosures, are certain customers being misled regarding the availability of considerably less expensive banking services, such as traditional overdraft protection? For instance, suppose a customer was informed that the fees for overdrafts under an overdraft privilege program resulted in an APR of 300 percent. Suppose also that that customer was aware that the same institution offered a traditional overdraft line of credit with an APR of 8.5 percent, and cash advances on a credit card with an APR of 19 percent. Would that customer still utilize the overdraft privilege program?

- As institutions implement overdraft programs, do they correspondingly implement measures to routinely inform more frequent users of overdraft privileges of less expensive alternatives that are available regarding personal financial management?

Does the proliferation of overdraft privilege programs arguably encourage irresponsible or inappropriate maintenance of transaction accounts?

Public Policy

- Notwithstanding institutional limits on how frequently a consumer may use an overdraft privilege, a consumer could look to overdraft privileges as an ongoing cash management solution. Such usage of overdraft privileges has the potential to create a debt treadmill wherein the consumer becomes obligated for aggregate fees that exceed the amount of the initial NSF check. The debt treadmill is compounded if an institution chooses to pay checks in a sequence of high amounts to low amounts.

- Historically, the dollar amount of

NSF fees and overdraft fees has been imposed by financial institutions to discourage irresponsible or inappropriate maintenance of a transaction account, among other reasons. Does the proliferation of overdraft privilege programs arguably encourage irresponsible or inappropriate maintenance of transaction accounts and portend public policy issues regarding the nation's banking system? In this regard, does the mass availability of overdraft privilege programs encourage consumers to incur simultaneous overdrafts at multiple institutions?

- Some contend that the current marketing practices by institutions to promote overdraft privilege programs have the effect of targeting and exploiting certain population segments that are generally less informed as to available alternatives or have less financial resources to make economic choices in their best interests.

Regulatory Perspectives

To date, the Board of Governors of the Federal Reserve System has not issued any substantive pronouncement regarding the implementation of overdraft privilege programs by state member banks. However, on November 26, 2002, the Board issued, as part of a proposal to revise the Official Staff Commentary to Regulation Z, a request for public comment on transaction account services offered by financial institutions that are commonly referred to as "bounce protection."[1] In particular, the Board stated that, "Fees imposed in connection with 'bounce protection' services may or may not meet the definition of a finance charge... Information and comment are solicited on how 'bounce protection' services are designed and operated and how these services should be treated for purposes of the *Truth in Lending Act* in order to assist the Board in determining whether and how to provide guidance on potential coverage under Regulation Z or to address possible concerns under fair lending or other laws." The deadline for public comment was January 27, 2003. At the release of this publication, the Board was still in the process of assessing all comments and making a determination as to whether or not it would issue additional guidance on "bounce protection" or overdraft privilege plans regarding Regulation Z or other consumer protection laws.

On August 3, 2001, the Office of the Comptroller of the Currency (OCC) publicly issued Interpretive Letter #914 to address several regulatory concerns raised by the OCC about the implementation of overdraft privilege programs.[2] The interpretive letter was issued in response to a request for an evaluation of a particular overdraft privilege program and the implementation of the program by banks. Overall, the letter expresses a critical view of the proposed overdraft privilege program and discusses safety and soundness issues and compliance issues regarding various consumer protection regulations. The letter also articulates concerns over marketing materials used to promote the overdraft program, particularly noting ambiguities in language that possibly overstate the benefits of the program to consumers. Additionally, the letter discusses public policy issues, stating, in part, that, "The Program is designed to increase fee income by encouraging customers to write NSF checks. Although the Program may be valuable to customers who might inadvertently or infrequently write an NSF check, banks participating in the Program will, in essence, attempt to entice their customers to write NSF checks more frequently and on purpose in order to generate fee income. *This use of the Program could promote poor fiscal responsibility on the part of some consumers*. In this regard, we note the complete lack of consumer safeguards built into the program."[3]

Fees imposed in connection with 'bounce protection' services may or may not meet the definition of a finance charge.

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[1] The Board of Governors' press release and the accompanying request for comment can be found on the Board of Governors' web site at <www.federalreserve.gov/boarddocs/press/bcreg/2002/20021126/default.htm>.

[2] A redacted copy of the OCC's Interpretive Letter #914 can be found on the OCC's web site at <www.occ.treas.gov/interp/sep01/intsep01.htm>.

[3] OCC Interpretive Letter #914 included the emphasis as it appears in this paragraph.

In addition, the Indiana Department of Financial Institutions (DFI) publicly released a letter dated February 21, 2002 documenting its response to a law firm that presented a particular overdraft privilege program for the DFI's review.[4] In that letter, which the DFI informs should be considered advisory in nature, the DFI states, in part, "The effect of the Program is to increase the fee income of the bank by encouraging customers to intentionally write non-sufficient funds ("NSF") checks." The DFI further opines, " A program such as that being proposed arguably entices a customer to unwittingly commit a criminal offense...it is a Class A misdemeanor when a person knowingly or intentionally issues or delivers a check knowing there are insufficient funds in the bank. Since the program gives no assurance of coverage in the event of an overdraft, but leaves that to the discretion of the bank, a customer will never be certain that a bad check will be covered. This could make both the customer and the bank accountable under the criminal statute." Finally, the letter states, "However, please be assured that if the Program is found to not be an extension of credit, the Department will take whatever steps necessary to make a bank cease and desist from participating in a transaction that could be considered a criminal offense."

If the logic of the DFI's opinion is sound, conceivably other states could adopt and pursue similar regulatory positions.

Final Thoughts

It seems that commercial banks are increasingly implementing overdraft privilege programs as a means to enhance fee income. Some regulators, particularly the OCC, have raised concerns over the programs. At present, the Federal Reserve System is considering whether or not to provide additional guidance with respect to overdraft privilege programs under Regulation Z or other consumer protection regulations.

Currently, several programs appear to be available through various vendors. Thus, institutions that have either implemented or are considering the implementation of overdraft programs should be sensitive to the consumer protection concerns noted in this article. Institutions should be especially sensitive to the operational details of a given program and the nuances of the actual implementation of a program by an institution.

Additionally, the Federal Reserve Bank of Philadelphia would encourage any state member bank or bank holding company in the Third Federal Reserve District that is considering overdraft programs to consult with legal counsel for appropriate guidance.

Please contact Robert Snarr (robert.snarr@phil.frb.org) at (215) 574-3460 or John Fields (john.fields@phil.frb.org) at (215) 574-6044 with any questions that you might have regarding overdraft privilege programs and related consumer protection concerns. In addition, although the deadline for comment to the Board of Governors of the Federal Reserve System regarding overdraft privilege plans has passed, please feel free to contact Mr. Snarr or Mr. Fields with any applicable comments.

[4] The letter from J. Philip Goddard, Deputy Director and General Counsel of the Indiana Department of Financial Institutions can be found on the DFI's web site at <www.in.gov/dfi/whatsnew/overdraft/MorrisseyNSFPhil_Goddard.htm>.

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