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Compliance Corner

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Website Compliance for Banks, Part I

by Kenneth J. Benton, Consumer Regulations Specialist

While most banks are diligent in complying with banking laws and regulations for their brick-and-mortar facilities, some may devote less attention to compliance issues related to loan and deposit advertisements on their websites. This article is the first of a two-part series reviewing the requirements for consumer regulation website compliance. Part I discusses compliance for loan products, and Part II will discuss compliance for deposit products and will appear in the Third Quarter 2006 issue of *Compliance Corner*.

This article focuses on Regulation Z and the Board's Order on Fair Housing Advertising. Regulation Z contains two provisions that regulate advertisements covering both closed- and open-end credit, as well as credit card applications and solicitations. The Board's Order on Fair Housing Advertising sets forth requirements for banks that advertise loans secured by dwellings. It should be noted that while Regulation M, the implementing regulation for the consumer leasing provisions of the Truth in Lending Act, contains requirements for the advertisement of consumer leases, it will not be covered in this article.

Regulation Z defines an advertisement as "a commercial message in *any* medium that promotes, *directly or indirectly*, a credit transaction."[1] Because of the broad definition of advertisement, any bank website that promotes a credit product, such as a car or mortgage loan, must comply with the advertising provisions of Regulation Z.

Regulation Z violations are some of the more common compliance weaknesses cited by examiners. This reflects both

[1] 12 C.F.R §226.2(a)(2).

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FEDERAL RESERVE BANK OF PHILADELPHIA

Getting in Sync: Contractual Obligations, Disclosures, and Operating Practices

by David A. Center, Manager

Banks must have adequate operating procedures and internal controls in place to ensure that the terms and conditions expressed in their contracts and disclosures are consistent with their operating system specifications and parameters. Examiners often uncover discrepancies between what is stated in a bank's legal agreements or required disclosures and the institution's actual operating practices. While all discrepancies are not necessarily strict violations of consumer protection regulations, they may expose the institution to potential civil liability and increased compliance, legal, and reputational risk.

Banks are contractually obligated to follow the terms and conditions of any legal agreement formed with their customers. So it is essential that the contractual language accurately describe what the bank intends and that it accurately reflect the bank's operating practices. Discrepancies have been found in all facets of customer disclosures; however, they appear to occur more frequently in connection with consumer open-end credit.

Let's look at Regulation Z, the implementing regulation for the Truth in Lending Act, to illustrate this point. One of the primary tenets of Regulation Z is "disclosures shall reflect the terms of the legal obligation between the parties."[1] Generally, this is not an issue because it is common for the legal obligation and disclosures to be contained within the same document. However, problems arise when the legal obligations and disclosures say one thing, and the bank's actual operating practices are not reflective of these documents.

The following two examples illustrate some of the common Regulation Z violations related to home equity plans that examiners have uncovered.

Example 1

Regulation Z requires institutions to accurately disclose information regarding the payment terms of a home equity plan. Specifically, the disclosures should accurately describe the length of any draw and repayment periods and the manner in which the minimum periodic payment will be determined.

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1 Section 226.5(c) for open-end credit and section 226.17(c)(1) for closed-end credit.

Examiners have found numerous instances where the disclosed payment terms were inconsistent with the bank's actual operating practices. It can be argued that, unless the bank's loan accounting system precisely replicates what is stated in the legal documents or disclosures, not only has a violation of Regulation Z occurred, but customers also may have been harmed, because what they had contractually agreed to was not being adhered to by the bank. This is especially true with regard to the minimum payment, which directly affects the amount the borrower is required to pay and the length of repayment if a customer only makes the minimum payment.

Consider the following: a contract states that the minimum payment will equal 2 percent of the outstanding principal balance at the end of the billing cycle. Assuming that $10,000 was outstanding at the end of the billing cycle, the minimum payment would be $200.00. Let's further assume that the billing cycle was 30 days and the interest rate during the entire billing cycle was 10 percent. So according to the contract, $82.20 ($10,000 x 0.10/365 x 30) would be applied to interest, and the remaining $117.80 would be applied to principal.

However, this is not how the bank intended to calculate the minimum payment, nor is it how it is actually calculated on the bank's loan accounting system. The bank intended to and actually calculates the minimum payment as 2 percent of the outstanding principal balance at the end of the billing cycle, plus all accrued finance charges. Therefore, the minimum payment is not $200.00, but rather $282.20, with $200.00 being applied to principal and $82.20 being applied to interest.

This is just one example of how unintentionally misstating the payment terms could directly affect the amount the borrower is required to pay and the length of repayment if a customer was to make only the minimum payment. Not only could this disclosure error result in numerous violations of Regulation Z, it also could lead to increased compliance, legal, and reputational risk.

Regulation Z requires institutions to disclose the method used to determine the balance on which the finance charge may be computed.

Example 2

Regulation Z requires institutions to disclose the method used to determine the balance on which the finance charge may be computed on both the initial disclosure and the periodic statement.

This is also an area where examiners have found numerous inconsistencies. It should also be noted that the actual method must also be accurately described on the bank's periodic statement.

Consider the following: a bank offers a variable rate home equity line of credit program, and the rate is subject to change on a daily basis. The account agreement and the initial disclosure states that finance charges are calculated using the "average daily balance" method. The bank's periodic statement states that finance charges are calculated using the "daily balance" method. The bank's actual practice is to calculate finance charges using the "daily balance" method.

It should be noted that either balance computation method will yield the same finance charge if the interest rate does not vary during the cycle. However, if the rate varies during the statement cycle, a different finance charge could be obtained, depending on the balance computation method used. The amount of

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the complexity and breadth of the regulation and the popularity of bank products within the scope of Regulation Z, including mortgages, auto loans, home equity plans, and credit cards. Banks should therefore pay particular attention to verifying that their websites comply with Regulation Z.

Closed-End Credit Advertising Rules

If a creditor uses any "trigger" terms in a closed-end credit advertisement, it must make additional disclosures. The trigger terms are: 1) the amount or percentage of any downpayment, 2) the number of payments or period of repayment, 3) the amount of any payment, and 4) the amount of any finance charge. The use of *any* one of these terms requires the creditor to also disclose the following additional terms in the advertisement: 1) the amount or percentage of the downpayment; 2) the terms of repayment; and 3) the annual percentage rate (APR), using that term.[2] If the rate may be increased after consummation, that fact must also be disclosed. For example, if a bank advertises an auto loan on its website and mentions the monthly payment, it must also disclose the APR, the repayment terms, and the amount or percentage of the downpayment, if one is required. If the interest rate can change, the bank must also disclose that possibility.

Advertising the rate of the finance charge. If an advertisement states a rate of finance charge, it must state the rate as an "annual percentage rate," using that term or the abbreviation "APR." If the APR can increase after the loan closes, the advertisement must disclose that as well. However, the advertisement does not have to describe the new rate or its effect on the payment schedule. Also, the higher rate disclosure does not apply if it takes effect as a result of a delinquency, late payment, default, acceleration, assumption, or transfer of collateral. The advertisement cannot disclose any other rate, except a simple annual or periodic rate that is applied to an unpaid balance, which may be stated in conjunction with the APR, but which cannot be more conspicuous than the APR.

> It is important that banks compare their credit advertisements against the written customer agreements for these products to ensure that they match.

Actual available terms. Advertisements for credit, stating specific credit terms, can only state terms that are actually offered by the creditor. In other words, the product advertised on the website must match the terms and conditions of the credit product itself. Examiners have encountered instances where credit advertisements, both in printed form and on bank websites, do not match the actual terms and conditions of the bank's contractual agreement for the product. It is therefore important that banks compare their credit advertisements against the written customer agreements for these products to ensure that they match.

Open-End Credit Advertising Rules

The advertising requirements for open-end credit closely mirror those for closed-end credit. Creditors can only advertise products that are actually available or will be available, and open-end credit advertisements are also subject to a trigger. That is, if a creditor uses any terms required for disclosure—such as finance charges, other charges, security interests, and statement of billing rights—the creditor must also clearly and conspicuously disclose the following: 1) any minimum, fixed, transaction, activity,

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[2] Section 24(c) of the Official Staff Commentary clarifies that the abbreviation "APR" can be used instead of "Annual Percentage Rate." Banks should always consult the Official Staff Commentary for clarifying an issue related to Regulation Z.

or similar charge that may be imposed; 2) any applicable periodic rate (and if the plan provides for a variable periodic rate, that fact must be disclosed); and 3) any membership or participation fee that could be imposed.

Regulation Z imposes a "clear and conspicuous" standard for some of its open-end credit advertising disclosures. The Official Staff Commentary clarifies the advertiser's obligation in meeting this requirement: "Section 226.16 is subject to the general 'clear and conspicuous' standard for subpart B [see §226.5(a)(1)] but prescribes no specific rules for the format of the necessary disclosures. The credit terms need not be printed in a certain type size nor need they appear in any particular place in the advertisement."[3]

Regulation Z imposes a "clear and conspicuous" standard for some of its open-end credit advertising disclosures.

Home equity plans. Regulation Z has a number of restrictions on advertisements for home equity plans, which are outlined below:

1. If an advertisement for a home equity plan contains any of the terms required to be disclosed, which includes finance and other charges, the advertisement must also clearly and conspicuously disclose: 1) loan fees that are a percentage of the credit limit under the plan and an estimate of any other fees imposed for opening the plan (if property insurance is required by the creditor, the creditor may disclose the amount of the premium or may state that property insurance is required); 2) periodic rates used to compute the finance charge, expressed as APRs; and 3) the maximum APR that can be imposed in a variable-rate plan.
2. If an advertisement states an initial APR that is not based on the index and margin used to make later rate adjustments, it must also state the time period the rate will be in effect and a reasonably current APR that would have been in effect using the index and margin.
3. If an advertisement contains a statement about any minimum periodic payment, the advertisement must also disclose, if applicable, that a balloon payment can result.
4. An advertisement that references the tax deductibility of interest expense cannot be misleading.
5. An advertisement cannot refer to a home equity plan as "free money" or contain a similarly misleading term.

Website solicitations or applications for credit cards. Regulation Z has a specific provision that regulates credit card applications and solicitations.[4] Banks that offer credit card applications or solicitations on their websites must pay careful attention to the requirements of section 226.5a, as it clearly applies to bank websites. Subsection 226.5a(c) states: "The card issuer shall disclose the applicable items in paragraph (b) of this section on or with an application or solicitation that is mailed to consumers or provided by *electronic communication*." This point is also reinforced by the Official Staff Commentary for Regulation Z: "In all cases, a consumer must be able to access the disclosures (including the brochure) at the time the blank application or reply form is made available by electronic communication, *such as on a creditor's Internet website*."

Creditors have flexibility in satisfying this requirement.

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[3] The Bankruptcy Reform Act of 2005 directed the Board of Governors of the Federal Reserve System to amend Regulation Z to define specifically the meaning of "clear and conspicuous." The Board is currently in the process of drafting amendments to Regulation Z to accomplish this. Thus, the definition of "clear and conspicuous" will likely change at some point in the future.

[4] A solicitation, in the context of Regulation Z, means an offer to open a credit card account that does not require the completion of an application. In other words, a solicitation occurs when a bank is merely telling a consumer about the features of a card, without requiring the consumer to complete an application.

For example, if a link is not used, the application or reply form must clearly and conspicuously refer the consumer to the fact that rate, fee, and other cost information either precedes or follows the application or reply form. Alternatively, creditors may provide a link to electronic disclosures as long as consumers cannot bypass the disclosures before submitting the application or reply form.

This section of Regulation Z requires eleven specific disclosures for credit card solicitations or applications; however, only the disclosures that actually apply to the card issuer's product have to be disclosed. The eleven required disclosures are:

1. the APR
2. any annual or periodic fee that can be imposed to open or maintain the account (including inactivity fee)
3. any minimum finance charges
4. any transaction charges imposed for using the card for purchases
5. the date by which payment must be received to avoid a finance charge, or, if no grace period is available, that must be disclosed
6. the balance computation method that is used to determine the customer's balance[5]
7. a statement that charges incurred during a period are due when the customer receives the periodic statement
8. the fees imposed for a cash advance
9. the fees imposed for a late payment
10. the fees imposed for exceeding the credit limit
11. the fees imposed for transferring a balance

It is also important to note that the famous Schumer Box, named after New York Senator Charles Schumer for his involvement with amending the Truth in Lending Act to require certain credit card disclosures in a tabular format, should contain the first seven disclosures set forth above. Two model forms for the Schumer Box disclosures are included in Appendix G-10(a) and G-10(b) of Regulation Z. The creditor can also include the remaining disclosures in the Schumer Box, or, alternatively, can include them clearly and conspicuously elsewhere in the application or solicitation. One final requirement for credit card disclosures is that if a creditor makes a credit card available to a consumer through a home equity plan, then the creditor is exempt from the disclosure requirements of section 226.5a for credit cards and solicitations.

Board Order on Fair Housing Advertising and Poster Requirements

Banks engaging in *any* form of advertising of any loan for the purpose of purchasing, constructing, improving, repairing, or maintaining a dwelling or any loan secured by a dwelling must prominently indicate in such an advertisement, in a manner appropriate to the advertising format, that the bank makes loans without regard to race, color, religion, sex, national origin, handicap, or familial status (having children under the age of 18). With respect to electronic advertisements, this requirement may be satisfied by including in the advertisement a facsimile of the logotype with the equal housing lender legend contained in the Equal Housing Lender Poster in section 2 of the Board's order.

Closing Comments

The Internet has provided banks with an additional medium in which to market their products and services. However, the use of the Internet also gives rise to additional compliance issues for banks, and they must be vigilant in ensuring that their websites are in compliance with all relevant banking laws and regulations. The complete text of Regulation Z is available online on the Board of Governors' website at <www.federalreserve.gov/regulations/default.htm>. If you have any questions about this article, please contact Consumer Regulations Specialist Kenneth J. Benton (kenneth.j.benton@phil.frb.org) or Supervising Examiner John D. Fields (john.d.fields@phil.frb.org) through the Regulations Assistance Line at (215) 574-6568. □

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[5] The four approved methods for computing the balance—average daily balance, two-cycle average daily balance, adjusted balance, and previous balance—are set forth in section 226.5a(g).

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the difference is a function of the timing and magnitude of changes in both interest rates and the outstanding principal balance.

If the method used to calculate finance charges differs from the method described in the loan agreement or required disclosures, the bank may either be undercharging or overcharging its customers. Again, this disclosure error may result in violations of Regulation Z, and it could also lead to increased compliance, legal, and reputational risk.

Final Thoughts
The examples above illustrate the point that the terms and conditions of a legal agreement between a bank and its customers and all required disclosures must be consistent with the bank's actual operating practices. Unfortunately, errors and discrepancies are occurring all too frequently. Management must be vigilant in establishing strong controls to ensure compliance with consumer laws and regulations and to avoid increased legal, compliance, and reputational risk.

If you have any questions about this article, please feel free to contact Team Manager David Center (david.center@phil.frb.org) or Supervising Examiner John D. Fields (john.d.fields@phil.frb.org) through the Regulations Assistance Line at (215) 574-6568. ☐

Compliance Alert:
Regulation B and Special Benefits for Senior Citizens

Regulation B is the Federal Reserve System's implementing regulation for the Equal Credit Opportunity Act (ECOA). Both the ECOA and Regulation B prohibit discrimination in the extension of credit based on race, color, religion, national origin, sex, marital status, age, the fact that the applicant receives public assistance, or the fact that the applicant has exercised any right under the Consumer Credit Protection Act. Regulation B contains an exception that allows creditors to discriminate in favor of elderly people, who are defined as age 62 or older, in extending credit.[1]

In offering special benefits to senior citizens, some banks fail to recognize that Regulation B's age discrimination exception only applies to persons 62 or older. That is, some banks offer more favorable credit terms to persons who are over a certain age, for example, 52, without realizing Regulation B *only* allows them to offer better credit terms to customers age 62 or older. This typically happens when banks include a loan discount for senior citizens who are younger than the defined age for the discrimination exception of 62 or older.

The federal banking agencies are authorized to use the full range of their enforcement authority to address discriminatory practices. This includes placing enforcement actions that may require prospective and retrospective relief and, depending on the nature of the violation and the degree of culpability, civil money penalties. As a result, a violation of Regulation B's discrimination provisions can be very costly. Thus, banks should regularly review their loan products to ensure that they are not offering more favorable credit terms to customers who are not considered to be elderly, as defined by Regulation B and the ECOA.

If you have any questions related to the ECOA and Regulation B, please contact Supervising Examiner John D. Fields (john.d.fields@phil.frb.org) through the Regulations Assistance Line at (215) 574-6568. ☐

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[1] See 12 C.F.R. 202.2(o). Creditors can discriminate *in favor of* elderly people (i.e., treat them more favorably in offering them credit than their non-elderly customers), but creditors cannot discriminate *against* them based solely on their age.

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